

FX Daily: Rate protests and credibility hazard

The Fed's job today was made harder by yesterday's drop in US inflation, but we still think Chair Powell will try to deliver a credible rate protest and push back against easing financial conditions after delivering a 50bp rate hike. This could take some pressure off the dollar, but downside risks remain - admittedly - quite high



Federal Reserve building in Washington, DC

USD: In need of some Powell "magic"

Yesterday's US inflation reading made the Federal Reserve's job even harder as it prepares to announce another rate hike at 1900 GMT today. Core CPI dropped to 6.0% year-on-year, and headline to 7.1% in November, prompting a new round of dovish speculation on the Fed's rate path. As discussed [here by James Knightley](#), we are not changing [our call for a 50bp hike](#) today, but the chances of the peak rate reaching 5.0% have admittedly shrunk.

The market's pricing for today's announcement has also remained anchored to 50bp, and it's fair to believe that investors' reaction will be primarily driven by the forward-looking language of the statement and of Powell's press conference.

Our perception is that the Fed will want to deliver some sort of "rate protest", essentially pushing

back against the recent easing in financial conditions. To do that, Powell will need to downplay the recent abatement in price pressure, stick to the view that the inflation battle is still to be won and ultimately try to re-anchor peak rate expectations to the 5.00% handle. That is easier said than done.

The unsuccessful reiteration of “transitory inflation” in 2021 served as a lesson to the Fed, and now warns against abandoning rate hikes too early or sticking too long to the notion that inflation isn’t yet on a reliable downward path. So, Powell will have to walk the fine line between credibility risk and the Fed’s explicit preference to overdeliver rather than underdeliver on policy tightening.

While we are in the camp of higher interest rates and a stronger dollar, we have to admit the risk of wanted or unwanted dovish mis-steps is elevated. We knew December would be a challenging month for dollar bulls like ourselves, and downside risks remain significant today. Still, our base case is that the dollar can recover some of the lost ground as Powell works his magic to deliver a broadly hawkish – and above all credible – message.

Francesco Pesole

📌 EUR: Powell effect larger than the Lagarde effect

EUR/USD is consolidating above 1.0600 after the post-US CPI knee-jerk reaction brought it to a 1.0660 high. While positioning data suggests little room for more short-squeezing on the pair, markets appear more comfortable in laying down the basis for a more structural bullish approach.

Today’s FOMC announcement will tell us whether the Fed can still offer some support to the dollar, and tomorrow’s European Central Bank announcement may give hints about balance sheet reduction. However – as discussed in [our FX and rates preview](#) – the Lagarde effect on EUR/USD should be significantly smaller and shorter-lasting than the Powell effect.

A dovish Fed today could open the door for a rally to 1.0800 before Christmas, but we favour a correction to sub-1.05 levels instead, fuelled by a Fed rate protest and higher energy prices.

Francesco Pesole

📌 GBP: Inflation slowdown not that relevant now

Inflation has also started to decelerate in the UK. The November reading, released this morning, showed a smaller-than-expected month-on-month CPI reading (0.4% vs expected 0.6%), which brings the YoY number to 10.7% from 11.1% in October. Core inflation slowed from 6.5% to 6.3%.

The pound’s reaction to the data has been quite muted, which is not surprising given the wait-and-see approach ahead of today’s FOMC risk event and since the inflation figures do not suggest a different outcome for tomorrow’s Bank of England meeting. Consensus and markets are expecting a 50bp hike, and this is also our [house call](#).

Today, cable will be primarily moved by the FOMC reaction. We expect a correction below 1.2300, but the risks of a negative dollar reaction are – as discussed above – non-negligible: in that case, 1.2500 may be tested before the Christmas break.

Francesco Pesole

📌 SEK: Inflation in Sweden going the wrong way

While inflation shows signs of abating in some major economies, Sweden's CPI report showed that – as expected – both core and headline rates kept rising in November. Headline CPIF moved from 9.3% to 9.5% YoY, and CPIF, excluding energy, from 7.9% to 8.0% YoY.

The krona is slightly stronger after the release, mainly because the rise in inflation was slightly smaller than consensus expectations. Still, this is enough to reinforce our view that Riksbank will have to deliver another 75bp of tightening in the first half of 2023. The next meeting is in February, and a few more data releases should offer markets and policymakers some clearer guidance. Incidentally, we'll see a change at the helm of Riksbank, with Erik Thedéen taking over as governor from 1 January.

EUR/SEK is trading in the 10.85/10.90 range at the moment, and we currently see some upside risks (to 11.00) for the pair in the short term driven by a renewed deterioration in market sentiment, especially in Europe. For 2023, we forecast a moderately bearish scenario for EUR/SEK, targeting 10.40/10.50 in the second half of next year.

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