FX Daily: Volatility set to stay high

It is a busy week for FX markets, with key policy rate meetings on both sides of the Atlantic and some tier-one data releases. The question to be answered this week: is the Federal Reserve ready to pivot? We would argue that the Fed has less cause than many to pivot. And weak growth overseas should mean that it is too early to unwind long dollar positions

USD: Wednesday's FOMC will dominate

FX markets this week will be dominated by Wednesday's FOMC meeting and whether the Fed provides any oxygen to the idea of a pivot - or a shift to a slower pace of tightening. As we discuss in our FOMC preview, the Fed faces several challenges here, but we suspect the bar is quite high for a pivot and we feel it is too early to call time on the dollar's rally. After all, the market in effect already prices the pivot (pricing a 75bp hike this week and a 50bp hike in December) and we suspect the chances of another 75bp hike in December are under-priced. In addition, this week sees a whole raft of US data culminating in Friday's nonfarm employment data. We forecast 220k in job gains and an unemployment rate of 3.6% - still below the 3.8% the Fed forecast for year-end. Recall that even with the unemployment rate rising to 3.8%, the Fed's dot plots had assumed that a policy rate in the 4.25-4.50% area would be appropriate for the end of this year.

As always there are two sides to the dollar story - what's going on at home and what's going on abroad. High beta currencies like the Norwegian krone, New Zealand dollar and British pound have been some of the best performers against the dollar over the last month. That has largely been due to the turnaround in sterling. But as my colleague James Smith discusses in his Bank of England (BoE) preview, the BoE may well disappoint with just a 50bp hike. A weaker tone in sterling could undermine the recent renaissance in European currencies and push more wind back into the dollar's sails. At the same time, Chinese data continues to disappoint, with the October composite PMI dropping back into contraction territory for the first time since May.

In short, it looks as though the dollar's month-long, 4.5% correction could have ended last Thursday and events this week could prove a catalyst to send the dollar back towards the highs. Our base case does see the dollar retesting the highs later this year. A break of 111.00/10 in DXY today could open up a move to the 111.80 area.

Chris Turner

EUR: Markets still price a 75bp ECB hike in December

The eurozone continues to battle with inflation and today should see the release of a new cycle high in CPI at 10.3% year-on-year - and potentially even higher given the German CPI release. Today we will also get a first look at 3Q22 eurozone GDP, expected at 0.1% quarter-on-quarter. The news may temporarily push eurozone rates higher, even though a 75bp hike is virtually priced for the 15 December ECB meeting. Ultimately, however, our macro team believes the ECB will only hike 50bp in December and that the terminal rate for this cycle proves to be in the 2.25% area rather than the 2.80% currently priced by the markets. And bluntly, the ECB has far more cause than the Fed to pivot.

With global growth under pressure from tighter rates and a misfiring Chinese economy, we think the eurozone and the euro will continue to struggle. That is why last Thursday's high of 1.0089 in EUR/USD could have been significant. A close back under the 0.9900/9910 area this week would support our preferred view of EUR/USD retesting the lows near 0.95.

Chris Turner

GBP: Thursday's BoE could do some damage

GBP/USD is consolidating above the important 1.1500 level, holding onto recent gains. The highlight this week will be Thursday's Bank of England meeting. The market firmly prices 75bp, but we think the risk of a softer 50bp is under-priced as the BoE prepares for the coming recession. As we have argued previously - now that a lot of the fiscal risk premium has come out of sterling - the forthcoming tighter fiscal and more dovish than expected monetary policy could prove a bearish combination for sterling. We are dollar bulls and would thus favour GBP/USD breaking back under 1.1500 based on this week's confluence of events.

This would also point to current EUR/GBP losses under 0.8600 proving short-lived.

Chris Turner

CEE: Tough times are back

This week we have a busy calendar not only at the global level but also in Central and Eastern Europe. Today we start with Polish inflation, which will be crucial for next week's National Bank of Poland meeting. We expect a jump from 17.2% to 18.1% year-on-year, slightly above market expectations, mainly due to higher fuel, energy and food prices. Tomorrow in the Czech Republic, 3Q GDP data, October PMI and the state budget result will be released. The first GDP result in the region should show a contraction in the economy and confirm the start of a shallow recession. On Wednesday, we will see October PMIs in Poland and Hungary, which will confirm the downward trend in industrial sentiment.

On Thursday, the highlight of this week is the Czech National Bank meeting. In line with the market, we expect interest rates to remain unchanged. A new forecast will be presented which will show lower inflation but higher wage growth, which together with the cost of FX intervention is the main risk for us in terms of a possible additional interest rate hike at the coming meetings. However, we consider the CNB hiking cycle to be finished.

The FX market in the region will be dominated by global events in the coming days. Already last week, the positive trend in CEE was halted by the ECB meeting. This week will see a series of central bank meetings led by the Fed. Therefore, we see both support from high-interest rate differentials in the region and EUR/USD as being at risk. In addition, gas prices have been rising again in the last two days and many of the reasons for the strengthening trend in the CEE region over the past two weeks are now dissipating. Of course, at the local level, we will be watching the inflation numbers in Poland and the CNB meeting in particular but this week speaks strongly against CEE FX.

We see the Czech koruna as the most vulnerable at the moment, which will again be the focus of short positioning ahead of the central bank meeting. We will likely see a move towards the 24.60-24.70 EUR/CZK levels. The Hungarian forint is likely to look above 415 EUR/HUF again. On the other hand, the Polish zloty should be best positioned this week, supported by a high inflation number and an increase in NBP rate hike bets.

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