

FX Daily: Testing the market's cautious optimism

Yesterday's tentative recovery in risk sentiment will be tested today as investors still deal with the unresolved regional bank crisis in the US and AT1 bond market turmoil in Europe. Barring clearly positive developments in the banking sphere, we suspect the approaching Fed announcement (tomorrow) could favour some defensive dollar positions today



US Federal Reserve building in Washington, DC

USD: FOMC risk event draws closer

Today's session will really be a test of the sustainability of yesterday's rebound in risk sentiment and pro-cyclical European currencies. The market's focus in Europe appears to be on the vulnerability of Additional Tier 1 bondholders after the Credit Suisse acquisition deal by UBS saw AT1 bonds being wiped out. European regulators and central bankers are now attempting to restore confidence in the AT1 bond market, which now poses a major threat to any extension of the recovery in investor sentiment in the region.

In the US, the regional bank turmoil remains far from resolved. The Treasury is reportedly seeking legal paths to expand the FDIC insurance to all deposits greater than \$250,000 following requests

by multiple banks concerned about contagion risks and further deposit outflows. The core of the issue is whether the Treasury ultimately holds the authority to expand that insurance without the approval of Congress. The market impact of such emergency measures has not proven to be unilateral during the ongoing banking crisis, as officials are often walking a very thin line between offering a backstop against systemic risk and risking an exacerbation of the ongoing banking turmoil by sending the “wrong message” of mistrust in the banking system.

This is a similar kind of conundrum to that faced by the FOMC as it starts its two-day meeting today. A 25bp move, which is still narrowly our base [case](#), can either be read as a sign of confidence in the financial sector and a reiteration of the inflation focus – remember the Fed already deployed a funding facility and boosted USD swap line to ease financial stress – or as a policy misjudgement that could accelerate banking troubles. On the flip side, a hold may either reassure investors or be interpreted as a de-facto sign of alarm.

What is undoubtful is that tomorrow’s rate announcement will be a big risk event, and markets are only pricing in a 60% chance of a hike. From an FX perspective, we wouldn’t be surprised to see the dollar – which fell yesterday as risk sentiment rebounded – find some support into the FOMC announcement as markets turn more defensive and potentially factor in a greater risk of a hawkish scenario.

Francesco Pesole

EUR: Lagarde has a new motto

The post-European Central Bank meeting period has been a rather crucial one for the Bank’s communication in recent times, and the current fast-developing environment makes incoming comments highly valuable for markets. Yesterday, President Christine Lagarde reiterated her new motto: there is no trade-off between financial stability and price stability. The recent big change in rate expectations across major central banks during the ongoing banking crisis might argue against her point, but her message is a clear one (and to a certain school of thought, a necessary one): the ECB will keep the monetary (inflation-oriented) and financial stability tools separated – at least as long as it is feasibly possible. We’ll see whether the Federal Reserve repeats this rhetoric tomorrow.

Still, the impact on the euro of ECB speakers is probably not very significant at the moment. First, unlike in other instances, it seems like there has been no communication gap between markets and Lagarde at last week’s press conference. Second, higher rate expectations on the back of hawkish rhetoric are not a short-term EUR driver in the short-term at the moment, as the common currency is trading strictly in line with risk sentiment and on news about the banking sector. The ability of European regulators to restore some calm to the AT1 bond market appears a necessary condition to keep EUR/USD supported, even though we think some USD recovery is possible into the Fed meeting.

Lagarde will speak again today, along with French governing council member Francois Villeroy, although both are participating at an event about CBDC, where monetary policy may be only a side topic, if anything. On the data side, we’ll start looking at a some March activity surveys ahead of Friday’s PMIs: the German ZEW is released today, and expected to show a mixed picture after recent improvements.

Francesco Pesole

📉 CAD: Inflation a secondary factor

Inflation data for February will be published in Canada today. Consensus expectations are for a 0.5% month-on-month reading and a deceleration from 5.9% to 5.4% in the year-on-year CPI. The Bank of Canada's preferred measure of inflation should also decelerate. All this should endorse the BoC decision to stop tightening and give very few hints that there is a need to reconsider this policy pause. The bigger incentive to stay put from now on is, however, the recent banking crisis in the US, which is seeing the Canadian dollar perform quite poorly compared to other high-beta currencies, likely due to Canada's vicinity and exposure to the US financial system.

Today's inflation may have a very limited impact on CAD given the BoC's recent stance. CAD should continue to lag other pro-cyclicals on any rebound in risk sentiment unless there is a clear stabilisation in market sentiment on the US banking sector. At the same time, the BoC's dovishness is likely lowering the medium-term attractiveness of CAD: we continue to expect a drop below 1.30 in USD/CAD by the second half of this year, but that should primarily be a consequence of USD weakness rather than idiosyncratic CAD strength.

Francesco Pesole

📈 CEE: Forint signals a turnaround in the region

Yesterday's monthly industrial and PPI data in Poland reflected a stagflationary [picture](#) rather than a disinflationary one. Today's releases will also again come from Poland. Retail sales fell 1.4% YoY in February according to our estimates, roughly in line with market expectations. However, we can expect the CEE region to continue to be driven mainly by the global story.

The FX market yesterday showed signs of relief coming from the core markets as the Hungarian forint closed trading with a 0.75% gain and the rest of the region was essentially flat, showing that unless the global situation escalates further, we have peaked in the region. As we mentioned earlier, the Hungarian forint currently has the highest beta to global sentiment and risk aversion and should be the first to signal a turnaround in CEE FX. Yesterday's move could thus be the first hope for easing conditions in the region. In addition, the National Bank of Hungary and the Czech National Bank will get their say as early as next week. We think both central banks will maintain a hawkish tone given the currently weaker FX in an effort to support currencies and help each other fight inflation. Thus, unless the global story brings further negative surprises in the meantime, both currencies, in our view, have decent potential for a recovery in the days ahead. However, we will need to see a more pronounced decline in risk aversion for bigger gains. For now, we see room for a move to 393 EUR/HUF and 23.85 EUR/CZK.

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