FX: Fed taking back control could hit the dollar

A combination of heavy tax/coupon payments and low bank reserves has seen a USD liquidity squeeze drive overnight repo rates to 10% and the Fed struggle to contain the Fed funds rate within its target. Speculation is growing that the Fed may address the issue of low excess cash in the system by re-starting balance sheet expansion. This could hit the dollar

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USD: Renewed balance sheet expansion could hit the dollar

On the day when the FOMC announces its latest policy decision, the major focus is: how does the Fed take back control of money markets? Here a combination of heavy tax/coupon payments and low bank reserves has seen a USD liquidity squeeze drive overnight repo rates to 10% and the Fed struggle to contain the Fed Funds rate within its 2.00-2.25% target. Tight money markets mean the Fed will today conduct another overnight system repo operation to add up to $75 billion in overnight funds, following a similar operation yesterday. Beyond a rate cut and a potential cut in the Dot Plots (please see our preview here), speculation is growing that the Fed may address the issue of low excess cash in the system (excess cash at the Fed has fallen from $2.7 trillion in 2014 to $1.3 trillion today) by re-starting balance sheet expansion. Even though it would be a technical move to address tight money market rates rather than a macro move to address disinflationary risks, we presume a fresh round of money-printing from the Fed would hit the dollar. As per our preview, a dovish Fed would provide a fillip for pro-cyclical currencies, where we think the Norwegian krone is best placed to take advantage. 8.80 looks a viable short term target for USD/NOK and because of this new money market story, DXY could break under 98.

EUR: Surprising recovery

It seemed strange that the euro and pound led the FX bounce against the dollar yesterday. The move seemed to come after the Fed announced the overnight repo operation. We don't think the EUR has a lot going for it right now, but if the dollar edges lower/slides on renewed quantitative easing from the Fed today, EUR/USD will go along for the ride. Above the 1.1080/1110 area, EUR/USD could push to 1.1200.

GBP: Better hedging levels

We think this bounce in GBP should be used to lock in better hedging levels ahead of a very uncertain six weeks. While a dovish Fed could send cable above 1.25 (outside risk to 1.2670), we doubt the move will be sustained.

CAD: Inflation to stay around target

The spike in oil prices has averted a break above 1.33 in USD/CAD at the start of this week, and may continue to prove broadly supportive for the Canadian dollar in the short term. Today, August CPI numbers should underpin the positive sentiment on CAD by signalling that inflation remains anchored around the Bank of Canada target mid-point (2.0%). However, we continue to see a high chance of the BoC cutting rates in October on the back of rising trade tensions. Today, the balance of risks for USD/CAD appears tilted to the downside as activity currencies should be the outperformers if a dovish Fed triggers some dollar weakness.

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