FX Daily: Soft landing seems wishful thinking

Global asset markets have rallied after FOMC Chair Jay Powell suggested that the Fed's tightening trajectory might not be as extreme as some of the most hawkish expectations. Yet it seems wishful thinking, at least now, to expect the Fed to thread monetary policy through the eye of the needle and deliver a soft landing. Expect the dollar to remain bid on dips

USD: Sizing the dollar correction

The dollar is weaker across the board after last night's FOMC meeting. One could be forgiven for thinking this was a dovish hike given the market reaction. The catalyst for the move seems to be Powell's remarks in his press conference that 75bp increment adjustments were not on the table. Despite the 1% correction in the dollar, US interest rate markets have not really moved that much. Pricing of the Fed terminal rate in 2023 has perhaps come 10-15bp off its highs, but at 3.20% is still higher than it was a few weeks ago.

A sustained decline in the dollar would require confidence that the Fed can deliver an orderly tightening cycle, taking the steam out of the US economy and delivering a soft landing. It seems far too early to make that call given the lingering fears of inflation and the risks - as we have seen over the last 12 months - that the Fed cycle is re-priced even higher were, say, the Dot Plots in the June FOMC release to project the policy rate well over 3% in 2023.

Instead, then, the broad sell-off in the dollar looks more a function of a technical correction to overbought conditions. DXY could well find support in the 102.00/30 area as we await tomorrow's US April nonfarm payroll release. Following last week's Employment Cost Index shock of a 1.4% quarter-on-quarter increase, another strong rise in average earnings tomorrow warns that the Fed has its work cut out in trying to keep inflation under control.

EUR: 1.0650 may be the EUR/USD corrective high

EUR/USD has participated in the dollar sell-off, but we think there is a chance that the rally stalls ahead of the 1.0650 area. As above, it seems too early to position for the type of orderly Fed policy normalisation which would create benign conditions for the global risk environment. Instead, challenges both in Europe and China create many headwinds for the pro-cyclical euro. On the former, the EU is close to agreeing on a Russian oil embargo, which will hit growth prospects. On the latter, China's April Caixin PMI plummeted and is consistent with lower growth prospects as China navigates its way through the pandemic. The balance of risks suggests it is hard to make the case for a meaningful EUR/USD rally.

Elsewhere in Europe today we have rate meetings in the UK and Norway (see below) and also in Poland and the Czech Republic. Our Polish team is looking for a 100bp hike in Poland, taking the base rate to 5.50%. We like the zloty on a multi-quarter view and see it towards 4.50 by year-end, though investors and corporates will be unlikely to chase zloty gains in the short term given the uncertainty to the East.

In the Czech Republic, we are looking for a 50bp hike to 5.50%. EUR/CZK could prove quite volatile today as the Czech National Bank could project rate cuts next year. There is also a slim outside risk of a smaller 25bp rate hike, with a more conservative stance taken. At the moment, money markets seem to have fixed on 5.75% as the top of the cycle.

GBP: BoE to hike 25bp today, volatility assured

It is a big day for UK monetary policy, where the Bank of England is expected to hike 25bp to 1.00% and potentially start discussing active Gilt sales. Please see our full scenario analysis here. It is probably a little too early to look for a hard sell-off in sterling on today's meeting, but volatility looks assured.

NOK: Norges Bank should stick to its plans

Norges Bank will also announce monetary policy today, and consensus expectations are for no changes in the deposit rate in what is an interim meeting. This would be in line with what had been signalled in the rate projections, and we see no obvious reason why Norges Bank should diverge from its recent habit of sticking to its projections. We expect a short statement announcing that rates will likely be raised again at the June meeting.

There is some ongoing speculation that Norges Bank might use this meeting to signal an acceleration in its projected monetary tightening, but we are more inclined to think it will delay any adjustments in the policy message till June. The impact on the krone should be contained and if anything could be slightly negative as some hawkish expectations are defied.

From a longer-term perspective, NOK seems to have suffered too much from its high beta to global risk sentiment recently and still has to reconnect with a highly supportive commodity environment and rate advantage. We continue to expect a gradual depreciation in EUR/NOK and target 9.40-9.50 by year-end.

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