A crucial Fed meeting for the dollar

How long will the Fed's tightening cycle last? That's what's most important for the direction of the dollar. Here are three key signals to look out for

Source: Shutterstock

USD: Expect a 'buy the rumour, sell the fact' reaction to Fed meeting

When thinking about the implications of US monetary policy on the trajectory of the US dollar, the single most important thing for us to consider remains the longevity of the current Fed tightening cycle. And while FOMC meetings rarely give us any fresh insight into this – as the terminal rate is ultimately a function of the US economic outlook (and not what US policymakers believe) – the policy signals that the FOMC may directly or indirectly send at today's meeting could hold particular significance for future expectations of US interest rates and the broad USD outlook. We identify three key signals for investors to monitor today:

- In the September FOMC statement, watch for whether voting officials unanimously agree to drop 'accommodative' when describing the current stance of policy. If the Fed were to no longer see US monetary policy as being accommodative after a 25 basis point rate hike today takes the Fed funds rate to 2.25% (upper bound), one could infer that we are now in the latter stages of the tightening cycle – with policy approaching a neutral stance.

Subsequent policy moves may well be more data and market dependent – meaning limited need for investors to price in further Fed tightening beyond the 50 basis points already expected for 2019.
- In the September FOMC projections, the introduction of the 2021 'dot' may put an end-date on the Fed tightening cycle. The projections are typically extended by one year at September meetings and here the focus will be on where officials see policy heading in 2021. While it's difficult to envisage the FOMC signalling rate cuts, the median dot remaining at 3.4% would put an end-date on the hiking cycle – another signal that could put a cap on short-term US rates for now.
- In Chair Jerome Powell's press conference, commentary around the yield curve and risks of an inversion is worth monitoring. Signs that the Fed may pause if the yield curve flattens further may curb market fears over a Fed policy mistake.

The most hawkish scenario is one where the Fed still sees policy as being fairly 'accommodative', signals ongoing tightening into 2021 and expresses no real concern over an inverted yield curve. We don't see this as likely and think long USD positions could unwind in the absence of any fresh hawkish Fed impetus.

EUR: Hawkish ECB and Italian budget risks provide counteracting euro forces

Despite ECB chief economist Peter Praet's best efforts to play down market hype over President Mario Draghi's 'vigorous inflation' comment yesterday, expectations for an ECB rate hike in September 2019 have marginally notched higher (now around 10 basis points of tightening priced in). This has broadly kept the euro supported at a time when Italian budget risks are bubbling in the background. We expect these two forces to continue counteracting each other – pointing to stable euro dynamics in the near-term. Any EUR/USD move beyond 1.18 is more likely to stem from post-Fed dollar blues. In the UK, be wary of negative sterling headline risks from speeches by Prime Minister Theresa May and Labour's Jeremy Corbyn – with risks of EUR/GBP drifting back towards 0.90.

CZK: 25bp rate hike today a done deal; high bar for CNB to hawkishly surprise

Following comments by Czech national Bank officials, a 25 basis point rate hike today seems like a done deal – with one additional hike set to follow later this year. With this fully priced in (as well as another two hikes next year), we have a hard time seeing the CNB delivering a more hawkish signal versus what is already expected. As such, any positive impulse into the Czech koruna should be muted. Coupled with the expected seasonal year-end CZK weakness due to a decline in short-term implied yields, we retain a cautious CZK outlook in 4Q18. EUR/CZK to hover around the 25.60 level today.

Author

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com