FX Daily: Waiting for a volatility shake-up

Carry trades have remained popular in February's low-volatility FX environment, with the lower-yielding JPY and CHF as the main victims. US data still holds the keys to direction and volatility in FX; Friday's payrolls may confirm January's spike was an outlier. Elsewhere, the ECB and BoC's patience will be tested amid mixed data and summer easing bets

USD: Heading to the key payrolls test

The strong US data on inflation, jobs and growth published in February had a clearer impact on rates than the FX market. The rebound in US treasury yields did not translate into material dollar strength across the board – EUR/USD has remained flat since the end of January, the Swedish krona is stronger, and only the yen and Swiss franc have dropped more than 1% in G10.

The divergence between low yielders and other currencies in G10 has therefore been exacerbated as rates rebounded. Aside from the mechanical correlation of JPY and CHF with Federal Reserve expectations, depressed FX volatility has kept carry trades popular. It is no surprise that the Mexican peso, a common destination for carry trades, has had a good month. MXN/JPY climbed over 3% in February, and is up over 6% since the start of the year.

US data continues to hold the keys to FX volatility. At the end of this week, the February jobs report will tell us to what extent the stellar January numbers were an outlier. ISM and NFIB numbers before that will help us and the market formulate expectations for Friday's release, but for now, our US economist expects payrolls to come in at around 200k, in line with consensus. That would still be higher than the 185k consensus call for the January release. Investors have been forced to an upward revision on the US labour market, although a return to the 200k area would put the series on a more sustainable trend and more consistent with expectations of summer cuts by the Fed.

On Wednesday and Thursday, Fed Chair Jerome Powell will testify before Congress. A dovish change in the narrative does not look very likely given the latest inflation data, and a cautious wait-and-see approach should be reiterated – but may fail to impact markets too much given the proximity with jobs data.

The action in the US calendar starts tomorrow. Today, things look quiet across the board in developed markets, and we could see more of the kind of low-volatility price action from last week. Still, the balance of risks for the dollar before US payrolls looks slightly tilted to the upside and DXY could find some good support above 104.00.

Elsewhere, China's Two Sessions policy meetings have started today, with Beijing still facing pressure from investors to deliver support to the struggling economy. Here is our latest China macro update from our economics team. In Canada, the BoC will keep rates unchanged on Wednesday (more in our preview), and may stay relatively cautious on rate cut prospects.

Francesco Pesole

EUR: ECB's new projections in focus this week

The eurozone data calendar quietens down after the slightly hotter than expected inflation numbers published on Friday. The highlight of the week will be the European Central Bank's announcement on Thursday, where policymakers should still hold on to a broadly hawkish stance but may start discussing more openly about the conditions for rate cuts and this, crucially, will be accompanied by a new set of staff projections. Our economics team discusses the main things to watch at the ECB announcement here.

In EUR/USD, 1.08 has been the level associated with the low-volatility FX environment recently. A break from the range-trading is possible later this week given the combined effect of the ECB meeting and US payrolls. Looking a month ahead, we are not convinced the pair will be trading very far from its current levels, though. US data resilience may start to lose steam in March, but that may be only a gradual process, with more pockets of strong data emerging. Rates need to move lower materially to make the cost of selling the dollar bearable. As discussed here, investors may have raised the bar to turn against the greenback. Unless the ECB pushes back vehemently against rate cut bets (bucking its recent trend), a domestic idiosyncratic boost to the euro looks unlikely too.

Elsewhere in Europe, Switzerland has just published February CPI figures, which came in slightly hotter than expected. Headline inflation slowed from 1.3% to 1.2% and core from 1.2% to 1.1%, in line with consensus. Despite the smaller-than-expected decline, ongoing disinflation continues to suggest the new SNB President (Jordan announced his resignation last week) may stay clear of more CHF-supporting measures. EUR/CHF has had a strong run lately, but we had targeted a move to 0.9600 by the spring and do not see a bearish reversal on the horizon.

Francesco Pesole

GBP: UK budget is a key event risk for sterling

This could be an important week for UK markets. All the details of the long-debated Spring budget will be unveiled by Chancellor Jeremy Hunt on Wednesday, but it is common that some key decisions are spilt to the media in the previous days. We discuss in detail our expectations for the budget and the potential market implications [in this note](#).

Hopes of delivering pre-election tax cuts are likely to be met by funding constraints, even though we estimate the headroom has increased from £13bn to £18bn thanks to slightly lower market rates compared to November's Autumn Statement. UK media have reported Hunt is probably scaling back the size of the tax relief package and that support measures will also be smaller than in November.

The scars of Liz Truss' tumultuous budget in 2022 have not entirely healed, and markets will likely be very sensitive to the funding aspect of the budget. The implications of new measures obviously extend to the Bank of England rate expectation path. Tax cuts are inflationary, and the market has been rather flexible in pricing out rate cuts from the Sonia curve lately. At the moment, less than three 25bp rate cuts are expected for this year.

The strong pound – which has benefited from good carry – is facing a key test. EUR/GBP has rebounded from the mid-February 0.8500 low and was also supported in the second half of last week. A moderately-sized tax relief package (i.e., one that does not trigger turmoil in gilts) can probably give some support to GBP this week, but the spectrum of possibilities is admittedly quite wide.

Francesco Pesole

CEE: Rates unchanged in Poland, inflation print in Hungary

Apart from a few speakers, today's economic calendar is empty. In Hungary, we should hear from several government officials including the PM, economy and finance ministers. Tomorrow, wages in the Czech Republic and the second estimate of fourth-quarter GDP in Hungary will be released. Also on Wednesday, industrial production and retail sales for January will be released in Hungary. Later, we will see the National Bank of Poland's latest decision, and in line with market expectations, we do not expect any changes in rates. The key area to watch will be the press conference a day later. On Friday, Hungary will release February inflation, the first number in the CEE region. We expect a drop from 3.8% to 3.7%, below market expectations.

In the FX market, we maintain our bias from previous days – positive on HUF and PLN and neutral on CZK. In Hungary, we believe the correction in the rates market should support a stronger HUF. However, the resurgence of political noise is keeping the currency on the weaker side. In the case of a calmer week, we could see some gains with EUR/HUF back below 392. In Poland, EUR/PLN traded below 4.310 for most of last week, but we are now back above that level again. Confirmation of the hawkish NBP bias should help PLN to make gains again, which is already indicated by the elevated rate differential. For EUR/CZK (after peaking at 25.500 and currently traded around 25.350), we now see little reason to move in either direction.

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