FX Daily: Strong dollar at the end of central bank week

The dollar is enjoying good momentum after a week full of central bank decisions. Strong US data yesterday combined with a couple of dovish surprises from other central banks (Switzerland in particular) to give USD support. However, with the Fed having sounded optimistic about disinflation and rate cuts, we are not sure the dollar rally has legs

USD: End-of-week rally looks overdone

The dollar has found good support since yesterday afternoon when some US data prompted a USD/risk-off rally. The Leading Index printed a positive month-on-month number for the first time in two years, likely thanks to the strong equity performance and a weather-related rebound in the average work week. Existing home sales also surprised on the upside, rising from 4m to 4.4m. Consensus was understandably for a decline given mortgage applications have been falling. S&P PMIs were also published yesterday and showed good resilience in manufacturing, but slightly softer services.

The jump in the dollar appears overdone. The Federal Reserve sent a rather clear message earlier this week: some resilience in activity data won't be a barrier to cutting as long as inflation shows downward momentum. The USD two-year swap rate climbed by some 5bp after yesterday's data, but remains 5bp below the pre-FOMC levels. The dollar rebound appears to have exceeded the rebound in rates. We suspect the central bank's dovish surprises in Switzerland (rate cut) and the UK (less hawkish narrative) have contributed to the strong dollar momentum.

Today, we'll take a look at new home sales, and activity indices by the Chicago and Dallas Fed. There are also a few Fed speakers on the calendar: Chair Jay Powell participates in a Fed-organised event along with Vice Chair Philip Jefferson and Governor Michelle Bowman. Michael Barr and Raphael Bostic are also due to speak.

As things stand, we don't see the dollar rally having legs. As the dust settles after a very busy week for global central banks, we suspect markets may scale back long USD positions as the relatively dovish message by the Fed should still resonate. Our view is that key March US data, released in the first half of April, can pave the way for a more sustainable dollar decline.

Francesco Pesole

EUR: Manufacturing concerns deepen

Eurozone PMIs continued to paint a grim picture for the region's manufacturing outlook. In Germany, Manufacturing PMIs continued to grind lower despite expectations of a rebound. It now appears clear that the mild optimism around the turn of the year was likely misplaced. That is not hugely relevant for the FX market, anyway. The soft economic outlook in the eurozone has been priced in for a while, and with markets relatively confident about a June European Central Bank cut (23bp priced in), it's mostly dollar rate expectations that are set to keep moving EUR/USD.

It remains unlikely that the pair can enjoy a sustained recovery without a decline in USD rates, but we discussed above how yesterday's positive dollar reaction to US data appeared overdone considering the recent narrative by the Fed, and we don't feel EUR/USD should fall much further before bottoming out.

Elsewhere in Europe, Norges Bank remained generally hawkish as it kept rate projections unchanged and signalled rate cuts should only start in the autumn, and will be gradual. We have continued to hear Governor Ida Wolder Bache sounding rather concerned about the weak NOK-higher inflation risks if rates are cut too soon. Indeed, the soft performance of the krone since the start of the year does not give her reasons to sound more relaxed on this topic. We continue to see good upside potential for NOK once USD rates start moving lower, with Norges Bank's cautious tone on policy and focus on the domestic currency performance offering a good basis.

Francesco Pesole

GBP: A modest dovish shift by the BoE

The Bank of England opted for a more dovish than expected communication yesterday. Despite keeping its guidance unchanged (rates to be restrictive for an extended period of time), the two most hawkish members changed their vote from a hike to a hold, and there was a mention in the minutes that rates can still be restrictive even with rate cuts.

All this isn't hugely surprising, after all the real policy rate has continued to inch higher with inflation declining. Still, markets are largely reading this as an acknowledgement that cuts aren't too far away, and now increasingly convinced the BoE will start easing in June (20bp priced in), along with starting to speculate on a May move (7bp priced in).

Our economics team has maintained its call for cuts to start in August, but June is not an unreasonable expectation. The softness in GBP is something that we had expected given we have long been more dovish than markets on the BoE, but might have come a bit earlier than what we have anticipated. EUR/GBP may struggle to find much more support above 0.8600 as UK data still has to validate the recent repricing of the Sonia curve.

Francesco Pesole

CHF: SNB cut paves the way for more CHF weakness

The Swiss franc was dealt a blow yesterday as the Swiss National Bank unexpectedly cut rates by 25bp. Markets were pricing in around one in three probabilities of a cut yesterday, and the decision led to a broader repricing in the CHF curve. A back-to-back 25bp cut in June is almost fully priced in (21bp), and markets are expecting another one by year-end. Our economist thinks cuts in June and September now look likely. That would take the policy rate in Switzerland back to 1.0%, with another move potentially lowering it to 0.75%.

The EUR-CHF rate gap – a key driver of EUR/CHF – is set to prove supportive for the pair beyond the short term. We suspect markets are wrong in pricing in more than 75bp of easing by the ECB this year, while the SNB rate expectations can face further dovish repricing.

Crucially, the SNB's policy statement made two references to the strength of the franc in real terms, meaning the FX intervention tool can now be used to weaken the currency. Things may quiet down in EUR/CHF now, especially as markets may have an inclination to price in more cuts by the ECB, but selling the rally in the pair remains risky, and a gradual climb towards parity is a more likely outlook.

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