FX Daily: 'More forceful' tightening keeps risk assets pressured

A phrase starting to be used more broadly amongst the central bank community is the need for 'more forceful' monetary tightening to address inflation. Central bankers driving real interest rates higher will be a continued headwind for risk assets and for pro-cyclical currencies (especially energy importers). This is a dollar positive environment

USD: So much for the Fed pause

As above, one is starting to hear of the need for 'more forceful' monetary tightening around the world now. Banxico used this phrase in May as it prepares to shift to 75bp from 50bp increment in rate hikes. The Reserve Bank of New Zealand has used the same phrase this week and the Bank of Canada governor expressed the same sentiment yesterday. We have not heard from the Federal Reserve recently because of the blackout period ahead of next week's FOMC meeting, but one suspects they would err towards this camp as opposed to a September pause.

Feeding into this investment theme will be today's US May CPI number. The White House has warned this will be a high number and consensus expects the headline reading to remain at 8.3% year-on-year, while the core rate should dip to 5.9% YoY from 6.2% YoY. We see inflation staying sticky. Any upside surprise to the monthly core rate (expected at 0.5%) will likely drive short-term

US rates and the dollar higher. That would be our bias today and we doubt investors will care to run short dollar positions into what should be a hawkish FOMC next Wednesday.

The overriding need to fight inflation with higher real interest rates remains a headwind for risk assets, where equities suffered on both sides of the Atlantic yesterday. This cautious risk environment should continue to favour the dollar and provide a little more relative support to the Swiss franc and the Japanese yen. On the subject of the yen, we note that the Bank of Japan and Japan's Ministry of Finance have a meeting today to discuss financial markets. Intervening to sell USD/JPY under the auspices of disorderly markets is a difficult one to sell to the US Treasury - but were intervention to occur it should be expected at either the European or US open. Large-scale FX intervention normally triggers a spike in traded volatility prices and that may be another reason why one month USD/JPY implied volatility is trading back above 12% - and could go a lot higher were intervention to be seen.

DXY remains well supported at 103 and should remain bid as the US inflation/Fed narrative returns to dominate markets.

EUR: Rates up, currency down

We think the European Central Bank (ECB) will be disappointed by the euro's reaction yesterday. We had felt that the hawkishness seen since late April had been an effort to narrow rate differentials with the US and to get EUR/USD higher. The ECB delivered a hawkish update yesterday, eurozone interest rates rose - yet the euro fell. As Francesco Pesole wrote at the time, the weak link was peripheral debt markets being left unprotected without sufficient news on anti-fragmentation support packages. But one also sensed that, as a pro-cyclical currency, the euro may not appreciate rate hikes as growth forecasts are cut. This means we may start to hear more about growth differentials and what they mean for international equity flows. There also seems to be the start of a risk premium being built into the euro now - i.e. EUR/USD is trading some 1.5/2.0% lower than where short-term fair value models suggest. For today, a firm US CPI print and higher short-term US rates could break EUR/USD below 1.0600 in a move to the 1.0500/0520 area. We also favour EUR/CHF lower from these levels.

Elsewhere, yesterday's National Bank of Poland (NBP) press conference brought a surprisingly dovish tone to the market. Governor Adam Glapinski mentioned the impending peak in rate hikes and the indication of rate cuts next year without any sign of an easing in inflationary pressures. One reason behind this tone, in our view, may be the recent weaker PMI and the outlook for a slowdown in GDP. However, even so, in our view, this will not stop inflation from rising further and yesterday's press conference did not convince us that the NBP is changing course.

We continue to believe the terminal rate will reach 8.5%, but it will be a difficult road up for markets. After yesterday's press conference we find Polish rates at the short end of the curve lower despite very strong support from core rates. The differential against the euro has thus moved down by around 20bp. The zloty reacted by weakening, which was corrected towards the end of the press conference. However, in our view, the return of the interest rate differential to mid-May levels has left the zloty unprotected and we could see further PLN weakening above EUR/PLN 4.62 in the coming days. However, in the longer term, we believe that further data from the economy, led by inflation prints, will keep the hiking machine running and nothing will change in the tightening story.

And finally, in continental Europe, we have a Central Bank of Russia (CBR) rate meeting today.

Consensus expects a 100bp rate cut to 10%. The rouble has been exceptionally strong given that current account flows now dominate what is left of USD/RUB trading - the current account surplus being worth US$110bn in the January-May period. Not until foreign energy purchases really start to slow (later this year) should we expect much of a decline in the rouble.

GBP: Seven BoE hikes priced by year-end!

The fact that sterling money markets still price a further 175bp of Bank of England (BoE) tightening by year-end goes to show that investors struggle to buy into the idea of a pause anywhere. We have heard very little from the BoE over recent weeks, questioning whether there is to be a rude awakening on the BoE rate profile when the Bank announces rates next Thursday. GBP/USD one-month volatility is trading at 9.4% - not too far away from one-month realised volatility - and we could easily see traded volatility rising back to 11-12% levels given huge uncertainty over coming weeks.

Right now we would favour the dollar over sterling and could see GBP/USD breaking down to 1.2350 next week.

CAD: Jobs data to support good momentum

Jobs data for the month of May will be released today, and we expect a stronger headline figure than the 15k increase in April, fuelled by a rebound in full-time employment, as well as some further acceleration in wage growth.

The notion of a tight market has been central in allowing the Bank of Canada to push forward with 50bp rate increases, and we think today's release will continue to endorse a fast-paced tightening cycle. With rate expectations supported and crude prices enjoying good momentum, we think the Canadian dollar can stay on an appreciating path. We think a break below 1.2500 is likely in the coming days, and we expect sub-1.2500 levels to be the norm for the second half of the year.

Author

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