

FX Daily: Focus on a 'cosmetic' Czech rate adjustment

Having rallied over 3% this month the dollar is now entering a consolidatory period. 3% seems a barrier for the long end of the US Treasury curve as does the 0% level for the 10-year US real Treasury yield. However, expectations for Fed rate hikes remain strong and the dollar should stay supported on dips. Elsewhere, further hikes are expected in Czechia



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➔ USD: 10 year real yields hit zero. What does it mean for FX?

Having enjoyed a strong 3% rally so far this month, the dollar has now entered a consolidatory phase. Driving that may be the fact that the rise in longer-dated US Treasury yields appears to have stalled at the 3% area, consistent with the 10-year US real yield testing zero for the first time since early 2020. Driving this month's sell-off in Treasuries has very much been the story of the early and more aggressive Fed balance sheet wind-down - a story that will unfold over the coming months.

What effect could rising US real yields have on global FX markets? Roughly, the 10-year US real

yield can be used as a benchmark for financial conditions - be they loose, neutral, or tight. These yields were -1% for a large part of 2020 and 2021 and at zero are now moving back to neutral. The fear is that tightening real yields at a time when earnings yields in the corporate sector are coming under pressure could demand lower equity valuations. It is not clear that we have reached that point yet - but a turn lower in equities would argue for a slightly different FX dynamic, where say an FX pair like AUD/JPY (having rallied 15% over the last two months) could turn lower. Equally, some of the big rallies in the emerging market commodity exporters could stall or reverse - we are thinking here of the South African rand in particular. And the dollar should stay broadly bid.

Back to the shorter term, last night's release of the Fed's Beige Book ahead of the 4 May 4 FOMC meeting confirmed decent activity, tight labour markets and rising price pressures - all pointing to the Fed hiking 50bp at that meeting. Notably, expectations for Fed tightening this year remain firm and we expect any short-term dip in the dollar to prove temporary. The US data calendar is light today - FOMC Chair Jerome Powell and the European Central Bank's Christine Lagarde speak at 19CET in Washington - and we expect DXY to hold gains over 100. Elsewhere, the People's Bank of China did not fix the renminbi any weaker than models had suggested - but markets are still running with the theme that China would not mind a weaker currency right now - a theme that is generally bearish for Asian FX and bullish for the dollar.

➔ EUR: Macron's election to lose

Opinion polls post last night's French presidential TV debate suggest President Emmanuel Macron avoided any banana skins and is still favoured to win Sunday's second-round run-off. EUR/USD has not moved much - largely because wide rate differentials support it trading down at these levels. EUR/USD also has not enjoyed too much of a bounce on the back of hawkish comments from three ECB members over the last 24 hours - all pointing to the risks of a rate hike in July and presumably the deposit rate ending the year in positive territory - as opposed to the consensus of hikes in September and December and the depo rate ending the year at zero.

We doubt the debate over whether the ECB hikes 50bp or 75bp this year makes too much difference for EUR/USD - which we expect to trace out a broad 1.05-1.10 range over coming months. For today, 1.0800-1.0900 looks like the range.

➔ GBP: Another quiet session

The next take on UK activity is not released until tomorrow with March retail sales and the April PMIs. PMIs are also released across the eurozone as well, meaning we can see the relative damage done to sentiment by the war in Ukraine. We think GBP is more vulnerable to dollar than euro strength at the moment - and GBP/USD would come lower if and when the global equity environment soured on tighter financial conditions. For the shorter term, EUR/GBP may well trade in a shallow range centred on 0.8300.

➔ CZK: A cosmetic adjustment or a proper rate hike?

With the Czech National Bank's (CNB's) May meeting approaching, the board members are again coming out with their views on monetary policy. Yesterday we saw two of them, Governor Jiri Rusnok and MPC Tomas Holub. The governor made another dovish statement to the local audience that while he expects further interest rate hikes, this will be just a 'cosmetic adjustment'. We've got used to the governor being more dovish at home, and we're not drawing any big conclusions for the May meeting from this. Tomas Holub was more interesting from that perspective, as he

also said that rates need to be raised further. However, he does not see the possibility of using the FX tool as realistic at the moment. He said that although the CNB has huge FX reserves, if investors focus on the Czech market, these reserves could disappear quickly and the central bank would lose credibility. That is why it continues to prefer the classic rate instrument.

CNB's blackout period starts next Thursday, so early next week we are likely to see a number of speeches by other board members which should support market expectations of further rate hikes. However, [as we mentioned earlier](#), the new CNB forecast will show a sharp rate cut later, in addition to rate hikes now. We can see EUR/CZK trading in a 24.30-24.50 range heading into the 5 May rate meeting - but see the meeting itself as a possible negative event risk for the koruna.

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