FX Daily Dispatch

Global Rates, FX & Commodities Strategy

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▶ GLOBAL ▶ FX ▶ GLOBAL MARKETS

A Kink in the Road

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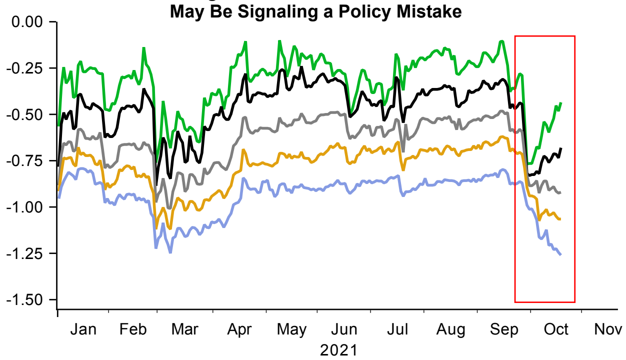
- Some calm has returned to front-end rates, but whether this sticks remains an open debate. While we may have already observed the most violent part of the move higher and some central bankers (past and present) have called it an overreaction, there is some credence in the move.
- Central bank credibility is being tested. With supply disruptions likely to persist well into 2022 by some surveys, the 'transitory' argument becomes harder to make. The BOE now looks likely to hike this year, though a kink in cable risk reversals may be the clearest sign yet that the market views this as a policy mistake.
- EURUSD has managed to stage a rally above 1.16, though concerns over elevated energy prices choking growth alongside a deceleration in global trade volumes suggest a challenge for the common currency's pro-cyclical features. We continue to hold USDCHF longs and EURGBP shorts. We note that nascent USD softness also coincides with seasonal trends, which give way to firmness in November.

Charts of the Day

Divergence in Cable Risk Reversals May Be Signaling a Policy Mistake

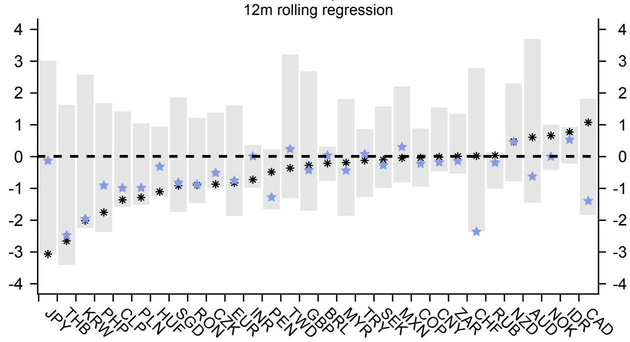


— 1y — 6-mth — 3-mth — 1-mth — 1w

Source: Macrobond, TD Securities

Snapshot of Global FX Positioning

PIT is residual of TD ChartVision, beta to fund performance, risk reversals and CTFC from 12m rolling regression



★ 1m lookback ✱ PIT, current level ■ MAX/MIN (1y)

Source: Macrobond, TD Securities

Inflation sympathizers. Some calm has surfaced in the STIRT space, while risk sentiment is well supported and commodity prices continue to climb. This combination has helped the USD to soften up and mainly support the commodity/risk-sensitive currencies. While there has been a flurry of comments from former and current central bankers to characterize moves in the rates space as an overreaction, we think there is some credence in the shift nonetheless.

Without a doubt, markets are testing central bank credibility. Inflation expectations have moved higher (though mostly in the 2y space for the US) amidst ongoing supply disruptions. Central bankers have spent a great deal of 'political' capital on pushing the 'transitory' argument. But, that argument becomes more difficult to buy into the longer that supply disruptions persist and/or the longer that inflation numbers remain elevated, which they likely will be well into next year. Indeed, yesterday's BOC Business Outlook Survey indicated that Canadian firms expect that disruptions are likely to persist for much of next year.

Rising commodity prices, particularly within energy, does raise the scope of choking off growth (and even creative destruction within energy). Nonetheless, within energy, our commodity strategists see elevated prices for the next couple of quarters. Against that backdrop, it seems unreasonable to not expect pass-through of higher input prices to the consumer. And, once they do, it does not seem to be reasonable to expect that there will be price cuts once disruptions fade (whenever that may be) without a corresponding aggregate demand shock.

Getting kinky. And, for some like the BOE, markets have expressed an urgency to hike despite indications that they also believe that this may be an error. Indeed, cable risk reversals have shown two-way risk with 1w-1m tenors effectively diverging from the 3m-1y buckets. That is, short-end risk reversals have shown a rising premium for GBP calls in the short-term, but at the same time, expect a notable erosion next year. This may be the clearest indication that markets are explicitly pricing in a 'policy mistake' if the BOE hikes near-term. And, while we think the BOE is now likely to hike this year (probably in November), this is largely because of Governor Bailey's urgency to act, and not because of macro reasons (which suggest more caution).

Given the scope of the adjustment in recent sessions, we have likely witnessed the most violent part of the move. The market is now pricing in two hikes for next year, which seems like it is more than enough from a risk/reward point of view. But at this point, the Fed will announce taper next month and it is likely to conclude no later than June. So, there may be some calendar limitations to how much more the Fed could hike thereafter. Of course, there is a debate as to whether 25 or 50bp in the grand scheme of things is a noteworthy shift in tightening.

A collective push. What is clear however, is that there has been a collective move by central banks to confront some of these challenges either by hiking or indicating an inclination to tighten. Perhaps that is an attempt to reduce the singular impact of one central bank acting alone. But the more banks that fall in line, the more difficult it becomes to disguise it. As we discussed yesterday, the market has attacked curves in regions where policy expectations have been suppressed in large part by the central bank's own doing (see the RBA for example).

Within all this, EURUSD has managed to stage a rally back above the key 1.16 threshold. 1.1750 should mark a near-term top as this coincides with downtrend resistance from the May 2021 highs. But this could be a rather heroic assumption to begin with given carry and growth implications from commodity squeeze that would hit the energy importer. Taken in conjunction with a moderation in China and global trade volumes, the pro-cyclical features of the EUR look to be challenged for some time. That leaves us still content in holding USDCHF longs given that it remains tethered to EUR and US rates. We have been holding EURGBP shorts, though the move has been impressive in our favor. Our positioning and valuation dashboard suggests some more room to the downside, but we acknowledge that it may be time to reconsider the position on a move to 0.84 (which is not far from our target of 0.8350). USDJPY looks near-term toppish around 114/115 following a deep build of longs (the most since 2014). That said, these moves in the FX space are coinciding with the seasonal tendency for the USD to weaken. This should reverse course in November. And, with the Fed expected to announce taper then, long-end rates likely to be pressured higher and fed funds pricing to be rather sticky, a USD dip is more likely a fade than a chase.