

FX Daily: Why we trust the dollar's momentum

Yesterday's Bank of England rate hold seems to have somewhat dented the recent hawkish expectations on other developed central banks as well (including the ECB). With today's US payrolls that may instead open the door to some more aggressive Fed tapering/earlier tightening speculation, we think the dollar may find more strength in the near term.



Source: iStock

USD: Policy divergence story swinging back in favour of the Fed, and the dollar

The dollar is back on its feet, having risen across the board yesterday amid a general unwinding of pro-cyclical bets in FX while the Bank of England's dovish surprise spilled over into other currencies. This last dynamic appears to be linked to the narrative of policy divergence between the Fed and other major central banks, which was likely behind some of October's dollar weakness as markets increasingly priced in tightening outside of the US. If the ECB's dovish communication proved insufficient to ease tightening expectations, yesterday's decision by the BoE not to hike rates

definitely helped to cast some doubt about hawkish bets on other central banks – including on the ECB itself. With a Fed that has just fired the starting gun on its normalisation process, momentum on the US-developed RoW monetary policy divergence story seems to be swinging back towards the US side, which is putting a quite solid floor under the dollar.

Another implication of the fact that the first step (tapering announcement) has finally been taken by the Fed could be that markets may now more freely speculate on the pace of tapering and the timing of tightening. Accordingly, rate expectations and asset prices may become increasingly sensitive to data.

Today, we'll see whether this is already the case as US payrolls for October are released. Our economist's view is in line with consensus: a 450k increase in the headline number, as the resumption of in-person teaching in schools should have encouraged many to go back to work, although excessive savings may continue to have an offsetting effect. Special focus will be on hourly earnings, which look set to approach the 5.0% mark and may well be used (along with any above-consensus read in headline NFP) by Fed hawks to advocate further against the “temporary inflation” narrative.

From an FX perspective, we think risks are asymmetrically skewed to the upside. A below-consensus read may not prove enough to fully erase the dollar's momentum that built up yesterday, especially considering that: a) Fed tightening expectations are not too aggressive compared to the Dot Plot, b) the last two NFP reads missed expectations, but the dollar losses were quite contained (6 hours after the release, EUR/USD was up 0.18% in September and 0.10% in October). On the other hand, we think any stronger than expected read should fuel speculation about a faster tapering and/or earlier tightening, all to the benefit of the dollar.

EUR: Fighting to stay above 1.1500 after negative BoE spill-over

The conservative hold by the Bank of England clearly had an impact beyond the UK's borders, and particularly on the ECB rate expectations, as markets scaled back tightening bets and no longer see an ECB rate hike in 2022. Arguably, the ECB October meeting failed in inverting hawkish bets as – unlike the BoE yesterday – it was only down to communication (and not to actual decisions on policy measures) to push back against markets' pricing. Earlier this week, President Lagarde reiterated her view that conditions for tightening will not be met by next year: after the BoE dovish surprise, it does seem markets are feeling more comfortable with this view as well.

Today, we should see a bunch of headlines from ECB speakers (Holzmann, Guindos, Centeno), but they have been quite ineffective on the market and we wouldn't expect anything different today. Retail sales data for September out of the eurozone should also have negligible market impact.

EUR/USD should therefore be driven almost solely by the dollar. As explained in the section above, the balance of risks appears tilted towards a stronger dollar ahead of NFP data today. It might be premature for EUR/USD to break below 1.1500 today, but should this happen, we would expect the technical break to generate more selling pressure on the pair.

GBP: The hike is only postponed, pound's weakness may fade

GBP/USD sold off around 1.5% in the aftermath of the Bank of England's decision to keep interest rates unchanged. We gave a more detailed debrief of the BoE decision [in this article](#): in a nutshell,

it appears that policymakers wanted to see more data and assess the impact of the end of the furlough scheme on the jobs market before starting the tightening cycle. We'll get two jobs reports (as well as two inflation reports) before the next BoE meeting on 16 December, and we expect the dataflow to prove all in all supportive for a 15bp December hike.

A December move is still not fully priced in by the GBP money market, which suggests there is some moderate room for sterling to benefit from hawkish re-pricing. Accordingly, we don't think we'll see a continuation in the EUR/GBP rally in the next weeks, and instead expect the pair to converge to the 0.8500 level by year-end.

📌 CAD: Jobs story still supportive, downside risks are external

The Canadian dollar is moderately weaker on the week, moving broadly in line with the bloc of commodity/pro-cyclical currencies. The question now is whether the upside correction in USD/CAD will extend meaningfully above 1.2500. We think this should be down mostly to external factors, as the domestic story of imminent BoC tightening remains likely supportive. Today's jobs data in Canada should see a slowdown in hiring but unless we see a negative headline number we doubt CAD will take a hit today. Still with a balance or risks skewed to the upside for USD ahead of US NFP (as discussed above), we think a move above 1.2500 in USD/CAD could be on the cards today. On the other hand, we'd probably need to see a very strong Canadian jobs read to prompt markets to shift their expectations for the first BoC rate hike from March to January (currently 70% priced in) and ultimately send USD/CAD back towards 1.2400.

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