FX Daily: Losing control

It is a very busy week for the events calendar, with central bank meetings in the US, UK, Australia, Norway, Poland, and the Czech Republic. The RBA has lost control of the short-end of the bond market and looks like it will have to shift policy, And it looks like the Fed will have to take inflation more seriously. We see scope for further dollar gains this week.

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USD: Even a policy error looks dollar bullish

Friday afternoon saw the dollar move higher with some momentum. Month-end flows have since been blamed, although the move did coincide with the release of a record quarterly increase in the Employment Cost Index. This measure had been a preferred one for the Greenspan Fed in the 1990s and a surging figure will no doubt be unnerving some core members of the FOMC. We think this will add to the case for a confident tapering announcement from the Fed on Wednesday

The 25bp flattening in the US Treasury curve seen over the last month has led to suggestions of a looming Fed policy error - i.e. the Fed tightening in response to temporary inflation only to have to cut rates again a little later. US Treasury Secretary Yellen has dismissed those fears citing the solid US recovery. And our bond strategy team would certainly favour higher longer-dated US yields

from current levels. In our experience, flat or inverted yield curves tend to be positive for a currency (only when a central bank becomes ready to cut rates might a currency respond negatively). So even if we are about to see a policy mistake from the Fed over the next 12 months, we would still favour the dollar rallying.

Back to today - the US data calendar sees October ISM. Data is expected to continue to demonstrate supply-demand mismatches - be it strong order books, backlogs in deliveries and higher prices. We doubt the data will have too much impact on the dollar today and instead see the dollar stay bid on dips ahead of the main event of the week - Wednesday's FOMC meeting.

Expect DXY to find support in the 94.00 area and major resistance at 94.55/70 could be tested Wednesday evening.

EUR: Bond market becomes a little unanchored

One often hears from the ECB the importance of the monetary transmission mechanism and more recently the need to maintain accommodative financial conditions. The ECB is reluctant to spell-out what those financial conditions actually entail, although a GDP-weighted average of Eurozone government borrowing costs is thought to be a key input. The ECB may therefore be looking at Friday's move in European bond markets with a little alarm - where Greek 10 year bond yields rose 23bp and Italian yields rose 11bp. The moves are understandably a reaction to the prospect of less PEPP buying coming through from the ECB over the next six months.

Does the widening of EMU peripheral debt spreads limit the ECB's ability to tighten rates? Our rates strategy team certainly think that the 20bp of ECB tightening expected for 4Q22 looks one of the most mis-priced stories in money markets today. That should mean that EUR/USD does take the strain from more hawkish Fed policy. We favour a test of major support at 1.1500 this week. A close below there opens up 1.13, but a close below 1.15 is far from given.

The sharp widening of peripheral debt spreads also looked to be a driver of moves In EUR/CHF, which has now traded down to the lowest levels since last May. We do think the SNB will have a problem with this development and will be very reluctant to allow EUR/CHF to trade below 1.0500.

GBP: Positioning for Thursday's BoE

GBP has started to underperform a little and it looks as though investors are starting to adjust positions ahead of Thursday's BoE meeting. We are in the camp arguing that the BoE will struggle to deliver on all the hawkish pricing packed into the GBP money market curve and that EUR/GBP can correct up to the 0.8500 area on Thursday.

Given our preference for a stronger dollar this week, that probably means Cable can retest strong support at 1.3570/3600 area - though we suspect how EUR/$ trades at major support at 1.1500 will determine whether Cable needs to fall a lot further.

Beyond central bank inputs, GBP also has to cope with the UK-France fishing spat, where Macron has delivered a Tuesday deadline for the UK to approve more licenses to the French fleet. Brexit-related tension has not had a major impact on GBP over recent months (it has been hard to identify a political risk premium being built into GBP) and we suspect that will continue to be the case - i.e. monetary policy settings should dominate.

AUD: Time for the RBA to show its cards

It's been a tumultuous week for the Aussie bond market, with the post-CPI sell-off exacerbated by Friday's surprising decision from the RBA not to intervene to defend its 10-bp target on the April 2024 bond, now trading at 71bp**.** The RBA announces monetary policy tomorrow at 0330 GMT, and the key question is whether policymakers will abandon its yield-curve-control policy, a scenario that now appears very much embedded into asset pricing.

The alternatives – which would likely defy hawkish expectations – would be: a) raise the yield target, likely to 0.20%, b) change the YCC to the April 2023 bond (currently trading at 55bp c) keep the YCC as is. The latter scenario (not totally unrealistic given the jobs market slack) would be a move aimed at easing pressure on the targeted bond, but would realistically prove insufficient to bring the yield back to target without market interventions as well. On the asset purchase side, the RBA pledged to keep the current pace of purchases at AU$ 4bn per week (in the 5-10 year maturity bucket) at least until February, but potential changes to the YCC and any adjustment to forward guidance would likely tell the market a lot about the timing for those purchases to be discontinued.

From an FX perspective, it must be noted that the Aussie dollar has shown a contained reaction to the very wide swings in short-term rates. Despite our short-term fair value model showing that AUD/USD has generally had a lower sensitivity to short-term rate differentials than other G10 currency pairs such as EUR/USD, the magnitude of the Australian bond sell-off was so big that AUD/USD is now more than 4% undervalued. In light of this – and also considering the market's overstretched short positioning on AUD – there is significant room for AUD to catch up with the moves in rates, and the balance of risks appears skewed to the upside ahead of tomorrow's RBA meeting.

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