

FX Daily: What to watch as the Fed hits the peak

We expect the Fed to hike by 25bp hike and still leave the door open to some tightening if necessary. In practice, recent banking stress suggests this is likely the peak, and Powell may struggle to keep any hawkish rhetoric in the statement alive during the press conference. There are some upside risks for the dollar, but our base case is a USD stabilisation



➔ USD: Conflicting forces on the dollar today

The days leading up to today's FOMC announcement have been rather tumultuous in markets. The emergency takeover by JP Morgan of the collapsing First Republic Bank did not send excessively negative shockwaves across risk assets, but US regional banks have remained under substantial pressure. Yesterday, an ETF tracking US regional bank stocks was down more than 6%, with California-based PacWest down 28% on the day.

All this clearly matters for the Fed as it announces monetary policy today. [As discussed in our FOMC preview here](#), our base case is a 25bp rate hike (also market consensus), which should mark the end of this hiking cycle as the Fed may rely on the impact of financial conditions deriving from the recent banking crisis to deliver the final bit of tightening.

Indeed, the recent developments in the US banking sector have all but encouraged a pause after this one last rate hike, and markets have fully priced out any extra bits of tightening beyond May. The content of the statement will be key to driving the market reaction. In our view the Fed will prefer to leave the door open to more tightening on paper, by switching its language from “some additional policy firming **may** be appropriate” to “additional policy firming **may yet** be appropriate” (our emphasis), as opposed to switching to a fully data-dependent approach which would send a stronger signal that rates have peaked.

Such an outcome should constitute, per se, a slightly hawkish surprise, and may allow the dollar to recover some ground after yesterday’s drop following another contraction in US JOLTS job openings. However, Fed Chair Jerome Powell would face the rather hard task of signalling that additional tightening is possible in the face of mounting US banking stress, signs of cooling off in the jobs market and a worsening economic outlook. And we cannot exclude that one dissenter will emerge at this meeting.

We had highlighted, after the March meeting, how Powell’s unconvincing rhetoric at the press conference had – in our view – paved the way for aggressive speculation on the size and timing of Fed rate cuts this year, as the Fed had failed to provide a solid anchor to rate expectations. In FX, this had translated into downside volatility to the dollar, which was exacerbated at times when US banks came under pressure, in practice limiting the greenback’s ability to benefit from its safe-haven status. Powell’s task isn’t any easier this time, and while a softer tone than the one in the statement about future tightening is very much possible – and may offset initial dollar gains – some more convincing pushback against rate cut speculation could help put a floor under the greenback beyond the post-meeting impact. DXY should see volatility but may still be trading slightly below 102.00 tomorrow morning.

We also have some important data to watch today in the US. The ISM services index will be published four hours before the FOMC statement and is expected to have marginally rebounded after March’s drop to 51.2. ADP employment figures will also be monitored (consensus +145k) ahead of Friday’s official payrolls.

Francesco Pesole

➔ EUR: All about the Fed today

Yesterday’s eurozone CPI estimates (for April) came in largely in line with consensus, showing a marginal tick-up in headline inflation from 6.9% to 7.0% and a marginal decline in the core rate from 5.7% to 5.6%.

Ultimately, the figures have not convinced us to make any amendments to our European Central Bank call for tomorrow. We expect a 25bp “compromise” hike, paired with some hints that more increases are on the way. In [this note we published yesterday](#), we show four potential scenarios for the ECB meeting, as well as potential impacts for EUR/USD and bund yields. We also published [a note about the Norwegian krone's recent underperformance and Norges Bank's role](#) ahead of tomorrow’s policy meeting in Norway.

Today, it will all be about news from the other side of the Atlantic: first US data, then the Fed announcement. We think that signs of openness to further tightening by the Fed – even though some implicit or explicit acknowledgement that we are at the peak seems plausible – may be enough to discourage EUR/USD bulls to chase the rally further for the time being. It’s worth

reminding that the pair has a rather overstretched long positioning, amounting to 21% of open interest, more than twice its two-year standard deviation and not far from its five-year high (27%).

In line with our USD view, we think EUR/USD should face some downside risks today, even though our base case is that it should enter tomorrow's ECB meeting close to the 1.1000 handle.

Francesco Pesole

➔ GBP: EUR/GBP downside risks this week

The pound will be entirely driven by external factors this week. Today, the Fed may not have a sizeable impact on cable in our view, and leave it close to the 1.2500 mark. We don't see a high chance of last week's highs (1.2580) being tested again very soon.

When it comes to EUR/GBP, we are seeing some rebound in the run-up to the ECB meeting. We suspect that the ECB announcement may fall short of the market's hawkish pricing and therefore see some downside risks for the pair later this week (i.e. a return to 0.8750/0.8780 area). There are no Bank of England speakers due to the quiet period ahead of next week's policy meeting.

Francesco Pesole

⬆️ CZK: Koruna ready to rally again

Today's calendar offers only the Czech National Bank (CNB) meetings. We **expect** rates to remain unchanged in line with surveys and market expectations. However, we expect a strong hawkish tone supported by the central bank's new forecast. The bank board has reiterated that wage growth and the government budget deficit are the main inflationary risks to the central bank. Both have been accelerating above expectations in recent months, and moreover, yesterday's GDP numbers showed a significantly better performance of the economy than the CNB had anticipated in its February forecast. So overall, as a tail risk, we may see more votes for rate hikes than usual.

The Czech koruna weakened after profit-taking in the last two weeks and we think the hawkish CNB meeting will support the koruna again. More balanced positioning, still decent FX carry and potential risk of FX intervention and rate hikes should help push the koruna back to 23.30 EUR/CZK in the near-term, in our view. Given the aforementioned reasons, we see limited room for an upward correction in EUR/CZK. From this perspective, the koruna retains the best risk/reward in the CEE region, in our view.

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