

FX Daily: Testing the reaction function

Inflation remains the hot topic in global financial markets and FX will be driven by how central banks respond. This week should culminate in some decent US jobs gains which should keep the Fed on track to taper and then tighten. The dollar will be supported on dips. Central banks still viewing inflation as transitory will see their local FX underperform.



📈 USD: Strong domestic economy to keep dollar supported.

The US economy continues to perform well and, despite growth fears emanating from China, US manufacturers [remain optimistic](#). At front and centre for FX markets at present is how central banks look set to react to higher inflation. Many, particularly in emerging markets, have been tightening aggressively to keep 2022/23 inflation expectations in check. Norway has been the first of the G10 central banks to tighten and this week should be followed by New Zealand. Others, like the Fed, the BoE and the BoC have been laying the groundwork for tightening in 2022.

Yet central banks in the Eurozone, Sweden, Switzerland, Japan and Australia still tend to view the current spike in inflation as transitory. The members of this 'transitory' camp have seen their currencies underperform and arguably this makes sense. These central banks maintain a

reflationary mind-set, where a weaker currency is consistent with monetary policy. Not many central banks have joined the more mercantilist approach of the PBOC in engineering a strong currency to reduce commodity costs - although it is fair to say not many central banks have as much control over local exchange rates as the PBOC does.

As we discuss in the [G10 Week Ahead](#), we see the dollar staying bid on dips into Friday's jobs report, where a +400-500k increase should leave the Fed on a glide path to a November taper. For today the focus will be on whether we hear anything more from Evergrande and whether OPEC+ decides to increase supply by more than 400k barrels per day in November. A surprise supply increase in excess of 400k could help crude correct a little lower and unwind some of the recent out-performance of NOK and RUB. Yet we still like both those currencies on the gas stories and hawkish central banks.

DXY should find support at 93.50/70 this week.

➔ EUR: Looking out for ECB speakers

As noted above, how central banks respond to the inflation surge will be a key determinant of currency performance. So far the big hitters from the ECB remain resolutely dovish and this week we will see many ECB speakers and also the release of the minutes from the September ECB meeting. Interesting for us will be to see what the ECB felt about their inflation forecasts, which look too low.

EUR/USD is consolidating after breaking decent support at 1.1670/1700 last week. We would favour the correction stalling before the 1.1635/50 area and see scope for EUR/USD to press 1.1500 later in the week should payrolls come in on the strong side.

Elsewhere in Europe, we're looking at how central banks respond to inflation. Our team expects [Romania to hike tomorrow](#) and lend some support to the RON. Poland has a rate meeting this week, although policymakers have made clear that November should be the start of the tightening cycle. EUR/PLN is selling off and the PLN FRA market is pricing a tightening cycle to 1.50% next summer. But as our Polish team [point out](#) the NBP may well disappoint tightening expectations in November. As such we would not chase this EUR/PLN move lower.

Turkey has just released September inflation where both headline and core inflation have both risen. The CBT's decision last month to cut rates should still leave the TRY vulnerable - especially with high energy prices damaging Turkey's trade balance.

⬇ GBP: Brexit hangover

GBP has been volatile - caught behind a surprisingly hawkish BoE and lingering Brexit travails - particularly over the sea border with Northern Ireland. Both topics hit the agenda today. BoE's Dave Ramsden speaks at 14CET. He was one of the two MPC members voting for the BoE to end QE early. Later in the day we should be hearing from Lord Frost at the Conservative Party Conference. Here he may shed light on whether the UK government wants to fire up the [Article 16 protocol](#) - potentially opening up a can of worms again.

Given that we like the dollar over coming months, we suspect this Cable bounce stalls at the 1.3570/3600 break-out area and could drop back to 1.32 later this month. The very dovish ECB means that EUR/GBP looks more a 0.85-0.86 story.

📈 CNY: Enjoying high-yield quasi dollar properties

China is closed until Friday. That means USD/CNH will not stray too far from the onshore USD/CNY rate of 6.4435. CNH implied yields are a handsome 3%+ per annum. As we have been discussing this summer, we think the PBOC is keeping the CNY strong to insulate against higher commodity prices. Securing strategic energy supplies certainly seems a top priority now for China and they are using a stronger Renminbi to boost purchasing power.

The CNY is therefore playing the role of high yield, quasi dollar and should continue to perform well against low-yield currencies with dovish central banks and on the wrong side of the energy story. The JPY falls into this latter camp.

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