

## FX Daily: Time for even more defensive positions in FX

As cross-market volatility pushes up to new highs for the year, credit spreads widen and the market reflects on a near-miss with a financial crisis in the UK pension fund industry, it is probably time to take even more defensive positions in FX. These will involve owning the Japanese yen on the crosses. Look out for inflation data and Putin's address at 14CET



### ➔ USD: Quarter-end flows and position adjustments

FX volatility remains at its highs for the year and could extend even higher. We see two clear drivers here. The first is the continued tightening of monetary policy by central bankers around the world in an effort to prevent the current high levels of inflation from becoming pervasive in their economies. Leading the charge in this regard is the Federal Reserve. Today sees the August release of one of the Fed's preferred measures of inflation - core PCE. This is expected to rise 0.5% month-on-month and take the year-on-year rate up to 4.7% from 4.6%. Remember that according to the Fed's quarterly economic projections, the central bank expects this inflation measure to drop to

4.5% by the end of this year. Even that drop to 4.5% will require Fed Funds being taken into the 4.25-4.50% range, according to the Fed. Therefore any upside surprises in this data suggest the Fed may have to hike even harder.

Hiking into slowing growth really focuses attention on real interest rates. For reference, the Fed's measure of 10-year real interest rates has risen from near zero in early August to around 1.55% today - driving the dollar higher and weighing on financial assets. While the macro risks remain skewed for a stronger dollar, over the short term the dollar does look to be getting caught up with quarter-end re-balancing flows and the de-leveraging of tightly held positions - including long dollars. Our fear is that some disorderly moves in equity markets could prompt a little more of this position adjustment - even though the macro-driven dollar bull trend remains firmly in place.

This brings us to our second point. President Putin holds an address at 14CET today to likely announce the annexation of four regions of Ukraine. This will also be an opportunity for comment on what seems like sabotage of the two Nordstream gas pipelines earlier this week. This speech poses a geopolitical event risk to financial markets at a time when volatility is rising back to March 2020 levels and some parts of the financial system - e.g. the UK pension fund industry - are starting to creak.

This would suggest even more defensive positions should be taken in FX. Normally this would mean owning even more dollars. Our slight concern is that any disorderly FX de-leveraging in thinning markets could see investors temporarily reduce existing positions - including long dollars. Given the growing threat to equity markets - and based on this year's correlation in the FX markets - we think it is worth looking to position for a lower CAD/JPY. Strategies targeting 100 (-5/6% from current spot levels) during the month of October could be a good hedge for deteriorating conditions.

DXY has corrected more deeply than we thought. Look out for quarter-end flows around the 17CET WMR fix today. Any further losses should be corrective (outside risk to 110?) and we would still favour 120 later in the year as the Fed tightens conditions still further.

*Chris Turner*

## ➔ EUR: Double digit inflation

The major macro focus in the eurozone today will be the release of the flash CPI for September. After yesterday's upside surprise in German CPI (10% YoY), the risks look skewed to the upside for the consensus expectation of 9.7% for the eurozone number. Such a figure should bring the European Central Bank out in force and cement expectations for a 75bp hike on 27 October. As mentioned previously, short-term interest rate differentials have had little bearing on EUR/USD pricing recently. And the bounce in EUR/USD over the last 24/48 hours may well be a function of the recovery in sterling (more on that below).

0.9850/0.9870 may prove intra-day resistance for EUR/USD - but high volatility and tighter liquidity mean that we're in a noisier period for FX. Ultimately, however, we think the pressure remains for EUR/USD to break below 0.95 later in the year.

*Chris Turner*

Elsewhere, Norges Bank (NB) will announce October's daily FX purchases on behalf of the

government at 10CET today. Last month, NB surprised by announcing more than twice the expected amount of daily NOK sales (NOK 3.5bn vs 1.5bn), which prompted a negative reaction in the krone. Today, it seems unlikely that the Bank will announce another sharp acceleration in daily NOK sales, but we may see a modest increase to NOK 4.0bn, and that may be enough to trigger a decisive break above 10.50 in EUR/NOK today.

*Francesco Pesole*

## ➔ GBP: 400 pip ranges now the norm for cable

One week realised GBP/USD volatility is now 34%. That translates into a 418 USD pip daily range for cable! The late week recovery in cable must owe something to the Bank of England's aggressive intervention in the UK Gilt market on Wednesday. But also there is huge focus on the political side and whether Downing Street manages to rejig the fiscal numbers to assuage the recent panic in the bond market.

On that subject, sterling seemed to rally yesterday on speculation that the government could cut its capital spending plans by £20bn or so - though that would hit investment and productivity. And today the focus is on the PM and Chancellor meeting the Office for Budget Responsibility (OBR) to discuss spending plans. Recall it seems that the OBR had been shut out of last week's 'fiscal event' - prompting concerns that the new government did not want independent scrutiny of its new plans.

While the involvement of the OBR will be welcomed by the markets, the government still has to find a way to balance the books and avoid a very negative assessment from the rating agencies - two of which provide UK sovereign rating outlooks on 21 October. A Conservative party conference this weekend suggests it is far too early for a U-turn on fiscal policy and, combined with a very difficult external environment, sterling should stay vulnerable.

4 big figure ranges could easily put cable back at 1.07/.08 later today!

*Chris Turner*

## ⬇️ CEE: CNB determined to intervene further

The CNB [left rates unchanged yesterday](#), as expected while confirming that FX intervention will continue. The hiking cycle is over in our view, but wage growth and labour union wage demands seem to worry central bankers. Therefore, we need to continue to monitor incoming data, but we do not expect additional rate hikes in the baseline scenario. The situation was more interesting on the FX side. The governor sent a clear signal that intervention will continue, and the central bank does not feel constrained by the costs or time horizon to date. This, given the market's positioning, which was betting on an end to intervention, led to massive position closures and a jump in the koruna as we discussed yesterday, repeating the same scenario as in August. Given the global developments, we believe that the koruna will return to weaker levels near the CNB's intervention levels of 24.60-70 EUR/CZK soon and the market will test the central bank's patience again. However, we believe the CNB has enough ammunition to fight it for now.

Elsewhere in the region, the situation remains very volatile despite gas prices falling after a recent surge. Markets seem to be more focused on the outlook than on gas prices themselves and are more concerned about a supply stoppage via Ukraine, EU sanctions against Russia and a further

escalation of the geopolitical situation. In our view, the market is becoming oversensitive to these issues and CEE FX has not even been helped by a stronger euro against the US dollar. We would expect a correction of the losses of the last few days, given that the Hungarian forint and Polish zloty have broken out of levels consistent with traditional drivers, but at this point, we may remain in sell-off mode for a few more days.

*Frantisek Taborsky*

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