

## FX Daily: The spectre of Volcker looms large

Higher than expected US inflation has seen an extra 25bp added to expectations of the Fed tightening cycle, yield curves invert further, equities fall sharply and the dollar surge. The spectre of the early 1980s looms large. This also brings the return of a more interventionist approach to FX markets. Expect volatility to rise and the dollar to stay strong



Paul Volcker was US Federal Reserve Chair from 1979 to 1987

### 📈 USD: Recessionary fears grow

Yesterday's release of [stubbornly high August CPI](#) has increased fears that the Fed will need to slow demand even further to bring inflation back to its 2% target. This period in the global macro-financial cycle again recalls the early 1980s experience with Paul Volcker at the helm of the Fed. To put the inflation genie back in the bottle, Volcker took policy rates to 15% and was prepared to accept recession as collateral damage. No one in the market thinks the Fed funds policy rate is going above 10% anytime soon, but yesterday's inflation release did see the terminal Fed policy rate re-priced to 4.30% from 4.00%.

On the subject of Paul Volcker, please see an [excellent article](#) written by our EM Sovereign Debt

Strategist, James Wilson, looking at how this high US rates, strong dollar environment will hit emerging market sovereign debt - following Sri Lanka's recent default.

That re-pricing of the Fed funds cycle - or the pricing of a harder stamp on the brakes - saw the US 2-10 year Treasury curve bearishly invert 10bp on the day to -34bp and the S&P 500 fall 4%. Inverted curves typically are late economic cycle phenomena and are normally associated with a stronger dollar and weaker activity currencies in particular. On cue, commodity currencies fell around 2% against the dollar yesterday and remain vulnerable.

Dollar strength has been broad-based and is starting to elicit a stronger response from trading partners. In early Asia, USD/JPY got close to 145.00 again and this time prompted a report from the Nikkei news service that the Bank of Japan had been 'checking rates'. This is a throwback to the 1990s period of serial Japanese FX intervention where 'checking rates' meant the BoJ FX intervention desk would be asking dealers for direct prices ahead of intervention. It does feel that intervention is close at hand - there is a small risk of it today at the New York open 13-14CET. If the BoJ is preparing to do battle with the market, we think USD/JPY implied volatility is still far too low. 3m USD/JPY implied volatility could easily be trading up at 18% versus the 12.7% levels today.

Beyond the risk of FX intervention, today's US data calendar is light - though August PPI might be in focus. Were there BoJ FX intervention, Japanese authorities could easily sell around \$5bn. That could trigger a brief dollar correction. However, the dollar is up here for good reasons and we would expect the macro hedge fund community to be happy to buy dips on any 2-3% correction in USD/JPY. Barring intervention DXY should stay bid near 110 as the market awaits a hawkish FOMC meeting next week.

*Chris Turner*

## ⬇️ EUR: ECB story struggles to lift the euro

Yesterday's re-pricing of the Fed cycle saw a 20bp widening in the two-year EUR:USD swap differential - leaving it wider than where it was before last week's hawkish European Central Bank meeting and pressuring EUR/USD. In short, the ECB will struggle to out-hawk the Fed. That is not a surprise given the US economy went into this inflation crisis with an economy operating above capacity - unlike the negative output gap in the eurozone.

The highlight of today's session will be European Commission President, Ursula von der Leyen, unveiling what measures Europe stands to take to address the energy crisis. The prospect of liquidity support for utility companies does seem to have calmed energy markets - but that leaves German power prices just double, instead of triple what they were in the early summer. We doubt these support measures can make a meaningful difference for EUR/USD pricing, leaving it to trade offered in a 0.9950-1.0050 range.

*Chris Turner*

## ➡️ GBP: 50bp still on the BoE table for next week

The market looks caught between pricing a 50bp and 75bp Bank of England (BoE) hike at next Thursday's (22nd) policy meeting. We are still looking for a 50bp hike - a move supported by today's marginally softer than expected UK August CPI release.

The overall environment, however, remains sterling negative. Running a large current account

deficit and having a large financial sector representation in the UK economy, slowing growth and weaker equity markets should leave sterling as an underperformer. And [the jury is still out on whether Gilt investors will balk](#) at upcoming Gilt supply.

This all leaves sterling at the mercy of the strong dollar, where we expect a retest of the 1.1406 lows. And further equity weakness would send EUR/GBP back to the top of an 0.8650-0.8720 range.

*Chris Turner*

## 📉 Latam currencies: Trouble ahead

Higher US rates have sent the dollar higher across the board, including against Latam currencies. A few points to make here. The higher levels of FX volatility we see (as above) are bad for the carry trade. While the 12.7% per annum implied yields on Brazil 3m NDFs are undoubtedly attractive, higher volatility could well see the Brazilian real pressured further. There are very close and contentious Presidential elections due early next month and USD/BRL could easily trade back up to 5.45.

As always, the Mexican peso remains our preferred Latam pick. But this environment could easily see USD/MXN trade back to 20.40/50. And we are concerned about Chile's peso. The currency has performed poorly despite the [announcement of IMF support](#). In addition the central bank late last week said it would slow its FX intervention operation to support the peso. That withdrawal of support may have been premature and we are worried that the IMF's \$18bn Flexible Credit Line is too small. USD/CLP can easily trade back to 950, if not 1000.

As usual, please look out for our coverage of Latin currencies in our monthly [FX talking update](#).

*Chris Turner*

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