

FX Daily: The Fed disrupting the calm

The Fed disrupted the calm markets yesterday, with a more hawkish narrative than expected. Still, with Jackson Hole being more than two months away, this does not mean that carry cannot do well over the summer. But what is clear is that USD characteristics as a funding currency have deteriorated. In Norway, expect a hawkish shift from NB today too.



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USD: Fed disrupting the calm

The Fed has disrupted calm markets with a more hawkish narrative than was expected. There was an upgrade to interest rate projections (now 50bp of tightening expected in 2023) but important question marks have been raised on the extent to which the inflation overshoot is temporary. This also suggests that the QE tapering discussion could start a little earlier than thought and conclude more quickly. This means that all the focus will be on the Jackson Hole conference in late August as a possible date to formally acknowledge the need to taper. The dollar clearly benefited from the shift in the FOMC bias and rallied across both the G10 and FX complex.

That said, we note that Jackson Hole is still two months away, market expectations about the timing of QE tapering already shifted forward and it may be difficult for the current across-the-

board USD rally to have legs, particularly when the appeal of carry FX should remain in place. Rather, what may be changing is the appeal of the USD as the favoured funding currency. With the Fed moving towards policy normalisation, this means that EUR and JPY are likely to be favoured. Hence, even if we are to see some calm over the summer after yesterday's storm, low yielders are unlikely to benefit much and are set to struggle to outperform USD. But those currencies where central banks are opting for aggressive and front-loaded tightening cycles such as RUB or BRL should find support.

Still, after the Fed's shift yesterday, expect the dollar sensitivity to US data releases and Fed-speak to increase.

⬇️ EUR: Hit by the Fed

In line with the general trend, the euro got a hit from the Fed meeting yesterday. With the Fed moving towards policy normalisation a little faster than initially expected, yet the ECB remaining cautious (as per the ECB June meeting last week), EUR/USD may struggle to hit our 1.25 target this summer. This would be the case even if the risk environment normalizes in summer as the euro now looks a more appealing funding currency for higher yielding FX. The shift in prospects for the favoured funding currency is also one of the reasons behind the EUR/GBP decline overnight. With EUR/USD breaking below the 200-day moving average support level of 1.1997, the near term risks are clearly skewed to the downside

➡️ NOK: Upbeat NB forecast to help NOK

All eyes are on the Norges Bank meeting today. While interest rates are set to remain unchanged, the main focus will be on the updated NB interest rate path. With the domestic economy rebounding, higher oil prices and not overly strong NOK, the NB interest rate forecast is likely to be revised higher and likely signal a high probability of a rate hike in September. The scenario of two NB hikes this year (September and December) is thus closer to realization and, with the NB being the most hawkish central bank in the G10 FX space, NOK should benefit. An upbeat NB forecast next week should help EUR/NOK to move closer to the 10.10 level today and partly offset the negative spillover from the Fed.

⬇️ TRY: The CBT on hold

The CBT meets today. According to its forecast path in the latest inflation report, headline inflation should see a "significant fall" at end of the third quarter or the beginning of the fourth. Still, given that currently low ex-post real rates and ongoing risks to outlook leave little room to act, we do not expect any rate change from the CBT today. However, the expected improvement in inflation should allow the bank to come up with a moderate easing with a likely first move in October. Given the outlook for the eventual CBT easing, TRY should not benefit much even if it exhibits the carry in the EM FX space

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