

## FX Daily: Red ripple unlikely to make waves in FX

It looks as though the Democrats are doing a little better than expected in the US mid-terms. This news looks unlikely to unlock some of the equity gains that had been envisaged and we have yet to see the dollar extending its correction. Expect a day of FX consolidation ahead of US CPI tomorrow. Today's Polish monetary policy decision could weigh on the zloty



United States Capitol building silhouette and US flags at sunrise

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### ➔ USD: Mid-terms point to a challenging two years of US policy

What we have seen so far from the US mid-term results are: i) the Republicans likely taking control of the House, ii) a much closer Senate race than expected with a possibility the Democrats could retain it, and iii) the swing to Republicans not being as large as expected. How the US mid-terms play out in FX markets is rather a loose proposition - suggestions had been that a likely equity rally on the back of Republican control of Congress had been weighing on the dollar this month. In reality, buy-side surveys seem to have been split on what various mid-term outcomes would mean for equities, and hence the link between mid-terms and FX looks tenuous at best.

In our US [mid-term election preview](#), we suggested the scenario of a Republican House and a Democrat Senate might be slightly positive for the dollar in that a hamstrung Biden administration might be left to focus on Presidential executive orders including more hawkish policy on China. Additionally, reports suggest a Republican House will use next year's debt ceiling for policy leverage (such as tighter fiscal policy) and also launch a series of House investigations. On the former, a debt-ceiling stand-off in 2H23 could hit investor appetite for US asset markets and weaken the dollar - and our baseline forecasts already assume that the dollar will be turning by that stage.

Back to the short term, it looks as though calls for an uninterrupted US equity rally into year-end are built on weak foundations and instead the core story of tighter US financial conditions will continue to dominate. Tomorrow's release of the October US CPI will have an important say here. An outcome in line with the consensus estimate of a 0.5% month-on-month rise in core inflation would likely keep expectations of Fed funds at 5% next year on track and keep the dollar supported.

DXY is trading back under 110 again and barring a very soft US inflation release tomorrow, we see very little reason for the correction to extend much further. Favour a 109.50-110.50 range in DXU into tomorrow's CPI. Barring the mid-term results, the US calendar is light today. Fed speakers are Thomas Barkin and John Williams, both seen to the modestly hawkish end of the Fed spectrum.

*Chris Turner*

## ➔ EUR: Unpacking the EUR/USD correction

EUR/USD is now around 5% off its late September lows. What has driven it? Fed communication has been reasonably hawkish and pricing of the Fed cycle is still near its highs - thus we cannot blame the correction on the Fed. What about a hawkish ECB? Two-year EUR:USD swap differentials have narrowed a little (10bp since the start of the month) and the 10-year US Treasury-German Bund spread has also narrowed 10bp this month, too. However, interest rate differentials have not been a big driver of EUR/USD over recent months.

What probably is making the difference are equity markets. Since early October, European equity benchmarks are up 11% versus the 5-6% recovery in their US equivalents. Some bottom-fishing in European assets markets (including FX) may be at work here. We would argue that both the Fed and the ECB intend to take real rates even higher to turn the inflation trajectory around - meaning that further equity gains remain challenging. Above 1.0090/1.0100 EUR/USD could briefly see 1.02, but we would be in the camp saying that this correction does not endure and would still favour a return towards 0.95 into year-end as the Fed tightens the monetary knot still further.

*Chris Turner*

## ➔ GBP: Holding pattern

UK policymakers will appreciate the fact the UK asset markets have fallen out of the financial headlines for the time being. The UK's 5-year sovereign CDS is flat-lining near 30bp, back where it was in early September, if not early August (sub 20bp). When it comes to expected volatility in FX markets, EUR/GBP 3m volatility is trading around 8.5% - back to early September levels, while 3m GBP/USD volatility is also consolidating just below 13% and way off the near 20% levels seen in late September. So it is fair to say that some calm has returned to sterling FX markets.

We continue to favour some sterling underperformance going into year-end, however. A tight UK fiscal budget on 17 November could be the catalyst to wipe a lot more off the expected Bank of England tightening cycle than is to come off the ECB cycle. And our call for a difficult, not benign external environment should see sterling soften again. EUR/GBP dips below 0.87 could provide hedging opportunities for European corporates with GBP revenue exposure.

*Chris Turner*

## **CEE: Difficult decision-making by the National Bank of Poland**

A heavy calendar continues today in the Central and Eastern Europe region. October inflation will be released in Hungary and we expect another jump from 20.1% to 21.0% year-on-year in line with expectations. The common drivers here will be rising processed food and services prices with some extra pressure coming from durables as well as the forint hitting its weakest level versus all the majors during October.

Later today, the National Bank of Poland's decision will dominate CEE markets. [We expect a 25bp rate hike to 7.00%](#), but our economists admit it will be a close call and unchanged rates are also a possibility. Inflation continues to rise, but on the other hand, the Polish zloty has strengthened significantly since the last meeting and the situation in the CEE region has generally calmed down, which should make the MPC more complacent and continue with its dovish rhetoric. Surveys are also expecting a 25bp rate hike and markets seem to be leaning on the hawkish side in our view. Hence, we believe the overall tone of today's NBP meeting and tomorrow's press conference will be dovish regardless of the pace of monetary policy tightening and the meeting will be negative for the Polish zloty, which has strengthened from levels around 4.850 to below 4.70 EUR/PLN in the last three weeks. Hence, we see the zloty vulnerable and furthermore, this is supported by the significant decline in the interest rate differential in recent days and the drop in costs of funding, which make it less expensive to be short the zloty. So as we mentioned earlier, we expect the zloty to trade above 4.750 EUR/PLN.

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