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FX Daily: Defensive rotation in play

It looks like markets are going through a subtle regime shift. Higher energy prices no longer mean higher rates forever; instead, the long end is starting to express a little more fear about growth. The upcoming US midterms may also be playing a role. It looks like there is some defensive rotation underway into the Swiss franc, the yen and sterling



As the US midterms approach, investors appear to be rotating into defensive currencies

USD: Midterms could be starting to play a role

Risk assets are on the back foot this European morning as energy prices stay firm and tech stocks remain fragile. On the former, a hefty risk premium remains in oil prices as attacks against Saudi Arabia continue. On the latter, Q3 results from Meta and Tesla and what they mean for capex plans are still being digested, but there clearly remains a fine line to walk. The suspicion now is that global equity investors are starting to scale back their exposure to the tech sector and looking for more defensive plays in sectors like consumer staples, healthcare and utilities. This will favour more geographic allocation to European equities, where tech weights in benchmark indices are lower. The upcoming US midterms in early November may also play a role here, where a Democrat sweep of Congress could slow/reverse deregulation.

At the same time, we are seeing a subtle change in the rate markets. During the late summer and especially in September, higher energy prices were associated with 'higher rates forever'. The one-month USD OIS priced 10 years forward traded at 5.17% – miles away from any

neutral rate near 3.50%. These views are now changing. That OIS pricing has now dropped back to 4.85% as yield curves have flattened and investors seem to be a little more worried about growth than inflation.

This environment probably favours a little more outperformance of the defensive currencies over commodity currencies. But until the rock-solid short-end of the US yield curve starts to buckle, it is hard to make the case that the dollar needs to fall across the board.

We favour consolidation over correction for the DXY dollar index, but do not rule out some further softening to the 101.25/30 area.

The US data calendar is light again and we expect the dollar to be dragged around by tech stocks.

Chris Turner

EUR: Hard to be constructive

EUR/USD is trading quite well despite higher energy prices and an unresolved French budget crisis. One can only conclude that the biggest market driver at the moment is the heavy and concentrated positioning in US tech and the dollar, which is being gently pared back. Expect FX traders to keep a very close watch on the short end of the US curve now. Expectations for further Fed tightening have stayed rock-solid at around +75bp over recent weeks. We think that could remain the case for the coming months and that the dollar could stay strong. But any tech wobble that prompts a dovish re-pricing at the short-end could lead to a broader dollar correction.

There is little on the eurozone calendar today apart from the last of the ECB speakers before the blackout period commences later today. See here for a preview of next week's ECB meeting.

We do not think there is a strong case for EUR/USD to trade a lot higher. But if US tech does suffer now, a break of 1.1270/75 could open up 1.1340/50. However, we would not chase the rally. 1.13 remains our one-month forecast as outlined in this month's FX Talking.

Chris Turner

GBP: Back in fashion

It seems like sterling is riding on the coat-tails of PM Andy Burnham's popularity. In reality, it looks like there is both independent sterling strength and independent euro weakness at play in EUR/GBP. Earlier this summer, we had felt that sterling gains would not last. But now greater market confidence in a Bank of England tightening cycle – we look for 25bp hikes in February and November – makes sterling a high-carry European currency.

Next week's UK budget looks unlikely to derail the recent EUR/GBP break below 0.8400. And with the euro still having plenty of room to drop on French politics, EUR/GBP can stay offered in a 0.8360-0,8430 range for the time being.

Chris Turner

TRY: Easing resumes as carry trade holds

We expect the Central Bank of Turkey to resume its easing cycle for the first time since the US-Iran conflict began today, cutting rates by 100bp to 36.00%. September's inflation data provided a positive signal, while developments in investment funds point to downside risks for the economy in the final quarter. The authorities' swift response appears to have contained the fund shock, with no signs of systemic risk or a sharp rise in dollarisation, while foreign inflows have resumed.

However, it may further weaken domestic demand through tighter liquidity, wealth losses and lower confidence. Repayments to smaller investors could cushion consumption, but counterparty exposures remain the main spillover risk. Inflation sentiment has improved after benign September data and expectations of weaker demand. We expect 100bp cuts in October and December, taking the policy rate to 35% by year-end, versus our 29.0% inflation forecast for year-end.

Although crowded long TRY positions offer less and less carry, they remain popular in emerging markets, and we expect this demand to persist in the coming months despite renewed rate cuts. The recent weekly adjustment in USD/TRY does not alter the overall FX setup, and the carry trade continues. We expect a level of 51.50 USD/TRY by the end of the year.

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