FX Daily: Is the dollar correction done and dusted?

We think the recent dollar correction has worn off, and we expect a re-emergence of inflation and monetary tightening concerns to lay the ground for new USD strength. Today, we could see some stabilisation in G10 FX as a Powell speech and EZ PMIs may not offer reasons for directional trades. Elsewhere, we see split chances of a 25bp or 50bp rate hike in Russia.

USD: Powell may avoid fireworks in last speech before blackout period

We were reluctant to see the dollar weakness early this week as more than a profit-taking-related correction or as the start of a broader dollar bear trend. FX moves over the past two days seem to endorse our view that the market is far from turning bearish on the dollar, as record highs in US stocks failed to add pressure on the greenback while some of the pro-cyclical FX positions built in the past two weeks have been partly unwound.

Overnight, the RBA stepped in with a AUD 1bn worth of intervention to defend its 0.10% yield target on the April 2024 bond, which is now only 2bp above target, compared with 7bp before the

RBA announcement. This is clearly putting a curb on the speculation that the RBA may be turning less dovish by allowing its target yield to rise. Markets continue to price in 40bp of tightening in the next year in Australia, but the signal sent by the RBA today may prompt some scaling down of tightening expectations further down the road and ultimately weigh on AUD, which has seen the impact of the RBA intervention offset by the news that Evergrande paid $83.5 mln of bond interest that was due 23 September.

Back to the US dollar, we suspect that a quite convincing US earning season is set to leave space for the more structural concerns about higher inflation and the prospect of Fed tightening, which, in our view, should provide the basis of a new gradual re-appreciation of the dollar in the next few weeks.

The US data calendar looks quite uninspiring today, with only the generally non-market-moving Markit PMIs in focus. Markets will, however, get the last chance to hear from Fed Chair Jerome Powell's - who will participate in a virtual central bank panel on monetary policy - before the FOMC blackout period starts on Saturday. It seems likely that Powell will try to avoid hitting the headlines with any eye-catching comments, but given how close we are to the 03 November FOMC meeting, there is a risk that markets will overreact to any policy-related remark. Should Powell manage to keep his comments market-neutral, we may see a broad consolidation in G10 FX today, although in our view, the balance of risks for the dollar, remains slightly tilted to the upside.

EUR: PMIs to have limited FX impact

PMIs will be a more central story today in the eurozone than in the US, with France and Germany's numbers released before the euro zone-wide data this morning. The consensus is expecting a moderate decrease in both manufacturing and services reads for October, with labour and supply shortages likely to have put more obstacles in the way of the recovery. Still, the EUR has been quite unreactive to recent PMI releases, and we doubt that we could see a higher sensitivity to the release this time.

On the ECB side, only French Governor Francois Villeroy is set to speak today, but we have already heard a good deal of unsurprisingly dovish comments from his side this week. It seems, however, that markets are determined to stick to their current pricing of 10bp of ECB tightening within the next year, regardless of multiple signals from President Lagarde and other members who have clearly pushed back against this prospect. Crucially, it does not appear that the EUR is drawing meaningful benefits from tightening expectations. We think we saw the short-term peak around 1.1660 in EUR/USD this week, and we are expecting the pair to move back below 1.1600 into the FOMC November meeting.

GBP: Range-bound trading seems to dominate

Both Cable and EUR/GBP have been trading in a tight range since yesterday, as markets have now fully cemented their view that the Bank of England will raise rates by 15bp in two weeks' time. Yesterday, BoE's Chief Economist, Huw Pill, admitted there is an ongoing "finely-balanced" discussion about whether to hike rates in November. He also rang the alarm about possible 5% inflation in the UK later this year and clearly suggested that he favours a November hike.

Today, markets will monitor UK's October PMIs after some pretty grim September retail sales were released this morning. PMIs should however have little impact on rate expectations and given the absence of scheduled BoE speakers today, we think GBP may continue to trade range-bound into the weekend.

RUB: The gift that keeps giving

As Dmitry Dolgin discusses in his preview of today's Central Bank of Russia rate meeting, the outcome looks like a toss-up between a 25 and a 50bp hike. What is clearer is that the message will remain hawkish. We, therefore, suspect that the Rouble does not face too much risk of being hit on an 'end-of-cycle' narrative.

As we highlight in that preview, 3m implied Rouble yields mean that the majority of Russian OFZ purchases will probably be unhedged. And a continuing tightening cycle should keep the 2-10 year OFZ curve relatively flat.

While USD/RUB downside may be a little limited by the stronger dollar, we expect over the next six weeks, that this should not prevent a further decline in EUR/RUB. We believe that levels in EUR/RUB will be something like 80.50/81.00 over the next six weeks.

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