FX Daily: Late cycle dollar strength meets the carry trade

We see two key themes driving FX markets near term. The first is central banks continuing to battle inflation, yield curves staying inverted, and the dollar continuing to hold gains. The second is cross-market volatility continuing to sink - generating greater interest in the carry trade. Expect these trends to hold into Fed, ECB and BoJ meetings next week

USD: Late cycle dollar strength continues

Yesterday's surprise rate hike by the Bank of Canada (BoC) triggered quite a clean reaction in FX markets. Of course, the Canadian dollar rallied on the view that the BoC had unfinished business when it came to tightening. But the broader reaction was for short-dated yields to rise around the world, for yield curves to invert further, and for the dollar to strengthen. USD/JPY rose about 0.8% after the BoC hiked. The view here was that if both Australia and Canada felt the need for further hikes, in all probability the Fed would too.

This endurance of this late cycle dollar strength is therefore the key story for this summer. For the near term, it looks like the dollar can hold the majority of its recent gains into next Wednesday's FOMC meeting - though the release of the US May CPI next Tuesday will be a big market driver too. Our bigger picture call remains that the dollar will embark on a cyclical bear trend in 2H23 - probably starting in 3Q - though the risk is that this gets delayed.

This brings us to our second key observation which is that declining levels of cross-market volatility continue to favour the FX carry trade. Somewhat amazingly the VIX index - implied volatility for the S&P 500 equity index - has fallen below not just the 22 February pre-invasion levels but also below the March 2020 pre-pandemic levels. As is the case with low rates and FX volatility, presumably investors believe that policy rates will not be moving too much this year - perhaps a little higher and then a little lower. Lower volatility levels are favouring the carry trade which in the EM world favours the Mexican peso and the Hungarian forint and in the G10 space - as Francesco Pesole points out - favours the Canadian dollar. An investor selling USD/MXN six months forward at the start of the year would have made close to 16% by now.

Expect these core trends to continue for the near term. The data calendar is light today and we suspect a slight pick-up in initial claims will not be enough to move the needle on the dollar. Expect DXY to linger around 104.

Chris Turner

EUR: Range-bound into next week

EUR/USD softened on the BoC rate hike yesterday as the implications for Federal Reserve policy proved the larger driver. The softening in EUR/USD did mask some further hawkish rhetoric, where the European Central Bank's influential Isabel Schnabel was still sounding pretty hawkish. Please see our full ECB preview here. Today's session sees some revisions to eurozone 1Q GDP data - expected to be revised down after German figures. However, the market still looks comfortable pricing in two further 25bp ECB rate hikes by the late summer. Expect EUR/USD to remain becalmed well within a 1.0650-1.0750 range.

Elsewhere, we hear from Swiss National Bank (SNB) President Thomas Jordan at 1405CET today. The SNB is widely expected to raise the policy rate by 25bp to 1.75% on 22 June. Recent CPI releases have, though, shown core inflation dipping below 2.0% - a move that reduces the need for the SNB to drive the nominal Swiss franc any stronger. EUR/CHF could drift to 0.9800 should President Jordan acknowledge that better CPI trend today.

Chris Turner

We have updated our calls on Norges Bank and NOK. As discussed in this note, we now expect Norges Bank to take rates to 3.75% (two more hikes from current levels) on the back of NOK's weakness and we see non-negligible risks of a 4.00% peak rate. The short-term outlook for the krone remains clouded: the threat of more Fed tightening is keeping the illiquid and high-beta NOK under pressure, and domestically Norges Bank daily FX purchases have only been trimmed marginally in June. We expect rate hikes and potentially larger cuts to FX purchases later this year to pair with a solid set of fundamentals and a stabilisation in risk sentiment and bring EUR/NOK closer to 11.00 in late 2023.

Francesco Pesole

GBP: Sterling steady into jobs data next Tuesday

EUR/GBP volatility remains near recent lows and spot trades well within a tight 0.8570-0.8640 range. Second or third-tier UK data has been quite mixed recently, but the main event on the data front will be next Tuesday's release of jobs and wages data. We see that as a negative event risk for sterling, where wage growth could continue to slow and take some of the steam out of the 100bp+ Bank of England tightening expectations still priced in by money markets. GBP/USD to trade well within a 1.2400-1.2500 range.

Chris Turner

CEE: Rising chances for rate cut in Poland this year

Yesterday's press conference by the National Bank of Poland (NBP) governor delivered a dovish tone. The governor mentioned during the press conference that inflation could fall below 10% year-on-year in September, which is likely the main condition for a rate cut. We expect this condition to be met by that time, which could open the door for monetary policy easing. Our economists see the chances of a post-summer rate cut increasing from 30-40% to 50% after this central bank meeting. However, this move is roughly priced into the rates market.

May inflation in Hungary will be released today. We expect a fall from 24.0% to 22.1% YoY, slightly below market expectations, mainly on easing price pressures in food, fuel, and durables. Services inflation, however, will remain strong, thus core inflation on a monthly basis will stay high around 0.8%. And later today, we will see the May state budget result in Hungary, which like the rest of the region, is underwater, raising questions about meeting the target this year.

In the FX market today, rather than a local story, we will see a follow-up of yesterday's movement in core rates, which translated into lower interest rate differentials across the region, indicating weaker FX in Central and Eastern Europe.

Frantisek Taborsky

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com