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FI and FX Daily brief - Risk of a rate hike from Federal Reserve in September rise

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Summary

Federal Reserve Chairman Kevin Warsh delivered a hawkish speech on Friday at the Federal Reserve's annual Jackson Hole symposium. He reiterated that bringing inflation down is still the top priority for the Federal Reserve and warned that price pressures still remain. The market increased the probability of a hike in September and the US Treasury flattened from the front end. The dollar strengthened versus both the Euro and Yen. There has been a modest rebound in the USDJPY, while EURUSD is more or less unchanged this morning. US Treasury yields are more or less unchanged this morning in Asian trade.

This morning the oil price rose as tensions increased between US and Iran on the back of attacks from US on Iranian rocket launchers. Brent moved above USD 90.

This week we have another crucial event for the US market given the labour market report for August, which is released on Friday. On top of this we have inflation data from the Eurozone. Bank of Canada have a policy meeting on Wednesday, where consensus is for unchanged policy rates. In Scandinavia, there is focus on the Danish Central Bank as we have FX reserve data published on Wednesday. Here the market will look for any FX intervention from the Danish Central Bank in August.

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EUR/USD turned sharply lower below 1.16 during Kevin Warsh's speech at Jackson Hole on Friday. EUR/USD FX forwards moved higher particularly around the 1-year tenor, as markets repriced the relative monetary policy outlook in favor of higher USD rates - a move we generally expect to continue. Front-end risk reversal skews have more than reversed the rally triggered by US Treasury's buyback announcement in mid-August and are now back to negative territory. Markets are pricing nearly 60% probability of the Fed hiking rates already in September, with cumulative 60bp of hikes priced in by next June. As usual, Warsh did not refer to future policy decisions specifically, but he provided a clearer overview of his own thinking on the economy.

He emphasized that the labor market is steady, growth is uneven across sectors, but generally solid, financial conditions are not clearly restrictive and inflation is above target. We see a good chance he could join Hammack, Kashkari and Logan in voting for a hike in September (the former two have publicly supported tightening also after the July meeting). This week's main data focus is on Friday's US August Jobs Report, where we forecast NFP at +65k, unemployment rate at 4.1% and average hourly earnings at +0.3% m/m SA - generally slightly stronger than consensus. Today, we will look out for German flash inflation reading for August. Last Friday's data from Spain and France did not show clear signs of underlying inflation picking up.

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Yields climbed over the Friday session, as Fed Chair Warsh struck a more hawkish tone compared to back in July. He emphasised the Fed's 2% inflation target and the role of the Fed in determining the path of short-term rates. Market pricing for the September FOMC meeting jumped to near 60% from about 35%, as Warsh's comments compounded with similarly hawkish tones from Fed's Schmid and Hammack. The Treasury curve flattened with front end yields increasing 12bp and the back end moving some 1-4 bp higher. The move spilled over into European markets, where the belly of the Bund curve gained about 4bp, after declining earlier in the day due to HICP figures from France and Spain that overall showed inflation being driven by energy products, with no clear impact on underlying inflation. Today, the German HICP figures are up for release, and the underlying momentum will be the key thing to watch. The euro area flash inflation data and unemployment figures are set for release Wednesday. In the US, this week will revolve around labour market data, with the JOLTS report on Tuesday, the ADP private sector employment growth on Wednesday, Services PMIs on Thursday and the Jobs Report on Friday.

On supply, the EU will start off the week selling EUR 2.5bn in a 5Y bond, EUR 2.5bn in a 10Y bond and EUR 2bn in a 15Y bond. On Tuesday we will see Germany selling EUR 5.5bn in OBL 2.9% 2031. The Scandies are live on Wednesday with Denmark selling in DGB 2.25% 11/35 bond and DKK 2bn in DGB 0.25% 11/52. Sweden will sell SEK 2bn in a 2.5% 2036 bond and SEK 3bn in an 2.75% 2037. We await the details on what Norway will sell and whether they will do the 20Y syndication this week or a regular auction. The syndication could come already this week given a stack of Central Bank meetings during the rest of September. On Thursday Spain and France are both in the market. France will sell up to EUR 13.5bn in the long end of the curve, while Spain will sell in the 3Y to 9Y segment and the 15Y linker. Ireland have their second and last auction in Q3. It will be interesting to see if the recent upgrade from Moody's to Aa2 (positive) will have impact on the demand at the auction.