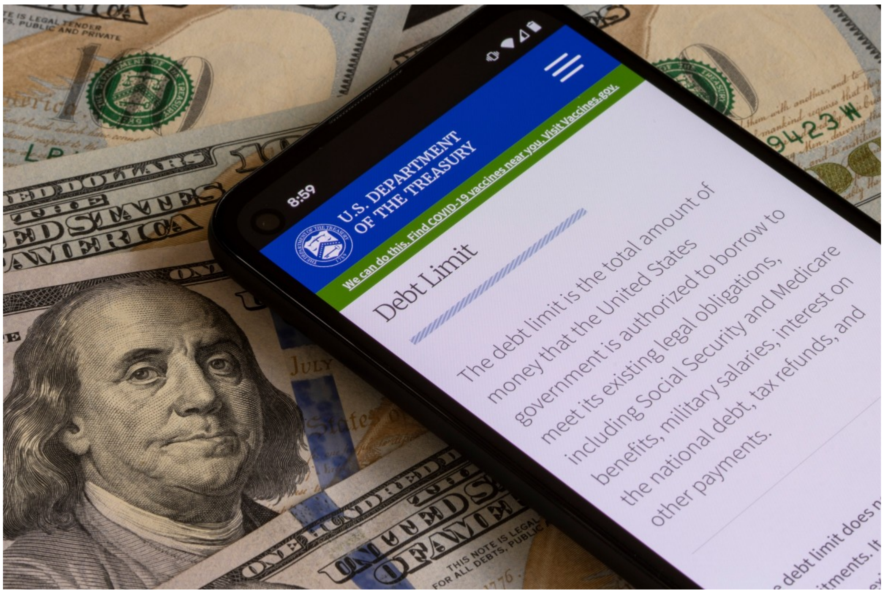
FX Daily: The ideal mix for the dollar – for now

A US debt ceiling deal is inching closer, and while the rebound in equities has been somewhat contained, pressure on bonds remains substantial. Contributing to that were hawkish comments by Fed's Logan and lower-than-expected jobless claims, which translated into another round of Fed hawkish repricing. It's an ideal mix for the dollar – for now



A US debt ceiling deal inches closer as talks continue

USD: Rates lifting the dollar

The dollar has continued to build bullish momentum, drawing strength from the repricing in Federal Reserve rate expectations now that risk sentiment seems to stabilise as a bi-partisan deal on the debt ceiling looks more feasible. Republicans are demanding stricter work requirements for social safety net programmes, a point the most liberal branches of the Democratic parties have firmly opposed. It seems, however, that President Biden may ultimately budge on this point, and House Speaker McCarthy said yesterday that an "agreement in principle" may be ready by this weekend.

The market reaction to the optimistic turn in the US debt ceiling story seems to be perfectly fitting a bullish dollar narrative as equities have stabilised, but failed to show a substantial rebound (the Dow Jones remains below the levels it was trading at 10 days ago). The clearest reaction has been once again in the bond market, with yet another bearish session for Treasuries. 10-year yields pressed above the 3.60% mark, the highest since March; 2-year USD swaps have risen to 4.45%, highest since mid-April. Against this market backdrop, a stronger dollar across the board is a natural reaction in FX.

The large move in rates was the consequence of markets seeing a potential debt-ceiling deal as a positive development for the US economy, but there were other contributing factors at play: initial jobless claims fell more than expected yesterday, and Federal Open Market Committee (FOMC) member Lorie Logan hinted that another hike is still possible given sticky inflationary pressures. The re-pricing in Fed rate expectations has been substantial. Only a week ago, markets were pricing in no chances of a rate hike in June and 75bp of cuts in December. Now, the Fed Funds Future curve embeds a 33% implied probability of a 25bp hike in June, and around 50bp of cuts by December.

It's hard to buck the dollar's bullish momentum now, as we also think some substantial squeezing of short USD positions can be behind the move. Today. We'll hear from Fed Chair Jerome Powell and he will probably have some interest in keeping a hawkish rhetoric alive, ultimately adding a bit more pressure on bonds and support to the dollar. A US debt-ceiling deal may be announced, but that appears to be mostly priced in by now.

We argue that the sustainability of this kind of dollar trend strongly relies on hard data confirming price pressure remain elevated and the US economic outlook stable. This may be a story for the near-term, where the dollar can still find some support, but we see the second half of the year as the period where evidence of sharply slowing US economic activity will force large cuts by the Fed and cause a rapid dollar depreciation.

Francesco Pesole

EUR: Squeezing still in progress

EUR/USD broke below the key 1.0800 level, although – as highlighted above – largely mirroring some drastically changed picture in terms of Fed rate expectations and rising USD rates. A key driver of the EUR attractiveness over the USD recently was indeed the notion that the Fed had reached the peak while the European Central Bank had still some way to go with tightening. The latter remains true, but a market that is now re-entering bets on a June hike by the Fed after Logan's comments seriously dents the underlying bullish narrative for EUR/USD.

We must remember that EUR/USD was the biggest G10 long positions entering the US debt-ceiling chaos, and since the latest development turned out to be positive for the dollar, we are probably seeing a substantial long-squeeze in the pair. There is considerable room for a hawkish repricing in Fed rate expectations, so it's risky to pick a bottom in EUR/USD. The next real support level will probably be at 1.0700.

Domestically, ECB President Lagarde and Isabel Schnabel will speak today, but the impact on the euro will likely be relatively contained.

Francesco Pesole

GBP: Quiet domestic drivers

GBP/USD is being driven almost entirely by the dollar leg at this stage, with comments by some Bank of England officials yesterday not having a sizeable FX impact. Governor Bailey said the BoE balance sheet will not return to pre-2008 levels, and Dave Ramsden signal a potential acceleration in the pace of quantitative tightening.

EUR/GBP has remained quite depressed, we think that EUR is probably still experiencing some bigger long-squeezing effect, but the UK inflation next week (24 May) is a major risk event for the pair and we see upside risks given considerable room for markets to price out BoE tightening. We still target 0.88-0.89 this summer.

Francesco Pesole

SEK: Left without a floor

We published a note yesterday discussing how the Riksbank has made the krona's path to recovery even narrower. The core of the issue for SEK is that the two votes against a 50bp hike back in April thwarted the main tool that the Riksbank was using to offer SEK a floor against adverse market moves: its own hawkish stance. Now that those adverse market moves are materialising, we are seeing SEK matching the losses of NOK, something that was not happening until the April Riksbank meeting.

With recent CPI data endorsing the narrative of the Riksbank's doves, it seems increasingly unlikely the Bank will be able to establish that SEK-supportive hawkish narrative in June. That is, unless we see an above consensus read in the May CPI figures. Until then, SEK should remain vulnerable. EUR/SEK may break above the 11.43 April highs and explore the 11.50/11.60 area, last seen in 2009.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com