

FX Daily: Letting the term premium do the tightening

US yields and the dollar are softer after two Fed officials said that rising bond yields and the resultant tightening of financial conditions might mean that the Fed has to hike less. Let's see whether this is part of some new Fed narrative. It is a quiet day for data in the G10 space, but CPI releases in Hungary and the Czech Republic will help frame policy



➔ USD: Fed speakers drive the market

European markets look set to open on a mildly positive footing today. Asian equities have seen some decent gains overnight and oil has not pushed any further higher in response to the tragic events in Israel. Driving today's moves has been a sizable drop in US Treasury yields. This market was closed for the Columbus Day public holiday but Asia has now responded to some Federal Reserve commentary and has seen US Treasury 10-year yields drop 16bp to 4.64%.

At the heart of that drop in yields has been commentary from two Fed officials yesterday. What seems to have resonated with the market is comments from Dallas Fed President Lorie Logan:

- *"Higher term premiums result in higher term interest rates for the same setting of the fed funds rate, all else equal. Thus, if term premiums rise, they could do some of the work of cooling the economy for us, leaving less need for additional monetary policy tightening."*

Here, it seems many people have been watching the huge swing in the US Treasury term premium over the last month. For the 10-year Treasury yield in September, the term premium was estimated at -50bp by [some popular Fed models](#). This is now estimated at +30bp as investors demand greater compensation for holding the duration risk of long-dated US Treasuries. Based on Monday's comments from the Fed, the market is starting to think that the central bank does take greater notice of bond yields after all.

However, we suspect that this may not be a defining story for the bond market in that no central bank likes being backed into a corner over what bond yields mean for monetary policy. For example, if US 10-year yields were to quickly fall to 4.25%, would the Fed hike? Unless fellow fed speakers really echo this theme – i.e., if this is part of some new Fed narrative to gracefully close the tightening cycle – it is hard to see US Treasury yields being chased too much lower. Note that we have US CPI data later this week which should still mark only slow progress towards the Fed's 2% inflation objective.

The above suggests that DXY does not have to come too much lower on this story, and we would have thought support levels at 105.70/106.00 can hold this week.

Today's US calendar has the NFIB small business optimism index, a couple more Fed speakers, and the release of major reports from the IMF such as the World Economic Outlook and the Global Financial Stability Report. On the former, world growth should be revised down, but US growth should be revised higher. On the latter, expect more focus on the commercial real estate sector and over-leverage in the shadow banking community.

Chris Turner

➔ EUR: Italian risk weighs

EUR/USD is enjoying a reprieve on the back of softer US yields. However, it would probably be trading even higher were it not for some emerging signs of stress in the Italian bond market. The 10-year BTP-Bund spread is now sitting at +207bp and even European Central Bank (ECB) officials are debating what kind of levels are serious – 250bp, for example. This and developments in the Middle East have proved a clean negative for EUR/CHF, which fell about 0.6% yesterday. The recent lows at 0.9515/20 beckon, although we would not expect EUR/CHF to go much lower given that the Swiss National Bank very much controls this cross rate.

Unless we are misjudging how much further US bond yields fall, it looks like 1.0600/0610 will prove strong resistance for EUR/USD and the one-month target ([as outlined in October's FX talking](#)) remains 1.04.

Chris Turner

➔ ILS: Bank of Israel supports the shekel

It looks as though the Bank of Israel (BoI) is battling with the weaker shekel and intervening to prevent USD/ILS from trading up to 4.00. Yesterday, it said it would sell up to US\$30 billion to support the shekel and that it would also provide up to \$15 billion in short-term liquidity to the swap market. We should find out how much FX the BoI has sold when it releases October FX reserve figures in early November.

For reference, we think foreigners own around \$100 billion of Israeli equities and \$20 billion of

Israeli bonds. The Bank of Israel has just over \$200 billion in FX reserves. Given the circumstances and should the Bol require greater firepower to resist the shekel weakening, we would not be surprised if the Bol and the Fed announced a large new FX swap line to provide FX to Israel.

Chris Turner

➔ CEE: September inflation prints in Hungary and the Czech Republic

Today, we have inflation numbers in Hungary and the Czech Republic for September. In Hungary, this morning's release showed a drop from 16.4% to 12.2% year-on-year, in line with market expectations but slightly above the National Bank of Hungary's expectations. In the Czech Republic, we expect a jump down as well from 8.5% to 7.2% YoY, slightly above market expectations but in line with Czech National Bank's forecasts. The drag down should be driven by food and energy prices and the seasonal downward movement in recreation prices. On the upside, fuel, education, and clothing prices are pushing up prices.

Lower inflation in the Czech Republic should support expectations for a rate cut, which should again push rates lower and undermine the fragile CZK. We already see EUR/CZK between 24.50-24.55 after yesterday's rate move lower and today's inflation has the potential to push it even higher. On the other hand, we're seeing the opposite picture for the HUF, which in turn should be supported by a higher interest rate differential. Yesterday, this differential reached its highest since early September, pushing EUR/HUF towards 384.

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