FX Daily: What today's BoC decision may mean for the Fed and the dollar

The dollar has come back bid this week. Any upside surprise to today's US November core CPI number would trigger another leg higher in the dollar – as would only a 25bp rate cut from the Bank of Canada. This is because a 50bp rate cut is widely expected from the BoC and a more conservative 25bp cut could be read as concern over whether the Fed eases after all

USD: Upside risks today

The dollar has come back bid – partly on the exceptionally strong US NFIB small business optimism index released yesterday. Perhaps it should be no surprise that US entrepreneurs welcomed the prospect of tax cuts and deregulation next year. At the top of the agenda today is the 1430 CET release of November US CPI. While it is tempting to say that the Fed has moved on from the inflation story, any upside surprise to the already high consensus expectation for core inflation at 0.3% month-on-month would likely send the dollar higher. This is because the market now prices an 88% chance of a 25bp Fed rate cut next Wednesday and a high core CPI reading could make it more of a 50:50 proposition.

On the subject of the Fed, we think today's Bank of Canada decision may have some read over to the US. Two-thirds of economists polled on the subject expect a 50bp rate from the BoC – where the BoC would emulate peers in New Zealand, who have delivered back-to-back 50bp rate cuts. Money markets also price 44bp of Canadian rate cuts today. Our thinking goes as follows: if the BoC cuts by 50bp, briefly taking the Fed-BoC policy rate spread to a hugely wide 150bp, the BoC will have a strong view that the Fed cuts 25bp next week. Under this scenario, the Canadian dollar weakens, but also the US dollar could soften a little as expectations of a 25bp Fed cut are firmed up.

Should the BoC surprise and only cut by 25bp, it will be a signal that the BoC has strong doubts about next week's Fed cut. For example, we doubt the BoC is ready to leave the Fed-BoC rate spread at 150bp at year-end (BoC cuts by 50bp to 3.25%, Fed leaves rates at 4.75%), where such a wide rate differential would send USD/CAD upwards of 1.43. If indeed the BoC only cuts by 25bp then the US dollar might catch a bid on the view that next week's FOMC meeting really is a toss-up after all!

Chris Turner

EUR: Downside risks

It has been a very quiet week on the European data calendar as investors await the main event of the week – tomorrow's ECB decision. Market pricing has settled on a 25bp ECB rate cut – with which we agree – although a dovish press conference from President Lagarde could keep the euro offered. Certainly, rate differentials remain very wide in favour of the dollar, although it will probably now require a hawkish repricing of the Fed curve to drive this differential wider from current levels.

For EUR/USD today, the focus will largely be on the US CPI reading and perhaps, too, on the Bank of Canada decision (above). Technical indicators suggest EUR/USD is now ready to restart its bear trend should macro and geopolitical inputs allow. For that reason, we have a preference that 1.0550/70 may be the best EUR/USD level of the day and look for catalysts to take it down to the 1.0450 area.

This month EUR/USD is staying offered despite a strong seasonal bullish tendency. Typically January and February prove bearish months for EUR/USD. We suspect corporate America would be very grateful for any EUR/USD bounce into which they would offload the euro.

Chris Turner

GBP: The mighty pound

EUR/GBP is closing in on a major support level at 0.82. And were it not for the strong dollar, the Bank of England's trade-weighted sterling index would be pushing to new highs of the year. Two related factors are driving the sterling move. The first is that a functioning UK government and some mild fiscal stimulus stand in contrast to the current political impasse in continental Europe. This means UK growth will be stronger than the eurozone's next year. And because of that, the Bank of England policy trajectory is being priced much closer to the Fed than the ECB. This is keeping sterling hedging costs relatively high, where one-year EUR:GBP swap rate differentials remain at 200bp.

Should EUR/GBP break 0.8200, expect to hear many reports of sterling returning to pre-Brexit levels – probably linking that to warming relations between the new UK Labour government and the EU. We think sterling can continue to perform well over the coming months (GBP pays the highest deposit rates in the G10 space), but our main concern is that the BoE turns more dovish in February once services inflation finally delivers another sizable leg lower.

For the time being, however, it is all eyes on 0.8200 in EUR/GBP.

Chris Turner

CEE: The complete inflation picture

After the inflation numbers in Hungary and the Czech Republic, this morning we also saw the numbers in Romania. November inflation rose from 4.7% to 5.1%, slightly above market expectations. Although inflation should fall again in the coming months, we see the National Bank of Romania returning to rate cuts in the second quarter of next year at the earliest. However, for now, the main theme remains the fiscal and political situation after the election in Romania. This is probably the NBR's focus for now as well and inflation is more of a secondary theme.

Elsewhere in the region today the calendar is empty and the market could get a chance to stabilise after a busy calendar in the previous days. Market attention should shift to the sovereign bond auctions in Poland and the Czech Republic before the end of the year. In both cases, we should see lower supply in December than in previous months supporting bond valuations. However, weak demand remains an issue in Poland, which should indicate an outlook for next year where supply will remain heavy.

FX remains rather muted in EUR-crosses where the Hungarian forint saw some retracement of previous fast gains. The Polish zloty and Czech Republic koruna remain fairly priced versus rates for now in our view. However, we see more CEE weakness against USD crosses coming from the EUR/USD dip, which remains our view since the US election.

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