FX Daily: Markets starting to favour front-loaded Fed rate cuts

The dollar is on the soft side again as investors seem to be favouring the front-loaded scenario of the Fed starting its easing cycle with a 50bp rate cut on Wednesday. We are also seeing breadth in this dollar decline, where large parts of Asia, Latam and Europe are all participating. Expect the dollar to continue trading on the soft side

USD: Investors shifting to the front-loaded scenario

Despite a mixed batch of US data last week, investors seem to be favouring a 'front-loaded' scenario for the Federal Reserve's easing cycle. This is premised on the view that if the Fed has decided that the time has come for rate cuts, then why not get rates back to some kind of neutral level as quickly as possible without sparking a panic? Currently, the market seems to be pricing a 41bp cut this Wednesday and has also brought forward and lowered the timing of the terminal rate in this easing cycle to something like 2.75% in just one years' time. This is what the OIS forwards market is telling us currently. Our house view remains that Wednesday's decision is an exceptionally close call.

With US rates continuing to fall but equity markets largely holding onto gains, the soft landing narrative remains dominant. This should be a bearish environment for the dollar - even though overseas markets do not look particularly attractive. For example, the weekend data dump from China showed another batch of sluggish data that - without more focused stimulus from Chinese authorities - suggests policymakers will again be missing their 5% growth target for this year.

Importantly, the current dollar decline is becoming more broad-based. Asian FX (ex-China) is enjoying some strong gains and USD/KRW has dropped to the lowest level since March. In focus here is whether Korean government bonds get added to the WGBI bond index - a move potentially worth $40bn of inflows to the Korean bond market. The decision for inclusion is scheduled for 8 October. And Latam FX is also enjoying some decent gains. We also take the view that the rally in gold and particularly in silver portrays building negative sentiment on the dollar.

Today's data calendar is quite light, but we do not rule out DXY drifting down to recent lows at 100.50/60 in quiet markets.

Chris Turner

EUR: Narrower spreads and stable equities are supportive

The continuing drop in short-dated US rates means that at 85bp, the two-year EUR:USD swap differential is at its narrowest level of the year. Assuming equities can hold up, this should be a cautiously positive environment for EUR/USD.

Additionally, we think some further narrowing of that swap differential can come from the eurozone side. Here, 11bp is still priced for an October European Central Bank cut - something we think is unlikely. On that subject, we hear from three ECB speakers today. Most relevant for markets is probably the 2:00pm CET speech from ECB Chief Economist Philip Lane. Should he pour a little cold water on the chances of an October ECB rate cut, EUR/USD could get a lift.

EUR/USD is currently pressing 1.1100 and think momentum and cross-market developments favour a move up to 1.1155.

Chris Turner

GBP: Resilient

Sterling continues to trade on the strong side. Dollar softness is the dominant theme and we have yet to have much bearish sterling news at all.

Away from the Fed, the biggest event risk for sterling this week is Thursday's Bank of England meeting. So far, the BoE has avoided any forward guidance on the easing cycle. It is unclear whether this will change on Thursday. Instead, a softer BoE profile for rates may have to be driven by the data, rather than being led through central bank communication. Here, Wednesday's release of services inflation data for August may have a greater say in the matter.

With greater confidence growing in the dollar's downside, GBP/USD looks like it may want to head back to the 1.3240/60 area short term.

Chris Turner

CEE: Quiet week favours stronger FX

The second half of the month is usually quieter in the CEE region. PPI in the Czech Republic and core inflation in Poland for August will be published today. In both cases, we expect year-on-year numbers unchanged from the previous month. Tomorrow in Romania, industrial production for July will be published. And on Thursday, we will see industrial production and wages in Poland.

On the central bank side, the Central Bank of Turkey is scheduled to meet on Thursday. We expect rates to remain unchanged at 50% and for the main focus to be on the central bank's communication. We think that the recent macroprudential tightening steps by the CBT have underlined hawkish determination. Our economists expect the first rate cut in November, later than markets are currently pricing in.

This week, we have scheduled speakers scheduled in the CEE region. The Czech National Bank's blackout period starts on Wednesday, so we can expect a few statements from the Board before then. However, another 25bp rate cut seems a done deal, and what's more important is the outlook for next year. In Hungary, the Minister for Economy will address a conference on Tuesday - the same day as the country's deadline to pay the fine from the EU, which could trigger some headlines. The PM is also scheduled to address the European Parliament on Wednesday.

FX in the region this week will be more about a global story and Fed decision. However, a rather dovish story should be supportive for CEE FX. We are bullish on the CZK, which could get a boost this week from a hawkish CNB statement.

EUR/CZK moved up to 25.15 on Friday, which we think offers attractive levels to turn bullish on CZK given the overly dovish market pricing of a terminal rate at 2.85% next year. We could see EUR/CZK going below 25.00 in the medium term, mainly due to a better rate differential. This has proved to be the main driver in recent months. We are also bullish on the HUF, which is getting stronger after misleading headlines regarding fiscal policy while rates favour stronger FX. We remain neutral on the PLN.

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