

## FX Daily: Race to the bottom

The pound has continued its disorderly fall today. Since a U-turn on freshly-announced fiscal measures seems unlikely just yet, many are calling for more significant tightening by the Bank of England.

However, an FX-related hike may prove unsuccessful. Cable may soon hit parity. Elsewhere, Italy's right-wing coalition electoral win may not mean much for EUR



### USD: Bolstered by Europe's troubles

Another week of large dollar gains forces us to re-address the question of whether the greenback is close to its peak. The answer can be found in the key drivers of the dollar's strength.

The first is Fed tightening expectations, which do not look likely to be scaled down in the very near term, especially after Chair Jerome Powell recently reiterated his commitment to bringing down inflation in spite of the potential economic damage. We have been highlighting how monetary policy is having a less and less pronounced direct impact on currency movements: this is quite evident when looking at most European developed currencies/central banks. However, the broader effect of Fed tightening expectations on global risk sentiment means that continued hawkish rhetoric may do little to ease the instability in risk assets, and this should ultimately continue to fuel demand for the dollar as a safe-haven currency.

The energy crisis and a faster deterioration in the economic outlook outside of the US have also been crucial drivers of dollar strength. Here, the latest developments in the Russia-Ukraine conflict are likely preventing markets from turning more optimistic for now, and activity surveys have continued to point at a grim outlook for the eurozone. In China, sentiment on the yuan has remained bearish, and the People's Bank of China took further steps today to try to support the yuan by imposing a risk-reserve requirement of 20% on FX forward sales.

Most importantly, the turmoil in the UK markets on the back of fiscal concerns – which is triggering an EM-like sell-off in the pound (more in the GBP section below) – is further boosting a rush for dollars, and having a spillover effect on other pro-cyclical currencies. Even if the other drivers of dollar bullishness start to lose some power (not very likely, anyway, as discussed above), expect the dollar to stay very well supported until we see some stabilisation in the gilts market and the pound.

On the data side, there aren't too many market-moving data releases to highlight in the US this week. Some interest will be in today's activity indices from the Chicago and Dallas Fed, on Conference Board consumer confidence tomorrow as well some housing data spread over the week. Fed Chair Powell will speak tomorrow at a conference on digital currencies, while we'll hear from FOMC members Raphael Bostic, Lorie Logan and Loretta Mester today.

DXY should retain a bullish bias for now, and may reach 115.00 even today if the GBP slump accelerates. Let's see whether, after the US seemed to overlook the Bank of Japan's FX intervention campaign last week, some speculation about a coordinated depreciation of the dollar (similar to the 1985 Plaza Accord) starts to emerge, although we suspect this is unlikely to be seriously considered as long as US inflation is running this hot.

*Francesco Pesole*

## **EUR: No obvious implications from Italy's election results**

Italy's election results overnight were in line with expectations: the right-wing coalition led by Giorgia Meloni has secured a solid majority in both the Senate and the House. While the euro is trading weaker this morning, it's hard to tell how much of the move is a mere spillover from the pound's selloff and how much is related to the election results. A similar warning should be made for BTP swings this morning considering Friday's big drop.

The process to form a government will take a few weeks, and markets will closely focus on the choice of key ministers (especially the Finance and Foreign Affairs ministers) as an early test of Meloni's pledges to respect EU fiscal rules and Italy's stance on international politics. At an early stage, we could definitely see the government attempting not to upset markets and broadly follow the reform path set out by previous PM Mario Draghi.

Questions about relationships with the EU may start to emerge at some point and could favour a widening of the BTP-Bund spread, although downside risks for the eurozone's peripheral bonds primarily stem from quantitative tightening discussions at the European Central Bank and spillover from the gilts market, at the moment. In FX, we simply think the euro is facing bigger challenges given the energy crisis and geopolitical uncertainty: we may need to see an escalation in EU-Italy confrontation before a political risk premium is embedded into the euro.

Today, we'll hear from a plethora of ECB speakers. President Christine Lagarde will testify before EU

lawmakers, but we'll also hear from Joachim Nagel, Luis de Guindos, Fabio Panetta, Pablo De Cos and Mario Centeno. Any hawkish further tilt still looks unlikely to offer any sustainable support to the euro.

On the data side, the highlight of the week in the eurozone is the CPI report on Friday, which is expected to have accelerated to 9.7%. This is partly due to the end of a cheap transport ticket programme in Germany, but the focus will be on how much other categories have risen. Today, the Ifo survey may continue to point to a generally unsupportive economic outlook for the eurozone, one that however appears largely priced in.

All in all, EUR/USD appears to be mostly a dollar (and, partly, a sterling) story. As highlighted in the section above, we think the dollar will stay strong in the near term and this should keep any recovery in EUR/USD quite short-lived. Risks of a break below 0.9500 this week are quite material.

*Francesco Pesole*

## ⬇️ GBP: Falling disorderly

Another 4% sell-off in GBP/USD today and one-week implied volatility up 28% now means this sterling sell-off is officially disorderly. The trouble for sterling now is trying to identify what policy shifts are viable to support the pound – indeed should UK authorities decide that the pound needs supporting.

A U-turn on fiscal policy looks highly unlikely just a few days after the new UK government unveiled its set of tax cuts and policy liberalisation. As the guardians of price stability, a few are saying that the Bank of England (BoE) should jump in with a large inter-meeting right hike. We think that the BoE is too psychologically scarred from the events of 1992 to try defensive FX-related rate hikes – e.g. what happens if the BoE hikes 300-500bp and GBP/USD ends up trading lower?

Given that fiscal concerns have been the [core factor undermining the pound](#), an announcement that the BoE will suspend planned gilt sales in October may be welcomed by the gilt (and then FX) market. Alternatively, there is FX intervention, but the UK has only around \$80bn in net FX reserves – barely enough to cover two months' worth of imports.

A recourse to larger Dollar Fed swap lines looks unlikely (that line is already unlimited and is designed to address dollar funding challenges not Balance of Payments crises). Other than that, UK authorities may have to let sterling find 'the right level'. Equally, we think sterling would have to fall a lot further before more credible talk emerged of the UK seeking the first supranational support since 1976.

Needless to say, until a policy response is seen, cable will be biased to 1.00 and EUR/GBP to retest the overnight Asian high near 0.9300.

*Chris Turner*

## ⬇️ CEE: CNB passes hawkish leadership to NBH

This week we have two central bank meetings on the calendar: the most dovish Czech National Bank and the most hawkish Hungarian National Bank within the CEE region. On Tuesday we start with the NBH, where [we expect](#) a 75bp hike in the base rate to 12.50%, although a 100bp move, as

in August, is also on the table, which is the market consensus at the moment. We have seen signs of attempts to steer the hiking cycle towards the end in recent statements from central bankers but still, the NBH remains the most open central bank to rate hikes in the region.

On Thursday, on the other hand, we will see [confirmation](#) of the end of the hiking cycle from the CNB, which was the first central bank in the region to leave rates unchanged back in August. In our view, the current situation of lower-than-expected inflation and a stable koruna make the board's decision-making easier, and we cannot expect too many surprises this week.

Then on Friday, we end the week in Poland with the release of September inflation. Our Warsaw team expects a rise from 16.1% to 16.6% year-on-year, a new record high. However late last week we heard several statements from the NBP including the most hawkish members that the hiking cycle is coming to an end, adding risk to our 25bp hike call for the October meeting.

On the FX front, the CEE market is still recovering from last week and is balancing between a falling interest rate differential, a strong dollar and on the other hand a stable gas price, indicating stronger FX. Based on current market expectations, it should not be a problem for the NBH to maintain hawkish expectations and Tuesday's meeting could add support. On the other hand, Fitch published a report on Friday indicating a negative rating outlook if Hungary does not find an agreement with the EC and Moody's did not publish a planned rating review, probably due to the current uncertainty related to the negotiations.

Thus, we can expect another volatile week around 405 EUR/HUF level. The Czech koruna is trading in the CNB's intervention band of 24.60-70 EUR/CZK, however, there is no indication of significant central bank activity in the market so far. Thursday's meeting may thus be a reminder that the CNB is still present in the market and is not going to change anything, which may lead some to close short positions. The Polish zloty saw the biggest recovery after the headlines from Russia last week and we believe that the squeezed positioning gives it solid ground within the region. Plus it could be supported by inflation growth late in the week, to settle below 4.740 EUR/PLN for now.

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