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US Treasury bond buybacks & ECB policy update in focus for FX market

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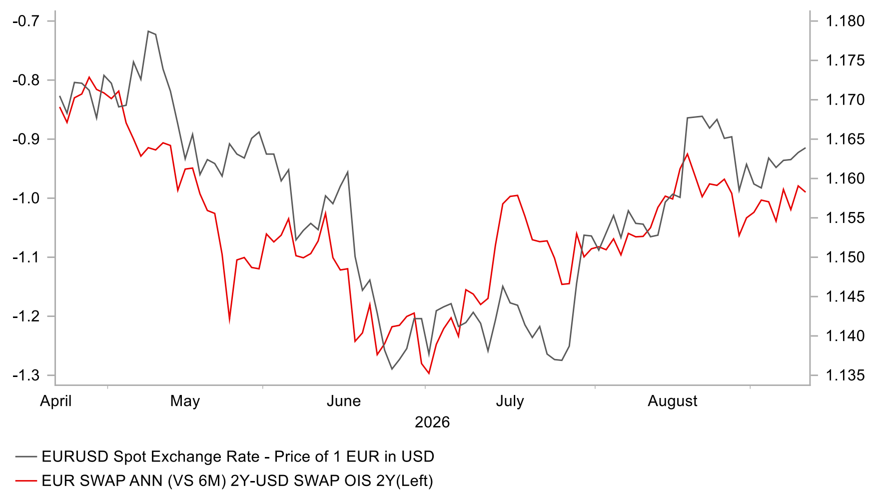
USD: US Treasury triples size of first bigger long-term bond buyback

The FX majors have remained stable overnight including USD/JPY which continues to trade just above the 153.00-level. The close proximity of today's ECB policy meeting, and tomorrow's US CPI report which is viewed as pivotal for the Fed's rate decision this month are contributing to the lack of movement in the FX market. In contrast there has been more movement in commodity and interest rate markets over the last 24 hours. The price of Brent has risen back above USD100/barrel which has encouraged expectations for more active central bank policy tightening. The 2-year German government bond yield has increased by around 7bps ahead of today's ECB policy meeting. European yields have proven more sensitive to higher energy prices over the summer than yields in the US, which continued again yesterday with the 2-year US Treasury yield increasing by around 4bps. It is one reason why EUR/USD has been moving gradually higher over the last couple of months.

At the same time, the weaker US dollar over the summer was triggered by the US Treasury's announcement on 19th August that it planned to at least double the size of

YIELD SPREADS SUPPORTING EUR AHEAD OF ECB UPDATE



Source: Bloomberg, Macrobond, MUFG Research long-term bond buybacks. The announcement triggered a US dollar sell-off and it has since remained around 1% weaker. The Treasury's efforts to dampen/cap long-term yields undermined confidence in the US dollar at time when upside inflation risks are increasing. The expanded bond buyback program has been compared to the Fed's 'Operation Twist' back in 2011-2012 when they sold short debt to fund long-term debt purchases.

Further details of the US Treasury's expanded bond buyback program were announced yesterday when it was revealed that the maximum size of the first bigger bond buyback operation was tripled from USD2 billion up to USD6 billion. In response long-term US yields initially jumped higher with the 30-year yield rising by around 5bps and has since settled about 2-3bps higher. The price action could reflect some initial disappointment that the size of the bond buyback was not even bigger. In contrast, the US dollar staged an initial modest relief rally but that has largely reversed now.

The US Treasury did not provide further updated guidance over the size of future operations. There are 6 further buybacks scheduled for the current quarter up to 3rd November. If the US Treasury continues to hold 9 bond buybacks each quarter, and purchases up to USD6 billion at each operation then it could give a rough ballpark figure for potential annual purchases of just over USD200 billion. It would be a smaller version of the Fed's 'Operation Twist'. Admittedly, it is highly uncertain how long the bigger purchases will be sustained and it is possible the size of operations could even be increased further going forward. For comparison, the Treasury's long-term debt issuance plans for the current quarter are USD231 billion which are similar to the previous quarter. Please see our latest FX Focus report (click here) for more details on how the bond market sell-off is impacting the foreign exchange market.

EUR: Will the ECB meet hawkish market expectations?

Market attention will now shift to the ECB's policy update later today. EUR/USD has been drifting higher at the start of this month moving back above the 200-day moving average at around 1.1635 ahead of today's ECB meeting. Market participants are anticipating a hawkish policy update from the ECB today taking into account higher energy prices over the summer and the resilience of the euro-zone economy to the energy price shock so far this year. The developments will provide justification for the ECB to deliver a second hike of the current tightening cycle. It will lift the policy rate up to the top of the ECB's estimated range for the neutral policy rate of 1.75%-2.50%.

The performance of the euro in response to the ECB's policy update will depend more on how strongly the ECB signals that further rate hikes are likely to be required. We have been forecasting that the ECB would be more reluctant to move rates into restrictive territory, but acknowledge that the latest unfavourable energy price developments will add to policymaker concerns over potential second round inflation effects. The euro-zone rate market is already almost fully priced for another hike by December so there is a high hurdle for a hawkish policy surprise (click here).

KEY RELEASES AND EVENTS

Country	BST	Indicator/Event	Period	Consensus	Previous	Mkt Moving
IT	09:00	Industrial Production MoM	Jul	0.3%	-1.0%	!!
EC	13:15	ECB Deposit Facility Rate	Sep-26	2.5%	2.3%	!!!
US	13:30	Initial Jobless Claims	46270	205k	206k	!!
US	13:30	PPI Final Demand MoM	Aug	0.4%	0.0%	!!
EC	13:45	ECB President Lagarde Press Conference				!!!

Source: Bloomberg & Investing.com

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