FX: Time for a little caution

It's unclear what can support the dollar in the near term

USD: Unclear support

The break in US 10 year Treasury yields below 2.13% has come as a surprise to most and so far sparked a benign dollar sell-off; most high yielding FX currencies continue to perform very well. Some of the reasons for that decline in US yields look benign, others less so. Remarks from Fed 'dove', Lael Brainard, have nudged the probability of unchanged Fed rates through 2018 to as high as 43%. But other factors look less welcoming for high yield FX, such as:

- 4 week US TBills being sold as high as 1.30% (above US 2 year yields) on fears of the debt ceiling
- fears of Hurricane Irma depressing insurance stocks
- Tensions surrounding North Korea

On this final point, it is noticeable in the FX options market that there is some serious buying of back-end volatility (e.g. one-year JPY volatility staying bid above 10%) warning of some strategic risk management measures underway. This cautions us that risk assets might be a little more vulnerable than they have been all summer. This leaves the USD vulnerable against the low yielders and DXY (the US Dollar Index) ready to retest 91.60.

The US data calendar is light, but further north the market is nearly split on another Bank of Canada rate hike today. We think it's too early.

EUR: Looking solid

EUR/USD remains well bid, as markets prepare for the big ECB meeting tomorrow. There is a growing suspicion that President Draghi will struggle to talk it lower – especially with USD headwinds growing. EUR/USD could drift up to 1.1980/2000. Elsewhere in Europe we have a Polish rate meeting (unchanged policy is widely expected) and the Romanian government potentially pushing pension reform, (e.g. the threat of a Pillar II grab as seen in the likes of Poland and Hungary). We see this as a risk to Romanian government bonds and RON, the Romanian leu.

GBP: Unclear catalysts

EUR/GBP has enjoyed a good correction over the last week, though the catalysts for a move much lower look unclear. We see decent support in the 0.9070/9100 area and feel these may be the lowest levels of the month.

BRL: Central bank to slash rates

The Brazilian Central Bank, BACEN, meets to set interest rates today and is widely expected to cut the Selic policy rate another 100bp to 8.25%. That would extend the dramatic easing cycle from the 2016 high of 14.25% and should be followed with a final flourish of a 75bp cut in October. The market appreciates BACEN's pro-growth measures, and by keeping real rates in the 4-5% area, the BRL remains very much in demand. The soap opera of local politics is also BRL supportive at present, with corruption allegations against President Temer being undermined by developments at the General Prosecutor's office. BRL to continue out-performing the forwards.

Read more about the Brazilian central bank's policy meeting here.

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