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Article

FX Daily: A dovish hike ahead of a hawkish hold

The ECB hiked rates yesterday but offered enough hints to convince markets this is the end of the tightening cycle. EUR/USD sensitivity to the dollar leg and – by extension – US activity data should be even higher at this point. Elsewhere, some BoJ members have reportedly pushed back against hawkish interpretations of Ueda's comments earlier this week



ECB President Christine Lagarde seems to have switched from a near-term hawkish narrative to defending a higher-for-longer approach

Content

- USD: Starting to gear up for a hawkish Fed meeting
- EUR: Driven even more by the dollar after dovish ECB hike
- GBP: ECB helped BoE expectations stay low
- JPY: BoJ officials push back on the market's hawkish interpretation



USD: Starting to gear up for a hawkish Fed meeting

The dovish ECB hike (more in the EUR section below) and another round of strong US activity data sent the dollar on another rally yesterday. US August retail sales rose more than the consensus (0.6% month-on-month), even though the bulk of spending growth was due to higher gasoline prices. When stripped of fuel sales, the print was a more modest 0.2%, although still higher than expected. PPI was also

higher than expected, while initial jobless claims were slightly changed (216k to 220k) after last week's big drop.

With the ECB meeting now past us, market attention will shift to next Wednesday's FOMC announcement. Evidence of slower disinflation has provided an incentive to keep one hike in the dot plot projections for the end of 2023, while resilient US data may well see a revision higher of the 2024 median plot (currently embedding 100bp of easing). We doubt that sort of adjustment would come as a shock to markets, but would further discourage bearish positioning on the dollar.

Today will see the final bits of data that can move markets before the Fed meeting. The University of Michigan's sentiment indicators are expected to decline, but inflation expectations remain unchanged. Empire Manufacturing is improving, while industrial production should slow down on the month-on-month read. It looks unlikely that these releases can materially affect expectations for next week's meeting when a hold appears a done deal, and all focus will be on new projections and forward-looking language.

The next resistance for DXY is the 105.85 March high: beyond that, it would explore levels last seen in November 2022. Today is starting on a more risk-supportive tone in FX, as China's August industrial production and retail sales both surprised to the upside, fuelling expectations that the worst may be behind us on the Chinese data flow. The dollar may correct a bit lower today, but the risks remain skewed towards further strengthening in the near term, or at least until the US activity picture starts to show some cracks.

Francesco Pesole



EUR: Driven even more by the dollar after dovish ECB hike

The ECB delivered a [25bp rate hike yesterday](#) but added a paragraph in its statement that quite clearly hinted this should be the last move of the tightening cycle. That paragraph, which President Christine Lagarde re-read multiple times during her press conference, says ECB rates have "reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target".

A data-dependent approach was reiterated, but it is now looking more likely that will be used to judge how long rates will be kept at such restrictive levels, rather than to decide whether to add another hike before reaching the peak.

We had discussed the asymmetrical downside risks for the euro yesterday, and those fully materialised. With a full 25bp hike already in the price by year-end, the ECB had to move away from dovish language to support the euro, while quite the opposite happened. We think that at this stage EUR/USD will revert to being even more driven by the dollar leg. Markets have taken on board the notion that the ECB has likely peaked, meaning that data releases in the eurozone should lose some degree of market relevance. Lagarde has probably switched from a near-term hawkish narrative to defending a higher-for-longer approach to combat inflation: expect some pushback against rate cut speculation if eurozone data deteriorate further.

On the other hand, another Fed hike isn't fully to be ruled out (although it is not our base case) and markets have had to reprice Fed rate cut expectations quite substantially of late on the back of resilient US economic data. Expect EUR:USD short-term rate differentials to be an even closer function of US activity prints from

now on.

We could see EUR/USD inch back higher today, but a return to the 1.0600/1.0650 area around the Fed meeting seems appropriate.

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GBP: ECB helped BoE expectations stay low

Sterling followed the euro lower against a backdrop of broad-based dollar strengthening yesterday, and Cable has heavily tested the 1.2400 support in the past 24 hours. The dovish tilt by the ECB likely added fuel to the ongoing dovish re-pricing of Bank of England rate expectations, and markets now price in only 34bp to a peak, a 40bp correction over the past month.

EUR/GBP moved back below the 0.8600 level after the ECB dovish hike, and may stay under some mild pressure into the BoE, but looks more likely to struggle finding much direction in the near term.

This morning, the BoE will release a 12-month-ahead inflation expectation survey, which came in at 3.5% last month, although it is not likely to move the market substantially. Both investors and policymakers will still get the chance to look at a CPI print (on Wednesday) before the BoE announcement (on Thursday), which has a good chance of tilting market pricing.

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JPY: BoJ officials push back on the market's hawkish interpretation

A media report this morning suggests that Bank of Japan officials saw a discrepancy between what Governor Kazuo Ueda stated in a recent interview about the timing of adjusting monetary policy and what markets interpreted. For some background, we discussed Ueda's comments in [Monday's FX Daily](#): he had hinted at earlier-than-anticipated timing (year-end) for the BoJ to have enough evidence on wages to decide on a potential monetary policy shift.

The actual tone of the interview was quite cautious, but a market that has been on its toes for any hawkish sign understandably overreacted to the remarks. USD/JPY is also in the FX intervention area. While the rate of change has probably not been alarming enough to justify Japanese officials to step in, Ueda's comments did look to us as a "soft" intervention.

Clearly, BoJ members are ready to trade some more yen depreciation for clarity on their stance – and avoid bond market volatility – so the chances of actual FX intervention are rising again, especially given the unlikelihood of an immediate turn lower in the dollar ahead of next week's FOMC.

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