

FX Daily: Risk assets warmly greet Fed tightening

Far from choking off growth, the start of the Fed tightening cycle seems to have been greeted warmly by equity markets. Clearly, there are many factors at work here, but it is noteworthy that equity investors are cheering measures to address high inflation. We favour continued dollar strength against the low yielders and commodity FX to outperform



📈 USD: We favour selective gains for the dollar

As our team wrote in the [reaction to last night's Fed 25bp hike](#), there is clearly a lot more Fed tightening to come and the standout macro impact of the war in Ukraine is an inflationary one. As has been the case in Central and Eastern Europe over the last six months, the Fed debate will now turn to both the speed and magnitude of the tightening cycle, where any above consensus US data will spark calls for 50bp, not 25bp, adjustments. Let us not forget that there was quite a consensus view in the market that the Fed terminal rate would be around 2.00%. Last night the Fed told us that the median of FOMC members expected the Fed funds target rate to be 2.75-3.00% by the end of 2023.

Currently, the one-month USD OIS curve sees Fed funds peaking at about the 2.30% area in one year's time - suggesting there is plenty more room for USD money market rates to adjust higher.

The standout market reaction since the FOMC meeting has been the strong equity rally around the world. That the S&P 500 closed 2.2% higher after a hawkish Fed meeting is encouraging and suggests investors believe the best action the Fed can take now is to get inflation under control. Clearly, there are a few other factors supporting equities such as China's push to support growth (sending base metals higher yesterday) and some very cautious signs of progress in Ukraine-Russia peace talks.

What does this all mean for FX? A risk-on environment is generally seen as a mild dollar negative - as cash leaves from the safety of dollar deposits to be put to work. If this is the case, we would continue to favour the commodity currencies which are enjoying strong terms of trade gains and in the Australian dollar's case could now be supported by the Reserve Bank of Australia's tightening this summer after some strong February jobs data.

But an aggressive Fed should continue to see the dollar perform relatively well too. Dollar gains, however, should be concentrated against the low-yielders. The clearest trend will be a higher USD/JPY, where a dovish Bank of Japan and Japan's large negative income shock from the fossil fuel rally will send USD/JPY to 120 and possibly 125 later this year. We also think the dollar can hold/build on gains against European FX too.

For today, there is only second-tier US data release and the focus will remain on events in Europe and also the wild gyrations in the commodity sector. DXY is consolidating near the highs and we would still favour a push to 100 near term.

➔ EUR: Let's hear from the ECB

We are a little surprised that EUR/USD did not stay offered near 1.0950 after the FOMC meeting, but the global rally in risk assets must be playing a role here. After a hawkish FOMC meeting, we today hear from several European Central Bank speakers at an ECB watchers conference, including President Christine Lagarde (1030CET), Philip Lane (1115) and Isabel Schnabel (1345). After the Fed's success with a hawkish message and some suggestion from sourced reports that the ECB was unhappy with EUR/USD sub 1.10, ECB speakers may be happy to support expectations that the deposit rate is raised 35-50bp by the end of the year.

EUR/USD could nudge a little firmer on a risk-on day, but we favour gains to stall ahead of the 1.1100/1120 area. As Francesco Pesole [wrote yesterday](#), we think that the negative terms of trade shock suffered by Europe has done some lasting damage to the euro's fair value. So we are not in the camp looking for an immediate snap back to pre-war 1.13-1.15 levels and prefer a move back to 1.08 this summer.

Elsewhere, the offshore USD/RUB is trading sub 100. Rather than this being a positive re-assessment of the rouble's prospects, we think it is a function of a dislocated market. Rouble gains are coming with overnight rouble implied yields at 700%, suggesting offshore names are struggling to get hold of rouble liquidity to e.g. rollover short rouble positions. Also, look out for whether the National Bank of Hungary adjusts its 5.85% one-week deposit rate today. Probably not given the forint has had an impressive rally. But given our bearish EUR/USD outlook, we do tend to have a view that the CE4 FX recovery has come too far, too fast.

➔ GBP: Another 25bp from the BoE today

The Bank of England is widely expected to hike the Bank Rate to 0.75% today. The market prices the Bank Rate close to 2.25%, yes 2.25%, by the end of this year. GBP pricing will be driven by when the BoE feels the need to disabuse the market of this notion. There are many thinking that this will come today and have probably positioned for a GBP sell-off.

Should the BoE continue to prefer a strong GBP to insulate against higher natural gas prices and the run-up in CPI to 8% this April, it could choose to delay a rate protest until later in the year. Our preference is for GBP holding gains through the first half of this year - and EUR/GBP continuing to trade near 0.83. If we are wrong and the rate protest comes today, EUR/GBP could spike to the 0.8480/8500 area.

➔ EM: The wild ride in emerging market FX

Emerging market FX implied volatility continues to trade near the highs seen in March 2020 - and it is not hard to see why. Over the last week, we have seen USD/CNY bounce around on the view that the People's Bank of China (through weaker fixings) might prefer a weaker currency. Yet Asian FX has come back strongly over the last 48 hours on the view that China is prepared to do more to reflate its economy - including buying local equity markets.

CEE FX continues a wild ride on the news in Ukraine. We do suspect that the rally has come far enough for the time being. And Latam FX continues to enjoy its positioning - both in terms of geography and as a commodity exporter. Last night, Brazil hiked another 100bp to 11.75% and promised to take rates to 12.75%. Expect continued Latam FX outperformance for the time being - though for choice we would prefer the North American currencies of the Canadian dollar and Mexican peso - especially on the cross rates against the Japanese Yen.

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