

FX Daily: Markets settle into more recessionary trading

After the broad-based risk rally seen over the last six weeks, financial markets now seem to be settling into the view of a 2023 recession. And as long as the Federal Reserve stays hawkish, the dollar should perform well. For today, look out for policy rate meetings in Canada and Poland, where we expect a 50bp hike and unchanged rates respectively



📈 USD: Recessionary fears should keep the dollar in demand

After a positioning-led rally in risk assets over the last six weeks, financial markets seem to be settling back into a macro-led environment where the 2023 global slowdown is front and centre. Brent crude is dipping sub \$80/bbl despite the OPEC+ supply cut, bonds are rallying and equities are starting to hand back some of their impressive rally from October lows. Importantly, the US yield curve continues to deeply invert. The 2-10 year Treasury curve is now inverted by a staggering 82bp.

This is by far the best representation of the macro view that recessionary fears are building, yet the Fed has yet to cave in. We continue to see this as a positive environment for the dollar and a negative one for commodity and pro-cyclical currencies. DXY has found support under 105 and could well make a run to 107 ahead of next week's FOMC meeting, where we think it is too early for the Fed to signal the 'all-clear' on inflation with its influential [Dot Plots](#).

The main threat to our bullish dollar view comes from the risk of any softer US November price data (PPI released tomorrow, CPI next Tuesday) or a more positive re-assessment of Chinese growth prospects on the back of relaxed Covid measures. However, poor Chinese trade data released overnight serves as a reminder that the export environment will remain exceptionally challenging for China into 2023.

Chris Turner

The Bank of Canada (BoC) will announce monetary policy today. As discussed [in our meeting preview](#), the consensus is split between a 25bp and 50bp hike, but we believe a half-point move looks more appropriate given strong economic activity and a very tight labour market. Still, we admit it is a very close call given that the expected economic slowdown and fragility of the Canadian housing market argue for a smaller rate increase. Markets are pricing in 35bp for this meeting, so slightly leaning in favour of a quarter-point hike: in our base-case 50bp scenario, the Canadian dollar should rally on the back of the hawkish surprise. However, we don't see the BoC impact on CAD to be very long-lasting, as external factors remain more important. A sustained recovery in CAD from these levels undoubtedly requires a rebound or at least a stabilisation in oil prices. Today, USD/CAD could trade back below 1.3600, but short-term upside risks remain high.

Francesco Pesole

➔ EUR: Sideshow

It has felt like EUR/USD trading has become more settled over the last week, yet one week and one month realised EUR/USD volatility are still above 13%. This could be a precursor to one of the main themes we outlined in our [2023 FX Outlook](#), one of less trend and more volatility in FX markets.

There is a case that last week's 1.0595 print was the corrective high in EUR/USD - we should know a lot more by next Wednesday evening after the FOMC meeting - and it will be interesting to see what the European Central Bank has to say on the 15th. Some are speculating that the current calm in European bond markets could prompt the ECB to be slightly more aggressive in its quantitative tightening plans - so let's see. We have a couple of ECB speakers today, Philip Lane at 0810CET, and Fabio Panetta at 1530CET, but neither looks likely to knock the market off its consensus of a 50bp hike next week. For today, EUR/USD could drift down to 1.0400 in quiet markets.

Chris Turner

➔ GBP: Mildly bearish

Trading conditions have certainly settled down for sterling where one-month traded volatility is pretty steady in the 12-13% area having traded above 20% in late September. It looks like the Gilt market has rallied enough for the time being, with spreads to German Bunds now starting to widen again. In other words, the fiscal rectitude rally has run its course and sterling will not find any more

positives here.

If, as above, we are turning to a more macro-led trading environment, then sterling should underperform. A Fed staying hawkish into a recession should see equity markets come under renewed pressure. Typically, this is a negative environment for sterling, where the UK's large current account deficit is penalised. GBP/USD has turned from a strong resistance level at 1.23 and our bias into next week would be for a return to the 1.19 area.

Chris Turner

📌 CEE: NBP ending the tightening cycle

Top of today's agenda is the monetary policy meeting of the National Bank of Poland (NBP). After last week's surprisingly low inflation, it is hard to expect any outcome other than stable interest rates. Although we think the peak in inflation is still ahead and inflation will slow only very gradually next year, the prospect of a weak economic performance will prevail at the MPC and we expect the same story next year. However, for now, the bigger focus will be on tomorrow's press conference by Governor Adam Glapinski and any potential mention of interest rate cuts, which could be a red rag to a bull for the markets.

As we mentioned on Monday, the gap between the zloty and the interest rate differential is the largest in the region at the moment and together with EUR/USD heading lower, this is not good news for FX. EUR/PLN is thus vulnerable, especially to the upside in our view and we could see a move above the 4.720 level which was already tested on Monday.

On the EU/Hungary story, as expected yesterday's Ecofin meeting did not bring a resolution to the current saga. The Ecofin was due to discuss both the recovery funds to Hungary and the European Commission's proposal for sanctions under the rule of law mechanism. EU member states have requested a new assessment of Hungary from the EC given that the original version did not include the latest changes on the Hungarian side. According to reports, the new assessment is expected to be discussed at an additional Ecofin meeting on 12 December and formally approved on 19 December. On the one hand, the EU's timing problems play into Hungary's hands, as the rule-of-law procedure will end without sanctions if the European Council does not decide on the issue; on the other, the EU may block the disbursement of cohesion funds after that date. However, after yesterday, it seems that the situation will be tense until almost the final day of the year.

On the FX side, the Hungarian forint touched its weakest levels since mid-November yesterday, but the currency erased some of its losses after the Czech finance minister, who is leading the current negotiations, said he believes a deal will be reached in the coming days. Thus, positioning continues to clear and in our view, the trend is tilting more towards the negative side of this story now. Hence, tangible progress should bring a significant rally, while further negative news may result in only slight weakening. Nevertheless, for today we expect a partial calming of the situation after yesterday's headline storm and we expect the forint closer to 410 EUR/HUF.

Frantisek Taborsky

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