

FX Daily: Hiking confidence

It's a close call, but we expect a 25bp hike by the Fed today. Ultimately, Powell's primary goal is to restore investor confidence and a hold might signal a lack of trust in the financial system. The dot plots may also be revised slightly higher, and the dollar could recover a bit. Still, the gradual improvement in sentiment points to another USD decline ahead



Federal Reserve Chair
Jerome Powell

USD: Fed to hike by 25bp

Late last week, we published our [FOMC meeting preview](#) and discussed how our base case was for a 25bp rate hike if market conditions didn't deteriorate further. Since then, the US regional banking crisis has remained broadly unresolved, but the Treasury is now examining an extension of the FDIC deposit guarantee (Secretary Janet Yellen pledged intervention if needed) and the Federal Reserve itself boosted money market liquidity via higher-frequency USD swap line operations. In Europe, sentiment appears to be stabilising after markets digested the fallout of the UBS-Credit Suisse deal for some categories of bondholders (AT1, in particular). We recommend reading this note from our credit colleagues on the topic "[Credit chaos: is the worst behind us?](#)". Ultimately, two straight days of gains in global equities tell us that investors have indeed turned tentatively more optimistic about the financial turmoil.

In other words, even if it is still a close call, market conditions have – if anything – become slightly more favourable and a 25bp hike is our base case for today's FOMC announcement. We think such a move is not purely motivated by the inflation battle, but probably fits the need to send a message of confidence to the financial system. Pausing rates after having opened the door to a 50bp hike only a few weeks ago might be read as an emergency move and risks exacerbating market concerns about financial stability.

Markets have also moved closer to pricing in such a scenario as sentiment recovered and currently factor in around 20bp (or an 80% implied probability). If a 25bp hike is now a more widely expected outcome, markets will zoom their lenses on: a) financial stability assessment and tools; b) forward guidance, especially the dot plots. On this first point, a lot of focus will be on details about the new Term Funding Facility, fundamentally because this will re-build bond holdings into the Fed balance sheet, which may appear inconsistent with the Fed's quantitative tightening policy. When it comes to the dot plot, our economics team expects the FOMC median projections to signal a 5.4% policy rate for 2023, up from 5.1% from the December update. This could also have a symbolic value: signalling that the Committee is confident the banking crisis will be resolved and the inflation battle can return as the priority. Finally, it will be important to see how much Fed Chair Jerome Powell stresses how the current financial turmoil is by itself a tightening of financial conditions and can accelerate the disinflationary process.

In terms of the FX impact, we think there is room for the dollar to recover some ground on the back of a moderate hawkish surprise by the Fed. However, we are observing a gradual improvement in investor sentiment on the global financial situation – and especially in Europe – which makes us tilt to a bearish short-term bias in the dollar. That is, naturally, highly conditional on no further setbacks in the ongoing banking crisis – which is a big caveat.

Francesco Pesole

📉 EUR: Equities behind the euro rally

A soft ZEW print yesterday was not enough to halt the good EUR/USD momentum, which boils down to European equities' outperformance versus US stocks as well as the general improvement in risk sentiment. We are observing how markets are returning to some pro-cyclical European currencies to the detriment of those Asian G10 currencies (JPY, AUD, NZD) that appeared as safe havens last week.

We think that today's FOMC announcement can trigger some recovery in the dollar, and therefore see mostly downside risks for EUR/USD. At the same time, regulators' efforts to contain the adverse side-effects of the UBS-CS deal for some bondholder categories appear to be yielding some positive effects for European sentiment, and possibly means that the balance of market concern is now tilted to the US given the still unresolved regional banking crisis. Beyond the FOMC impact, we think there is room for a break above 1.0800 in the near term as long as sentiment continues to stabilise.

The European Central Bank is playing a role in this, by staying rather hawkish on monetary policy while opening the door to deploying financial stability tools. There are a lot of speakers today, as the ECB holds a conference in Frankfurt: President Lagarde, Chief Economist Philip Lane, and then members from all parts of the dove-hawk spectrum. Still, the impact on the euro may ultimately be small given the proximity to the FOMC announcement. There are no market-moving data releases to flag in the eurozone calendar today.

Francesco Pesole

📉 GBP: Surprise acceleration in inflation

On Monday, we had called for a break higher in EUR/GBP as we deemed the recent resilience in the pound versus the euro as hardly sustainable. The pair traded close to 0.8850 yesterday but dropped back below 0.8800 this morning after a surprise acceleration in UK inflation. Headline CPI year-on-year rose from 10.1% to 10.4%, defying expectations for a drop below 10.0%. Core inflation also accelerated, from 5.8% to 6.2%.

This morning's data – along with the tentative recovery in market sentiment – reinforces the prospect of a Bank of England rate hike tomorrow (which is also our base case). Still, our economics team still deems a May pause as highly likely, and we continue to see the direction for EUR/GBP as bullish over the coming weeks.

Francesco Pesole

📈 CEE: US dollar will slow recovery

Yesterday's prints from Poland finished the monthly set of data [confirming](#) the weak economy. Today we will see only consumer confidence in Poland while in the Czech Republic, the Ministry of Finance will test the primary bond market for the first time since the recent rally to see whether Czech bonds are still attractive with yields well below 5%.

The FX market in the region yesterday confirmed the positive sentiment coming from the core market, supported by a higher EUR/USD. The rally led by the Hungarian forint and the Czech koruna will follow a further decline in risk aversion, in our view. However, the Fed and a stronger US dollar may be a drag on the EM recovery in the days ahead. Even so, we should see further gains in the CEE region. In our view, the Hungarian forint should settle below 390 EUR/HUF and the Czech koruna below 23.75 EUR/CZK. The Polish zloty and Romanian leu are likely to continue to stagnate at current levels and as we mentioned earlier, this part of the region will have to wait for a stronger move higher in EUR/USD.

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