FX Daily: Market finally prices 4% Fed Funds for next spring

It has taken some time, but money markets now price the Fed policy rate at 4% for next spring. A speech by the Fed's Christopher Waller on Friday re-iterated that a 4% Fed funds rate would be seen later this year even as inflation slowed. A high bar for the Fed to pivot and Europe continuing to struggle with the energy crisis should keep the dollar bid on dips

We would not put ourselves in the 'peak dollar' camp

USD: Expect consolidation ahead of tomorrow's August CPI print

The dollar is consolidating after entering another mini-corrective period late last week. Driving Friday's dollar sell-off was probably a combination of views that major trading partners (the eurozone and Japan) were entering a new phase in supporting their currencies - be it more aggressive rate hikes (eurozone) or FX intervention (Japan). The dollar correction has been worth just over 1% and again we would not put ourselves in the 'peak dollar' camp.

For one thing, Fed hiking expectations are still looking for the right level. On Friday, the US money market strip priced the Fed funds rate at 4% for the first time in this cycle. On Friday the Fed's

Christopher Waller gave a speech highlighting that 4% would be the right Fed level for the turn of the year - and this assumed that inflation would be slowing. He recalled the Fed's quarterly economic projections which assumed that core PCE would have fallen to 4.3% year-on-year by the end of the year. Core PCE currently stands at 4.6% YoY having peaked at 5.3%. The point here is that Waller felt that 4% would be appropriate if inflation slowed to 4.3% - if not the Fed funds rate should be taken into even more restrictive territory.

On that subject, the US data highlight of the week is tomorrow's release of August CPI. While lower gasoline prices should bring headline CPI lower, core inflation should still be rising. And with the Fed expected to hike another 75bp next week and introduce new quarterly projections, we doubt much momentum will build behind a dollar correction.

108.50 may well be enough of a correction for DXY and we would be favouring a move back above 110 next week.

Chris Turner

EUR: And 2% seems to be the target for the ECB

Following Thursday's hawkish European Central Bank (ECB) meeting, Friday saw an array of off and on-the-record comments from the ECB. Most seem to point to the need for the ECB policy rate (still seen as the deposit rate) to be taken to the 2.00% area - that is 125bp higher than its new target. Money markets price the deposit rate at 1.75% for year-end and perhaps closer to 2.50% next spring - suggesting the 2% pricing could move forward to year-end should expectations solidify that the ECB hikes 75bp at its 27 October meeting.

The hawkish ECB has seen EUR/USD push up to the 1.0100 area. 1.0150 looks like the top of a bearish channel that has contained the EUR/USD decline since February. That will be the trigger point for a further short squeeze in EUR/USD - though we think it may well hold. Beyond the ECB there is much focus on what European politicians can do to address the energy crisis. EU energy ministers were split on some issues on Friday given national interests. EU Commission President Ursula von der Leyen will, on Wednesday, deliver what has been agreed upon so far - though we suspect it will not be enough to allay fears of a European recession this winter.

Expect EUR/USD to consolidate into tomorrow's US CPI, with again 1.0150 proving the key intra-day resistance level.

Chris Turner

GBP: July GDP slightly softer than expected

July UK GDP has come in slightly softer than expected at 0.2% month-on-month. However, the adjustment for the June bank holiday makes the figures a little difficult to read and we think the Bank of England (BoE) will take more notice of tomorrow's August jobs data for insight into how tight the UK labour market really is. All in, we expect the BoE to hike 50bp again when it decides policy rates on 22 September.

We are not particularly bearish on the dollar - thus we doubt GBP/USD makes it as far as the 1.1730/50 resistance area. EUR/GBP can consolidate in a 0.8650-08720 range after recent gains.

Chris Turner

CEE: Hungary story reaches its conclusion

Inflation in the Czech Republic will be published today. We expect the year-on-year rate to be unchanged thanks to a strong decline in fuel prices. However, it is still unclear how the statistics office is approaching the sharp increases in energy prices and so a significant upside surprise cannot be ruled out. Tomorrow, we will see current account data for the Czech Republic, Poland and Romania. Industrial production in Romania will be published on Wednesday. On Thursday and Friday, we have secondary inflation numbers in Poland and the Czech Republic.

Beyond that, this week we could hear the first statements from CNB board members ahead of the September meeting and, more interestingly, we could also see some progress in the debates between the Hungarian government and the European Commission over access to EU money. On Wednesday, this topic will be discussed in the European Parliament, which could bring some negative noise, but the final decision should be published by the European Commission next week on Thursday and we expect a positive outcome.

In the FX market, the main theme was the gas price last week, which is now the main driver. Although the interest rate differential is lower across the region, the drop in gas prices late last week indicates further gains for CEE FX, especially for the Polish zloty and Czech koruna. Of course, the CPI print will be key for the koruna, which could potentially reignite hopes for an additional rate hike, but we believe the CNB pain threshold is high enough and even the potential upside surprise will not change the situation. In Hungary, on the other hand, we believe that a positive tone from the European Commission should help the forint settle below the 400 EUR/HUF level.

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