FX Daily: The big unwinding

Carry trades are being rapidly unwound as volatility starts to pick up again. The overbought Mexican peso and easing-affected Brazilian real remain in a vulnerable position. In China, conservative PBOC CNY fixing isn't adding fuel to the dollar rally this morning, although Powell's hawkish comments are keeping front-end yields supported

The Fed's Jay Powell acknowledged slower progress on inflation and hinted at rate cut delays

We have just published the April edition of FX Talking, which includes our latest views and forecasts for G10 and EM currencies.

USD: Powell and carry trade unwind keep helping USD

This week has so far seen the largest change in DXY weighted-average 3-month implied volatility since September 2023. That gauge has moved from the 6.00 lows to 7.37 since the start of this month, completely reversing the decline started in February. Measures of EM FX volatility have also rebounded to two-month highs; average rates volatility is at YTD highs and the VIX index at 6-month highs.

We spent several months discussing how a low-volatility environment due to highly correlated sticky global rate expectations had made carry trade enormously popular in FX into the new year. Our original thought was that a break lower in USD rates would have prompted a gradual unwinding of those trades. As rates go sharply in the opposite direction, that unwinding is proving anything but gradual. The high-yielding Brazilian real, Mexican peso, Indonesian rupiah and Polish zloty have dropped between 2% and 3.1% since the start of the week.

The magnitude of downside risks for these currencies also depends on positioning and ongoing domestic easing cycles. For instance, MXN is one of the most exposed EM currencies to long-squeezes, with CFTC reporting speculative futures positions at 45% of open interest last week. At the same time, some currencies had been shielded from domestic rate cuts as the rate advantage was still attractive in a low-volatility environment. Now we can see a delayed, but abrupt relinking of those currencies with their lower real implied yield: that is the case of the BRL, which had stayed below 5.0 vs the USD from November until this April selloff, and could be discounting Brazil's central bank 300bp of cuts. The Chilean peso is in a similar situation.

Looking at the dollar, China's PBOC FX policy proved to be an additional source of USD strength yesterday. This morning, the PBOC set the fixing at 7.1025, almost unchanged from yesterday's 7.1028, therefore failing to assist further renminbi weakness. USD/CNY is trading at 7.2400, and USD/CNH has moved marginally below 7.2600, effectively reversing yesterday's jump. Still, as discussed in yesterday's FX Daily, the broad-based decline in China's trading partners' currencies has made the renminbi strengthen on a trade-weighted basis, and with soft inflation and export figures in China, it is not unthinkable that the PBOC is now more at ease with letting CNY gradually slip now.

If the PBOC hasn't offered additional bullish arguments to the dollar this morning, some Fedspeak yesterday surely did. Both Chair Jay Powell and the often dovish-leaning Vice Chair Philip Jefferson acknowledged the slower progress on inflation and hinted at delays to cutting rates. That helped 2-year treasuries briefly touch 5.0% for the first time since November. We'll see how long US equities can stay strong in this environment: a sell-off in stocks would be the final element for a perfect USD storm. The risks remain tilted to further dollar gains, and DXY is eyeing the 107.00 October high.

Francesco Pesole

EUR: Divergence in narratives

EUR/USD is about to test the 1.0600 psychological level, but it seems unlikely this is will be a strong technical support. Instead, the next big supports may be at 1.0500 and the 1.0450 October low. Crucially, the lack of market moving data releases and the dollar drawing benefits from other FX developments (CNY depreciation, EMFX weakness) means a move to the 1.05 area in the near terms is a rather tangible risk.

The divergence between the Fed and the ECB narratives was underscored by Powell and Lagarde yesterday, with the former signalling tightening for longer and the latter confirming the ECB is ready to cut rates soon if inflation keeps easing. Today, we'll see the final print for March's CPI in the eurozone: even minor downward revisions can add pressure on the euro as markets move to fully price in a June ECB cut (currently 21bp in the price) and increase bets on a back-to-back move in July (34bp priced in).

Francesco Pesole

GBP: Services disinflation still too slow

UK CPI for March released this morning was a bit stronger than expected. While key measures of inflation declined from February, services CPI – which is what the Bank of England is mostly looking at – only slowed from 6.1% to 6.0%, against consensus and the BoE itself projections for 5.8%.

Along with yesterday's stickier-than-expected wage figures, it is looking increasingly likely that the first rate BoE cut will only come in August. Our UK economist, however, notes that next month's figures are crucial since April is when we get a load of annual price hikes across the service sector in the UK, and last year, this was a source of big upward surprise.

For now, the divergence between ECB and the BoE can keep EUR/GBP capped, and we forecast the pair to stay closer to 0.8500 than 0.8600 in the next month.

Francesco Pesole

NZD: Non-treadable CPI bump endorses hawkish RBNZ

First-quarter CPI data in New Zealand brought bad news for the RBNZ. While headline inflation matched expectations in declining from 4.7% to 4.0% YoY, non-tradeable inflation decelerated only marginally from 5.9% to 5.8% YoY (1.6% QoQ), against consensus expectations. Non-tradeable CPI is a gauge that has been monitored closely by the RBNZ as they attempt to isolate underlying price pressures from commodity-driven swings in the headline rate.

As discussed in this note from February, we think slow non-tradeable inflation mirrors the ongoing pressure from the sharp rise in net immigration in New Zealand. While the RBNZ has refrained from making a clear call on whether the rise in population is having a net-inflationary effect (since it also eases labour supply constraints).

We think today's data in New Zealand endorses the hawkish stance displayed by the RBNZ at the April meeting. Markets are pricing in 35bp of cuts by year end, and that starts to look like a reasonable expectation. Our call is for 50bp of easing in New Zealand this year, starting from October, although there are risks that an immobile Fed and sticky inflation in New Zealand force the RBNZ to deliver only 25bp or none at all.

The Kiwi dollar did not rise at all after the CPI release despite a 7bp selloff in 2-year NZD rates. The centrality of risk sentiment in NZD trading now makes domestic factors almost irrelevant. NZD/USD may extend its slide to the 0.5800 support in the near term.

Francesco Pesole

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Disclaimer