FX Daily: The moment of truth

The Fed may well match market expectations and hike by 75bp today. We cannot exclude some "sell-the-fact" reaction in the dollar, but any correction should be very short-lived, and the overall outcome should be USD-positive beyond the very short term. Elsewhere, markets are awaiting headlines from the ECB's ad-hoc meeting about fragmentation.

USD: 75bp by the Fed today

We approach FOMC day with a deeply changed picture in global markets and rate expectations compared to a week ago. Investors have now fully aligned with the view that the Fed will hike by 75bp today, following the unexpected acceleration in CPI and inflation expectations in May and media reports suggesting the option was being discussed by policymakers. While a 75bp move is not certain, we doubt such potential “leaks” to the media are a coincidence, and they do appear to us as a (successful) attempt to adjust expectations during the blackout period and prepare markets for the larger increase.

Accordingly, our base case scenario is a 75bp hike today. Markets are fully pricing in such a scenario, and the updated set of projections – in particular the dot plots – will be key in driving the market reaction. From an FX perspective, we expect the outcome of today’s meeting to be overall positive for the dollar's short-term outlook. This is not to say that the dollar's immediate reaction will necessarily be positive today, as there are indeed multiple scenarios where the Fed may fall short of expectations (the market-implied terminal rate is above 4% after all); by all means, some "sell-the-fact" dollar correction today after a big rally is possible.

However, we think any dollar correction will be quite short-lived, as we deem it unlikely that investors will turn materially less bullish on USD in an environment of accelerating Fed tightening, sharply rising Treasury yields (and inverted yield curve), the prospect of a global slowdown and equities in bear-market territory. We think DXY may have found a floor around 104.00, and any drop beyond that point may see increasing buying pressure.

The data calendar includes the Empire Manufacturing index and May's retail sales. The former should rebound and the latter should slow down, but the impact will likely be negligible given the proximity to the Fed risk event.

EUR: ECB stepping in on fragmentation?

The European Central Bank's Governing Council has announced it will hold an ad-hoc meeting today "to discuss current market conditions". Since most of the price action in the eurozone's bond market since last Thursday's ECB meeting has been about fragmentation, markets are likely making the association that the meeting will aim to actively discuss an anti-spread tool which was expected to be announced at the July meeting. The move to call an ad-hoc meeting appears to be in contrast with what we heard from Isabel Schnabel yesterday, who appeared to see no urgency to pre-announce any measure to reduce bond-market fragmentation.

The 10-year BTP-Bund spread has returned to the centre of market focus, having widened around 40bp in a week and now approaching the levels last seen at the peak of the pandemic-induced market turmoil in 2020. Futures point to a 20bp rally in Italian yields after this morning's ECB headline.

Markets will now await some ECB headlines sometime today, and all this should make the long list of ECB speakers even more interesting to watch. The main speech will come from Christine Lagarde this afternoon, but we'll also hear from three hawks this morning – Robert Holtzmann, Joachim Nagel and Georg Muller – and another one – Klaas Knot - later in the day. On the more dovish front, we'll hear from Pablo Hernández De Cos, Fabio Panetta and Mario Centeno.

So, we could indeed see some action in EUR/USD – which has risen to 1.0450 after the ad-hoc meeting news – before the Fed meeting, which will later drive nearly all market moves. As highlighted above, there are some risks of a small correction in the dollar today, and if this combines ECB steps with some reassurance for Italian bonds, we might see a mini-rally in EUR/USD today to the 1.0520-1.0550 mark today. However, as we see any dollar correction as short-lived, our base case remains a return to sub-1.0500 levels in the coming days.

GBP: Negatives piling up

The pound briefly traded below 1.2000 at the end of yesterday's session, having fallen to the March 2020 lows. It does appear to us that a lot of negatives regarding a slowdown in the UK economy are in the price, but there is still some downside risk related to a potential re-pricing in the Bank of England rate expectations, which continue to be overly hawkish (more than seven rate hikes expected by year-end), in our view.

As discussed here, we expect a 25bp rate hike by the BoE tomorrow, with a three-way split decision (some members voting for no change) which may well force markets to scale down their hawkish bets. For today, EUR/GBP should be a function of ECB-related news, and we could see some support above 0.8700. Cable will largely be a function of the FOMC meeting and some support around 1.2000 is possible today, even though risks remain skewed to the 1.17-1.18 area in the short-term, with more Brexit and Scottish referendum news potentially adding fuel to the fire.

AUD: Jobs numbers no game changer

Australian jobs numbers for the month of May will be released overnight, and markets are expecting quite a solid headline reading (around +25k) as well as another contraction in the unemployment rate (from 3.9% to 3.8%). While jobs markets tended to have a key role in driving rate expectations, we believe that today's actions by the Fed will have a bigger impact on the Reserve Bank of Australia rate expectations and on the Aussie dollar.

Anyway, AUD and RBA dynamics have not moved too much in tandem and we continue to see AUD/USD as mostly a USD and external drivers' story. With more USD support ahead, we think the pair will struggle to climb back above 0.7000 before the end of the summer.

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