FX Daily: Navigating the perfect storm ahead of the Fed

Global risk assets have remained vulnerable at the start of this week, and safe-haven bets have continued to fuel the dollar rally. We think more support to the dollar may come on Wednesday as the FOMC hikes by 50bp and upgrades its dot plots. This bodes ill for the battered yen, and raises the probability of an imminent round of FX intervention from Japan

USD: Waiting for a hawkish Fed on Wednesday

The above-consensus acceleration in US inflation on Friday left a deep mark on global market sentiment, and equities look set to remain under pressure today.

The combination of market turmoil and the prospect of aggressive Fed tightening is proving to be an ideal combination for the dollar. Some rebound in risk assets over the coming days is possible given how fast risk assets have dropped in the past few sessions, and the dollar might face a correction soon, but at the same time, we think the FOMC rate announcement on Wednesday will prove mostly supportive for the greenback.

As discussed in our June FOMC preview, a 50bp rate hike this week is a done deal, and the pre-commitment to a 50bp move in July appears highly likely. The market's reaction will be primarily driven by any clues about a potential deceleration in tightening in September, both through the updated dot plot projections and in Chair Jerome Powell's press conference.

When it comes to the dot plots, we expect the median projection to fall around to 2.60% for 2022 and to 3.0% for 2023. While market expectations are more hawkish than these projections, we suspect that some degree of re-alignment of the dot plots with rate expectations will be enough to prevent any material dovish re-pricing and keep market bets in more hawkish territory than what the Fed is currently signalling.

Ultimately, this should put a floor under the dollar, mostly to the detriment of pro-growth currencies and especially those that are more vulnerable to the energy story. Supported rates after the FOMC would also imply additional pressure on the yen: we discuss the possibility of FX intervention in Japan in the JPY section below. We think a break above the 105.00 mark (where the May rally halted) in DXY in the short-term is a tangible possibility.

On the data side, markets will keep an eye on the NFIB Small Business Sentiment indicator and PPI numbers out of the US today, which should however have a limited market impact.

EUR: Heading to the bottom of the range

The euro has been under a lot of pressure since the European Central Bank meeting, as higher rates in the eurozone following President Christine Lagarde's hawkish press conference appeared to do more harm than good to the common currency and deteriorating risk sentiment lifted the dollar. We discuss the euro's odd reaction to the ECB in this article, where we highlight the rising importance of the eurozone's peripheral spreads for the common currency. These spreads may continue to face widening pressure in the coming days given the unstable risk environment: expect this to be mirrored in some pressure in EUR/USD and even more in EUR/CHF.

The eurozone's data calendar this week is quite light, with some focus only on the ZEW survey in Germany tomorrow. We do have, however, a long list of ECB speakers, which are expected to refine the message by the Governing Council and Christine Lagarde last week. Today we'll hear from Robert Holtzmann, Gediminas Simkus, and Luis de Guindos, while Lagarde herself is scheduled to speak later this week.

Given the adverse reaction in peripheral spreads, there is the risk of some less dovish comments by some ECB members over the coming days. If it's true that the euro-eurozone yield relationship is currently "inverted", this might not be terrible news for the euro, although we simply think that external and equity-related drivers are playing a bigger role in driving EUR/USD at the moment, and the risk of a move to the bottom of the 1.02/1.08 trading range on the back of unstable risk sentiment and a hawkish Fed are quite elevated now.

GBP: Don't read too much into bad GDP numbers

UK's April GDP numbers showed a second consecutive month-on-month contraction (-0.3%), below market expectations. It must be noted that almost all of the contraction is down to the ending of the free Covid testing at the end of March, which shaved off 0.5% of GDP. Still, these numbers are paving the way for a negative 2Q growth figure, as the extra bank holiday in May also had a dampening effect.

We doubt all this comes as a major surprise to markets or to the Bank of England at this stage, and most focus should now be – instead – on how much the government's stimulus measures will be able to support the economy.

This week, the Bank of England meeting is the big highlight for the GBP market. We expect to see a marked divergence within the MPC at this meeting, as we forecast a three-way vote split: some members voting for no change, some for a 50bp hike, and the overall majority for a 25bp move. With markets currently pricing in seven 25bp rate hikes by year-end, we think the risk of a dovish repricing in the GBP curve after this week's meeting is high, and we expect more weakness in the pound after the announcement. Unless global sentiment rebounds, a move to the 1.20-1.21 area in cable appears to be on the cards, while EUR/GBP may test 0.8600.

JPY: FX intervention appears to be the only solution

The Bank of Japan announced the buying of an additional JPY 500bn of government bonds to defend the 0.25% yield curve control target on the 10-year bond after the yield rose to 0.254% this morning. In a way, the fierce bond-market intervention by the BoJ signals a renewed commitment to maintaining loose monetary policy, which remains a priority over the depreciating yen.

At the same time, Governor Haruiko Kuroda was quite vocal this morning in discussing how a sharply depreciating yen is "negative and undesirable" for the Japanese economy. At this stage, with no signs that the BoJ is deviating from its ultra-loose policy but with a growing desire to stabilise the yen, FX intervention really does appear to be the only solution, unless Japanese authorities are betting on market dynamics (i.e. a correction in US yields) to drive USD/JPY back lower. The prospect of a hawkish Fed on Wednesday does not bode well for such a bet.

Should Japan go ahead with FX intervention, expect it to be deployed around the European or US open, when markets are more liquid. We believe markets are starting to price in intervention and that might limit USD/JPY for now, although few tangible indications that such a tool is about to be deployed may trigger USD/JPY appreciation well beyond the 135.00 mark.

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