FX Daily: The race to neutral

We do not often get to talk about Chile in this publication, but overnight the local central bank surprised markets with a 125bp rate hike and said the policy rate would reach its 'neutral level sooner than foreseen'. The topic of earlier than expected rate hikes should continue to drive FX trends and keep the dollar supported against the low yielders.

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USD: Fed continues to edge towards loose policy exit

Chile and Singapore became the latest central banks to tighten policy in response to inflation pressure - although Chile faces many local political challenges which have contributed to a much weaker Chilean Peso. Interestingly Chile's central bank talked about the need to get the policy rate to neutral sooner than expected, questioning whether the 3.00% pre-pandemic policy rate is sufficient. Policy rates in Chile are now 2.75% after last night's 125bp rate hike. We know that Chile's central bank has some ties with the Czech National Bank who are also involved in some very front-loaded tightening. Somewhat incredibly the market prices a 100bp rate hike in the Czech Republic in early November after last month's surprise 75bp hike.

We mention the above since the re-rating of tightening cycles is a core story driving FX markets currently - including the UK and to a lesser degree the US. Last night's release of the FOMC minutes confirmed that the Fed is edging towards the exit of loose monetary policy, meaning that tapering would be announced/starting in November and concluded by next summer. The transition in views towards inflation becoming more persistent has been evident in Fed communication recently and may well be echoed by two Fed speakers today, Bullard and Bostic.

Interestingly the conviction of tighter policy seemed to play out in the US yield curve yesterday, with a dramatic 7bp flattening in the 2-10 year yield curve. The outright decline in long-dated yields could smack of a 'policy mistake' although the fact that equities and commodities stayed bid suggests perhaps we shouldn't read too much into the move. The dollar has weakened over the last couple of sessions, but our view would be that even if the Fed did make a policy mistake of too early and too aggressive tightening - it would still be positive for the dollar. In our experience, flat or inverted yield curves are positive for currencies and such a US curve would be negative for pro-cyclical currencies.

Expect the dollar to remain supported on dips, especially against energy importers with dovish central banks (Japan and Turkey stand out here). And today's US PPI data should be a reminder that the Fed needs to become more vigilant about inflation.

Expect DXY to find support in the 93.70/94.00 area.

EUR: Bear market bounce in EUR/USD

EUR/USD enjoyed a decent bounce yesterday in spite of an above consensus US CPI figure. We do not buy into the early Fed tightening is a dollar negative story and wouuld expect this bear market bounce to stall ahead of the recent high at 1.1640.

Look out today for ECB speakers today, especially the hawkish Knot speaking at 1430CET. So far the ECB is not being drawn into the early tightening debate, although this could come to a head closer to the December ECB meeting.

Elsewhere look out for Swedish CPI today at 930CET. CPIF ex-energy is expected to rise to 1.7% YoY. The ultra-dovish Riksbank (projecting policy rate unchanged until 2024!) blames higher prices on energy. Any upside surprise in the ex-energy number could question the Riksbank's dovishness and send EUR/SEK below the psychological 10.00 level.

GBP: Let's hear it from the doves

A 20bp BoE hike is priced by the end of this year. Surprisingly we have had little pushback from the BoE. Today we will hear from known dove Tenreyro at 1210CET and presumed dove Mann at 1640CET. Should they fail to push back against the aggressive, early pricing of BoE rate hikes, GBP could get a further lift. That should see EUR/GBP test the range lows at 0.8450/70 and GBP/JPY press the highs of the year at 156.

CNY: FX protest from the PBOC

We have been talking for many months about the strong trade-weighted CNY and how it is proving useful in fighting higher imported commodity prices. Indeed, latest inflation data, PPI near 11%

YoY, CPI at 1% YoY shows the pressure on margins faced by Chinese SMEs.

Yet overnight the PBOC fixed USD/CNY 40 pips higher than model projections - effectively the PBOC delivering a 'FX protest'. Should this mark the start of a series of moves to complain about CNY strength, then the big psychological level in USD/CNY at 6.50 could become vulnerable. Yet the CNH is an expensive sell (3.15% implied yields on the 3m forwards) thus any positioning against the CNH may come through the local high yielders such as the IDR.

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