FX Daily: The mother of all corrections

FX markets are struggling to come to terms with last week's huge correction in global asset markets, which owed as much to one-way positioning as it did to a re-assessment of the US monetary/China macro story. In this quiet week for data, the correction could have a little more to run. However, this should be good news for those needing to buy dollars

USD: Not very often that DXY falls 4% in a week

You only need one hand to count the number of times that DXY (a trade-weighted measure of the dollar) has fallen 4% in a single week. The severity of last week's correction owes in large part to the fact that dollar ownership has been the most 'crowded trade' in the global investment community. Equally, that community was substantially underweight equities and last week's combination of the softer core US CPI data and some supportive measures in China was the catalyst for a huge short squeeze in risk assets. This week is a quiet one for data and central bank policy action - meaning it is hard to rule out this correction running a little further. Could the DXY correction extend to 105 (from 106.90 currently)? Yes, but we would think 105 might be the extent of it.

Assessing how far position adjustment can drive asset classes is always a challenging task, but some of the FX moves have come very far indeed. For example, USD/KRW in a few sessions has retraced half of the January-October rally. That does seem a little excessive in that the Fed has yet to sound the 'all-clear' on its battle with inflation. Indeed, Fed hawk Christoper Waller said that 'we've still got a ways to go' before the Fed stops raising rates - comments which have stopped the fall in US rates. In fact, we have only seen a modest 20-30bp repricing of the Fed cycle over the last three days - not particularly large by this year's standards.

For those short dollars, the recent correction will be a welcome reprieve. There are no guarantees that these better levels will last, however. The Fed is still tightening and 2023 world growth forecasts are still being cut - including the IMF recently warning of even lower world growth than the downward revision to 2.7% made in its world economic outlook last month. The US data calendar is light today and the focus will be on; i) President Biden and Xi meeting at the G20 in Indonesia and ii) Fed speakers in the form of Lael Brainard (dove) and John Williams (mild hawk). Let's see whether this pair wants to push back against the big easing of financial conditions that the recent risk rally and softer dollar have delivered.

We do have a preference for DXY going higher later this year, but we have to allow position adjustment to run its course. That could see DXY trade 106.50-107.50 today.

Chris Turner

EUR: Caught out

The severity of the EUR/USD correction has caught out many (including ourselves). As above, this largely looks like a function of position adjustment. Even the European Central Bank's Luis De Guindos said on Friday that he felt markets had overreacted to the US CPI data. The very difficult question is whether this short EUR/USD squeeze has run its course near 1.0365 or needs to trade higher still. Given the depth, conviction, and one-sided nature of long dollar positioning (quite understandable given a sustained dollar rally since summer 2021), we all need to be careful about prematurely calling an end to this correction. Indeed, EUR/USD could easily trade to 1.05 were conditions/data to fall into place.

It is not a particularly busy week for the eurozone data calendar, but there are lots of ECB speakers including several today. Pricing of the ECB tightening cycle has remained quite resilient over recent days - prompting quite a sharp narrowing in the two-year EUR:USD swap differential - normally a EUR/USD positive. Those caught short EUR/USD may mean EUR/USD struggles to trade under 1.0250/70 today.

Elsewhere, EUR/CHF came lower on Friday as the Swiss National Bank sounded hawkish again and said it could sell FX reserves. This looks like a reference to being on both sides of EUR/CHF, rather than the continued buying of EUR/CHF seen over recent decades. We favour EUR/CHF lower over coming months as the SNB tries to keep the real exchange rate stable.

Chris Turner

GBP: This is going to hurt

The UK Chancellor, Jeremy Hunt, has been ramping up the rhetoric that Thursday's autumn statement is going to hurt - comprising tax rises for all and a large cut in government spending.

None of the choices are politically palatable, but failure to deliver would trigger another round of Gilt and sterling sales. 1.1670/1.1750 could be the short-term corrective low for GBP/USD before a possible push to 1.20 on a further short-squeeze (short GBP had been a conviction call amongst fund managers). But in the bigger picture, even these current GBP/USD levels near 1.18 should prove attractive for those with GBP receivables. We suspect that cable may trade back to 1.10 over coming months.

The UK data calendar is quiet today and more interest will be had in tomorrow's UK jobs and earnings data.

Chris Turner

CEE: Region to confirm strong levels due to global conditions

The Central and Eastern Europe region will see a bit of a lull this week but will still have the attention of the markets. Today we start with the September current account results for Poland, the Czech Republic and Romania. The entire region has fallen into record deficits in recent months, and we do not expect much change in September either. Third-quarter GDP for Poland, Hungary and Romania will be published on Tuesday. In the Czech Republic, the result was already published two weeks ago (-0.4% quarter-on-quarter) slightly below market expectations. In Poland, we expect a return to positive (0.2% QoQ) in line with market expectations after a negative surprise in 2Q. In Hungary, we forecast a significant decline (-1.0% QoQ), below market expectations, but in any case, the economy is expected to slow down compared to 2Q. A contraction in the economy is also expected in Romania (-2.0% QoQ) compared to a strong second quarter. Also on Tuesday, we expect October inflation in Poland to be confirmed at 17.9% year-on-year. On Wednesday, Poland's core inflation will then follow, and we expect a further rise from 10.7% YoY to 11.2% YoY.

In the FX market, the CEE regional picture remains mixed. At the global level, EUR/USD has moved well above parity in recent days, supporting emerging markets. The gas story seems to be no longer a problem for this winter with record full storage and gas prices below 100 EUR/MWh. The sentiment in Europe has improved significantly over the past two weeks with the DAX index hitting its highest levels since June this year. Overall, all point to stronger CEE FX.

On the other hand, rates across the region have fallen significantly following a dovish result from the National Bank of Poland, a massive downside inflation surprise in the Czech Republic and lower US inflation. Interest rate differentials thus collapsed, pointing to weaker FX. Overall, we expect CEE to maintain current stronger levels and further benefit from favourable global conditions. However, the biggest focus will be on the Polish zloty, which did not have much opportunity to react to governor Adam Glapinski's press conference due to closed markets. Therefore, we expect pressure on a weaker zloty towards 4.75 EUR/PLN at the beginning of the week. The Hungarian forint is teetering between the incoming EU dispute headlines, but we believe it will hold slightly above 400 EUR/HUF. The Czech koruna should maintain its current very strong levels thanks to low inflation protection and no pressure on Czech National Bank. The Romanian leu remains far from the National Bank of Romania's intervention levels, and we believe the RON should benefit the most from global conditions in the region, testing the EUR/RON 4.88 levels.

Frantisek Taborsky

Author

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

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer