

FX Daily: High volatility regime expected to stay in place

It may not feel like it today, but the FX options market expects volatility to stay high over coming months as central bankers deal with sticky inflation and are being encouraged to act fast. Insights into how aggressive central banks need to be come from the ECB's Sintra conference, where central bank governors from the US, eurozone and the UK all speak



➔ USD: Temporary calm

FX markets have entered a period of temporary calm and ranges have been quite subdued this week. Half year-end may have had some bearing on the matter and yet it would not be a surprise to see some moves developing around key fixings today - especially the WMR fix at 17CET. One might have thought these conditions would lead to lower levels of implied or expected volatility - perhaps on the notion of FX markets finding new equilibrium levels. But no, EUR/USD one-month volatility is still bid above 9%.

Keeping volatility bid remains the uncertainty as to how far and how fast central bankers need to tighten policy to keep inflation under control. Certainly [listening to the Bank of International Settlements \(BIS\) this week](#), the message to central banks was to act early and to act decisively. The short-term pain of aggressive tightening (perhaps a recession) would be far more preferable to the longer-term pain of a wage-price spiral.

On that subject, Federal Reserve Chairman Jerome Powell, European Central Bank President Christine Lagarde and Bank of England Governor Andrew Bailey all speak on a Sintra panel today at 15CET. Currently, money markets price US, eurozone and UK policy rates at 3.40%, 1.10% and 2.90%, respectively, by the end of this year. Of the three, we would think the pricing of US rates is still the most subject to upside risks. And that is why the FX option markets are allocating heavy day-weight volatilities to dates like 13 July, when the June US CPI data is released.

For today, look out for those remarks from central bankers and also the US May reading for the headline and core PCE deflator readings. High month-on-month readings are expected for headline and core (0.7% and 0.4%) and any upside surprise could see US rates and the dollar nudge higher.

DXY is consolidating above 104.00 and barring any large equity rally today on quarter or half year-end re-balancing, there seems little reason to expect much of a dollar sell-off.

➔ EUR: Will business confidence take a plunge?

EUR/USD continues to consolidate near 1.05 and must be keeping one wary eye on developments at the G7 summit where world leaders are trying to cap the price they pay for Russian energy, while avoiding an abrupt shut-off in Russian exports. ECB President Lagarde's remarks today will be in focus, where there is a risk that she embraces the earlier and more hawkish tightening path espoused by some of her colleagues. On that subject look out for the German state June CPI state releases today culminating in the national figure (released around 14CET) and expected to match last month's cycle high at 7.9% year-on-year. Any upside surprises here could give eurozone short-end rates and the euro a lift as well.

Also in focus today will be more reports on the ECB's anti-fragmentation scheme (will it be large and effective enough?) as well as the June reading for eurozone economic, industrial and services confidence. These have all been holding up quite well. Yet cracks have appeared in business confidence this month and any downside surprise here may question whether the ECB can be as aggressive as the market is pricing.

EUR/USD to probably continue tracing out a 1.0450-1.0550 range, barring any large fixing flows.

➔ GBP: Quite resilient

Sterling has weathered news of another potential Scottish referendum (19 October, 2023) quite well. That may well be because the chances of Westminster granting it are unlikely - though it looks like markets may be buffeted by UK supreme court opinions on this matter over coming months and quarters.

Look out for remarks from Governor Bailey today. This year the Bank of England's strategy has been to communicate less on forward guidance, which has seen UK rates track US rates more closely. With inflation staying near the highs, we doubt Governor Bailey will want to push back too

much against tightening expectations today.

Also look out for testimony from new MPC external member Swati Dhingra at 1515CET. She replaces erstwhile hawk Michael Saunders, and markets will be interested to hear whether she is in the 25bp or (like Saunders) 50bp hiking camp.

EUR/GBP can continue to trade near 0.8600, while cable looks more vulnerable.

➔ HUF: NBH joins the 100 basis-point club

The National bank of Hungary did the impossible and surprised financial markets by [raising the base rate by 185bp to 7.75% yesterday](#). The NBH also made a pre-commitment to hike the 1-week deposit rate by 50bp to 7.75% this Thursday. This means a slightly quicker pace of effective tightening since the last step size was 30bp. What is even more important is that from now on, the 1-week deposit rate and the base rate are at the same level. This makes the monetary policy toolkit, or at least the communication about that, simpler and easier to understand.

However, [as we mentioned yesterday](#), the forint is all about external factors and geopolitics these days. The 2y IRS differential against the euro moved to new records after yesterday's meeting and is the highest since 2008. However, the story does not change. In the short term, we expect the rate differential to widen further in the coming days, adding some more support to the forint. But we believe that under current conditions there is room for appreciation only towards the 395 level. In the long run, it is still about waiting for a turnaround in negotiations with the EU regarding Rule of Law and EU funds disputes, which will unlock the hidden potential of the forint in the second half of the year (perhaps in September).

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