

FX Daily: The perks of an inverted yield curve

The Bank of England surprised markets with a 50bp rate hike on Thursday, and we think a reserve currency like the pound may be kept afloat by a sharply inverted domestic yield curve. This is what is happening with the dollar, which has rebounded despite hawkish surprises elsewhere. Today, the focus will be on PMI releases



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➔ USD: Powell talking up the Dot Plot

The dollar found some support yesterday and this morning despite two major hawkish surprises in Europe that might have lured investors further away from the greenback and fuelled a rotation to European currencies. What has likely offered backing to the dollar has been the hawkish message pushed by Fed Chair Jerome Powell in the two days of Congress testimonies. While the overall rhetoric has been nearly identical to last week's press conference, Powell seemed to add more weight on the near-term prospects of further rate hikes compared to last week – implicitly encouraging markets to close the gap with the Dot Plot projections.

For now, that gap is still present. The Fed Fund rate curve is fully pricing in one hike by November, but there are only 18bp factored in by July and – above all – no signs of the other hike included in the latest median FOMC projections. It is clear that investors are awaiting the cue from data to

align with the Dot Plot, but Powell's hawkish rhetoric is a warning signal against jumping too early on a bearish dollar trend given the risks of a further inversion of the US yield curve.

Data-wise, the focus will be on PMIs across developed countries today. While being of secondary relevance to the ISM in the US, we can see some higher-than-normal market impact given the elevated market sensitivity to data at this juncture. 102/103 appears to be the holding-pattern range for DXY at the moment and we could see that hold into next week.

USD/JPY has continued to press higher, with a dovish Bank of Japan still leaving the yen more vulnerable than other G10 peers. We are now close to the 145 area, where Japanese officials started FX intervention last September.

Francesco Pesole

➔ EUR: PMIs hardly a game-changer for the ECB

The ECB had to resist two main dovish arguments at the June meeting: a faster decline in inflation, and signs of slowing growth outlook. The second will be tested again today with the release of PMIs. Consensus is looking at declining services PMI for a second consecutive month in the euro area and Germany, while manufacturing is seen holding up better. The composite EZ gauge is expected to decline very marginally from 53.9 to 53.3.

At this stage, it will probably take a pretty clear sub-consensus surprise print to prompt a materially negative euro reaction. The ECB has demonstrated it is firmly focused on inflation, and the debate around a September hike (a July one should be a done deal, according to President Christine Lagarde) does not seem likely to take these surveys under much consideration.

The euro is showing more resilience than other activity currencies to the rebound in the dollar, and barring big downside surprises in PMIs may hold above 1.0900 into next week.

Francesco Pesole

➔ GBP: A sharply inverted yield curve can come in handy

The pound's neutral reaction to the [Bank of England's 50bp hike yesterday](#) would suggest that was a well-telegraphed outcome. Instead, markets were only pricing in 35bp before the meeting. The market impact of the BoE's surprise move must therefore be seen in the context of the pricing across the Sonia curve.

150bp of tightening was already priced in before the meeting, and investors are now looking at a 6.0%+ peak rate after the hike. The attempt by the BoE to get ahead of the curve with more aggressive tightening is being accompanied by rising speculation that this will trigger monetary easing starting in the summer of 2024.

Still, that price development is not enough to impact the highly inverted shape of the GBP yield curve. From a currency perspective – as we note in the [BoE review note](#) – a sharply inverted yield curve can work as a positive factor for a reserve currency like the pound (as opposed to growth-sensitive currencies). We suspect that a rebound to 0.88 in EUR/GBP will need to be delayed on the back of that.

The data calendar includes PMI releases in the UK today, with consensus expecting a marginal

deterioration for both manufacturing and services. This morning, retail sales for the month of May declined less than expected.

Francesco Pesole

NOK: Confusing post-hike price action

Norges Bank opted for a 50bp hike yesterday, bringing the policy rate to 3.75%. If that was not enough of a hawkish surprise, the Bank raised its forecasted peak rate to 4.25% (in the fourth quarter of this year). As discussed in this note, supporting the weak krone remains the primary aim, although the Bank's rate-setting model seemed to suggest that higher wages and inflation played a much bigger role in the rate path's upward revision.

The post-meeting EUR/NOK price action is a reminder of how domestic factors and the role of Norges Bank in the currency market remain secondary to external factors for such a risk-sensitive currency like NOK: the pair is back above pre-meeting levels this morning (11.75) amid a large risk-off repricing. Next week's FX purchase announcement is also a key risk event for NOK.

We are of the view that the krone is now in a stronger position thanks to the aggressively hawkish stance of Norges Bank. We expect, however, to see NOK's gains against the euro materialise later in the year as sentiment stabilises. For now, we see NOK outperform its closest peer SEK on the back of policy differential and smaller domestic tail risks.

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