

FX Daily: Hold your horses

The rebound in global equities is fuelling a widespread recovery in G10 pro-cyclical FX against the USD. Still, yesterday's remarks by Jay Powell were a reminder of the very hawkish Fed policy. Ultimately, rate and growth differentials should curb the dollar's weakness against most peers - except for the CAD where today's CPI should endorse more hikes



➔ USD: Don't forget the rate and growth factor

The rebound in global equities has continued to fuel a recovery in pro-cyclical currencies, and a correction in the safe-haven US dollar and Japanese yen. Overnight, Asian equities were mixed, and the CSI300 failed to follow yesterday's jump in US-traded Chinese tech stocks following some unusually supportive comments for China's tech companies from one of Beijing's top officials, which fuelled speculation of some easing in the current crackdown. Stock index futures suggest a flat open in major Western equity markets today.

Clearly, the monetary policy story is playing a secondary role in the market narrative at the moment, but yesterday's comments by Fed Chair Powell were quite relevant from a signalling perspective, as he firmly reiterated the Fed's determination to bring inflation sustainably lower, even by hiking beyond the neutral rate if necessary.

While the dollar momentum is set to remain weak as long as global assets stay in recovery mode, the notion of aggressive Fed tightening continues to argue against a sustained bearish dollar trend. Incidentally, this week's moves have likely placed the dollar in a less overbought condition. With this in mind, DXY should find increasing support below the 103.00 area.

The US economic calendar includes some housing data today, and Patrick Harker is the only Fed speaker scheduled for remarks.

➔ EUR: Upside room starting to shrink

EUR/USD has risen in line with other pro-cyclical pairs this week, breaking back above the 1.0500 level and now being at a safe distance from the key 2017-low support of 1.0340, which if breached would probably pave the way for a move towards parity. Today, the eurozone calendar is not busy and only includes the final print of April's CPI numbers.

We'll also hear from European Central Bank hawk Madis Muller today, although the recent re-pricing higher in ECB rate expectations (markets now fully price in a deposit rate at 1.0% in December) means that the bar for any hawkish surprise is set very high.

Our view on the limited downside risk for the dollar beyond the very short term obviously implies that the room for appreciation in EUR/USD should also start to shrink soon. We also believe that markets are pricing in too much tightening by the ECB – though not by the Fed – and expect the theme of growth divergence (exacerbated by the EU-Russia standoff on commodities) to become more relevant into the summer.

With this in mind, we suspect that any further rally in EUR/USD may start to lose steam around the 1.0650-1.0700 area, with risks of a return below 1.0500 in the near term being quite material.

⬆ GBP: Inflation rises, but double digits aren't assured

This morning's inflation report in the UK was broadly in line with consensus expectations, as headline CPI rose to 9.0% (largely due to the increase in the electricity price cap) with the core rate rising to 6.2% year-on-year in April. This means inflation is largely where the Bank of England expects it to be. Still, the BoE projections embed a move to double-digit inflation by the end of the year, a prospect that we are still not convinced will materialise. There are no BoE speakers today.

The oversold pound has faced a strong rebound this week, recouping some of its recent sharp losses as global risk appetite improved. While the good GBP momentum may continue as equities find some stability in the coming days, the pound still faces two major downside risks in the coming months: a) a further dovish repricing of BoE rate expectations (the implied rate for end-2022 is still 2.0%); b) Brexit-related risk, as the unilateral suspension by the UK of parts of the Northern Ireland agreement would likely trigger a trade war with the EU. We think cable will mostly trade below the 1.2500 mark during the summer.

⬆ CAD: Inflation data unlikely to affect BoC policy expectations

Inflation data will be released in Canada today, and the market is expecting some signs that the headline rate has peaked (at 6.7% YoY), which would imply a monthly increase of 0.5% in April. Core measures may however continue to inch marginally higher.

Barring major surprises in the data today, we suspect that the impact on the Bank of Canada's rate

expectations and on the Canadian dollar will be limited. The BoC remains on track to deliver 50bp of rate increases in tandem with the Fed, being able to count on a tight labour market, growing workforce and positive commodity story. In our view, the BoC will ultimately have to deliver more monetary tightening than the Fed in the next year.

USD/CAD has broken below 1.2800 and should continue to weaken if we see further signs of stability in global sentiment today. Crucially, the rate and growth differential that may curb EUR/USD don't apply to CAD vs USD given a hawkish BoC and strong growth in Canada, which means that a rally in the loonie should prove more sustainable than the EUR/USD one. We continue to target sub-1.25 levels in USD/CAD by the second half of the year.

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