

FX Daily: Playing the pause

Market pricing of the Fed tightening cycle has settled down now. And yields at the short end of the US yield curve are now quite steady. The benign case for global asset markets is that the Fed pauses after hiking the Fed funds rate to 2% in July. That could lead to further stability in the dollar and gains in high yield FX. But there are still many risks



⬇️ USD: Fed pause idea gathers some support

Global asset markets have found a little stability this week. In terms of China, we have seen authorities announce a package of measures to support the economy and some improvement in the Covid situation in Shanghai. Most remain fearful that lockdown restrictions spread to Beijing, but Chinese asset markets and the renminbi are being given the benefit of the doubt in the short term. We mention this since the devaluation of the renminbi from mid-April to mid-May had been a key factor undermining emerging market FX and lifting the dollar. We can see USD/CNY trading in a 6.65-6.70 range for the remainder of this week, barring news of lockdowns in Beijing.

When it comes to the US, the idea of a Fed pause in the summer is gaining a little traction. The FOMC's former arch-hawk, Esther George, yesterday seemed to support the view that the Fed should re-assess the situation after 50bp hikes in both June and July. The idea of 75bp hikes seems

to be waning and we are hearing a little less about the Fed terminal rate in the 3%+ area. This could all change at the next FOMC meeting on 15 June if the Dot Plots were to show 3%+ rates for end-23. But that FOMC meeting is three weeks away. This could provide a brief window for some money being put to work in depressed credit and equity markets. Recent buy-side surveys have shown investors with the highest cash allocations since September 2001.

What does this all mean for the dollar? Stability in the US rates markets could start to see volatility levels temporarily edge a little lower - e.g. one month USD/JPY traded volatility dropping under 10% would be a good sign of slightly calmer markets. We would favour stability over a sharp correction lower for the broad dollar trend - largely since the Fed has the largest cause of any to be tightening rates sharply.

For today, we will be looking at the release of manufacturing confidence indices both in the US and Europe. We would use the 102.00 level in the DXY as a benchmark for whether the dollar needs to correct a little further - but that is not a given.

➔ EUR: ECB spells out the tightening cycle

Providing support to EUR/USD has undoubtedly been the pick-up in European Central Bank tightening rhetoric. We speculated last week that this might have been triggered by the need to stabilise the euro and Carsten Brzeski [wrote on this subject](#) over the weekend. That ECB rhetoric was crystallised in a [blog post](#) by President Christine Lagarde yesterday, which all but confirms 25bp hikes in July and September from the ECB. Money markets now price close to five 25bp hikes from the ECB by year-end.

That re-assessment of the ECB cycle has seen two-year German-US sovereign yields shift up from -254bp in March to -220bp today. That undoubtedly has given EUR/USD some support, but one must argue how much further narrowing of this spread can take place. For that reason, we prefer EUR/USD consolidation over a sharp corrective rally. 1.0670/1.0700 may be the extent of this near-term correction, though 1.0770/1.0800 is the outside risk.

Elsewhere, stability in EUR/USD has encouraged more interest in the carry trade. In Europe, the 6% implied yields available amongst the CE4 community are looking more attractive now. We would favour the Polish zloty and Czech koruna in this period, while the Hungarian forint remains beset by friction between Budapest and Brussels.

➔ GBP: BoE tightening expectations hold up

Just a few weeks ago, some analysts were declaring that it was all over for sterling. But the incredibly resilient pricing of the Bank of England (BoE) tightening cycle is keeping sterling supported against the euro and allowing cable to rebound with EUR/USD.

Unless UK May services PMI falls off a cliff today, we can see EUR/GBP continuing to trade within a 0.8450-0.8500 range. Cable can stay gently bid and threaten resistance at 1.2590/2640, although any further strength looks unsustainable since we are backing the dollar this year.

➔ RUB: Russia softens domestic currency controls

In addition to Russia's foreign exchange market being bifurcated across onshore and offshore jurisdictions, the domestic market is also been driven by the diverging trends of sharply lower

imports, but ongoing export revenues are driving the rouble stronger. USD/RUB briefly traded under 60 yesterday. This strength in the rouble, which softens FX export earnings with negative implications for budget financing, is now being addressed by some softening in domestic currency controls.

Announced yesterday, Russian exporters now have to sell 50%, instead of 80%, of their FX export earnings within 60 days. Whether this makes much difference to USD/RUB remains to be seen, but it does suggest Russian authorities are taking a stand against further rouble strength.

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