FX Daily: US inflation data to endorse November tapering bets

Recent history shows the dollar has struggled to benefit from strong CPI reads, but given the vicinity to the November FOMC, we expect USD strength today if headline inflation comes in at 5.3%, as markets cement Nov. tapering bets. In Sweden, Prospera's inflation expectations rose ahead of tomorrow's CPI, and pressure on the Riksbank is likely rising.

Source: Shutterstock

USD: Expecting a stronger dollar as Nov. tapering bets are cemented

The energy story has continued to play a central role in global markets, as equities seemingly continue to discount higher inflation expectations and struggle to stage a broad-based recovery. In FX, most G10 crosses have failed to find a clear direction this week, although two trends continue to emerge.

First, the currencies of big energy exporting countries are still receiving some support. NOK and CAD are the two most notable examples in G10, but AUD (Australia is a large coal and natural gas exporter) is also emerging as an outperformer. AUD (down 0.4% MoM) has indeed room to catch up with NOK and CAD (both up more than 1% MoM), although the stark policy divergence between the dovish RBA and the hawkish Norges Bank and BoC is currently warranting more moderate gains in AUD. We'll keep an eye on Australia's jobs data tonight: it looks like we'll see another negative reading as virus restrictions hit hiring in September, which should keep RBA rate expectations depressed and AUD upside capped for now.

The second clear trend is a bearish one on the yen. Japan's position as a heavy energy importer, paired with the recent sell-off in US treasuries, is a toxic combination for JPY, and USD/JPY also seems to be receiving some extra support from breaking key technical levels. After breaking above the 2020 and 2019 highs, more support may come if we see a break above the 114.55 2018 high. At this stage, we could see the USD/JPY rally extend to 115.00 in the near term.

Looking at today's events, US inflation numbers for September will likely set the tone in FX. Our US economist is in line with consensus in forecasting headline inflation at 5.3%, while expecting the core rate at 4.1% vs cons. 4.0%. The last seven CPI releases were either in line or above consensus, although only in two instances (in May and July) did the US dollar index strengthen after the release. While this does suggest the dollar has struggled to benefit from higher inflation numbers after the release, we think that the vicinity to the upcoming November FOMC meeting means that an inflation read at or above 5.3% will fuel November Fed tapering expectations and ultimately force a move higher in the dollar across the board.

Later in the day, the Fed will release the minutes of the FOMC policy meeting held on 22 September. The question is how much support had built at that point for an autumn tapering announcement as well as whether inflation is still mostly seen as transitory. Only yesterday, Raphael Bostic was quite vocal in arguing against the "transitory" term as he called for fast action. We'll get more Fedspeak today as Governor Lael Brainard (a front-runner for the role of Fed Chair if Powell fails to secure a second mandate) is set to make remarks at an afternoon event.

EUR: Stark divergence in ECB-Fed speakers' tone

As a number of hawkish voices within the FOMC have offered markets reasons to keep their hawkish Fed bets on, it's been quite the opposite with the ECB. Only yesterday, French central bank governor Villeroy added to the recent dovish tone as he argued in favour of some PEPP flexibility to retain some room for additional monetary stimulus in the future.

Should US CPI help markets price in a November taper and support the dollar, as we are inclined to expect, we may see the 1.1500 support in EUR/USD coming under increasing pressure, as the EUR continues to lack clear catalysts to potentially offset the downward move.

GBP: Data not denting BoE hawkish bets

Yesterday, UK's jobs data for September gave no reasons for markets to scale back their aggressive pricing for Bank of England tightening (15bp are priced in for the December meeting). This morning, some mixed data likely had a neutral impact on rate expectations. August's monthly GDP growth (0.4% MoM) came in slightly below consensus, while industrial production (0.8% MoM) grew more than expected.

We think rising bets on a BoE rate hike this year should continue to offer a positive underlying narrative to GBP (and offset the Brexit-related news) and keep EUR/GBP below 0.8500 in the coming days.

SEK: Building pressure on the Riksbank

The Prospera survey released this morning – which offers a well-regarded measure of Sweden's inflation expectations – saw CPIF projections being revised slightly higher. One and two-year CPIF expectations rose from 1.7% to 1.9%, while the five-year projections rose from 1.9% to 2.0%. We'll see September's CPI numbers for Sweden tomorrow, and consensus is looking at a rise to 3.0% in CPIF inflation.

Clearly, the only marginal uptick in Prospera's inflation expectations tends to signal that market participants remain a bit reluctant to price in more persistent inflationary pressures. But at the same time, some pressure on the Riksbank to start pencilling in some rate hikes at one point in their projection horizon (that goes until 2024) is surely building. Any moves in that direction by the RB would likely offer short-term support to SEK, but we doubt that, in the longer run, the inflation outlook will warrant a hike before the end of 2022 – which is where markets are currently pricing in 20bp of tightening. For this week, rising domestic inflation could make EUR/SEK test the 10.1000 support again.

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