FX Daily

(07:15 CET) **19 October 2021**

Stagflation, policy mistakes or why GBP trades like EM FX

Asia overnight

Reports that Chinese officials are considering asking media companies to let rivals access and display their content in search results had little impact on Chinese technology stocks. Investors also were heartened by a dip in UST yields. At the time of writing, most Asian bourses were trading higher and S&P500 futures roughly flat. Lower UST yields weighed on the USD and it was the weakest performer in the G10 in the Asian session. The Antipodean currencies were the strongest performers. The AUD was held back by a dovish set of RBA Minutes.

AUD: RBA expects a low inflation recovery

The RBA Minutes suggest the central bank is looking for a low-inflation recovery. The RBA expects strong rebounds in household consumption and employment growth once Covid restrictions are lifted and these restrictions are being lifted earlier than the RBA expected. The RBA still expects GDP to return to its pre-delta path (trend growth) in H222, but it believes Australia will experience lower inflation relative to other countries experiencing similar economic recoveries. Supply-chain blockages are not having as large an impact on Australia's CPI. Australia's wages growth was weak before the pandemic (unlike in the US and UK) and so it will take longer for this growth to recover and accelerate to the level required to push inflation sustainably into the RBA's 2-3% inflation target band. By the RBA's own calculations, wages growth needs to accelerate above 4% and this will take until 2024. The Minutes also highlight that Australia's hot housing market will not push the RBA into raising rates. Board members believe macroprudential measures are better suited to dealing with the systemic risks around the housing market. While rate hikes would lead to lower housing prices and credit growth, they would also see fewer jobs and lower wages growth. This would obstruct the path to the RBA's goals of full employment and inflation sustainably within the target range. We continue to think the RBA and RBNZ are about to experience a historically long and large policy divergence and remain short AUD/NZD.

Stagflation, policy mistakes or why the GBP trades like an EM currency

Recent comments by BoE Governor Andrew Bailey have encouraged investors to frontload policy normalisation expectations, with the UK rates markets now pricing in a 15bp hike in November and a total of 125bp of hikes by the end of 2022. The latest rate hike frenzy has left FX investors cold, however, with the GBP losing ground vs the EUR and USD. There are two drivers of the underperformance in our view: (1) the first is the concern that the BoE will commit a policy mistake by tightening aggressively in response to surging inflation and risk derailing the UK economic recovery; and (2) some clients have further highlighted the inverse relationship between the GBP and UK rates as an indication that the GBP is trading like an EM currency. In particular, the relationship could indicate that both inflation and financial stability concerns are driving the recent hawkish BoE rhetoric as the MPC tries to stabilise the GBP in the face of deteriorating UK fundamentals. On the day, focus will be on speeches by BoE's Andrew Bailey, Catherine Man and Huw Pill. The views of the latter could be of particular interest for the markets given that they could signal that there is now a 'critical mass' of support for a rate hike at the MPC. That being said, we doubt that the BoE will be able to meet the already very hawkish market rate expectations. A moderation of the latter could thus represent an important downside risk for the currency from here.

EUR: the revenge of the ECB doves

The EUR has recouped some lost ground vs the USD and the GBP of late while extending its recent gains vs the JPY. We think that part of the recovery is driven by the recent recovery of the Eurozone money market rates. Indeed, the 2Y EUR swap rate hit its highest level since June 2020 and therefore one of its highest

https://research.ca-cib.com

Valentin Marinov
Head of G10 FX Strategy
+44 20 7214 5289
valentin.marinov@ca-cib.com

David Forrester
Senior FX Strategist
+852 2826 1529
david.forrester@ca-cib.com

Alexandre Dolci
FX Strategist
+44 20 7214 5064
alexandre.dolci@ca-cib.com

Latest publications

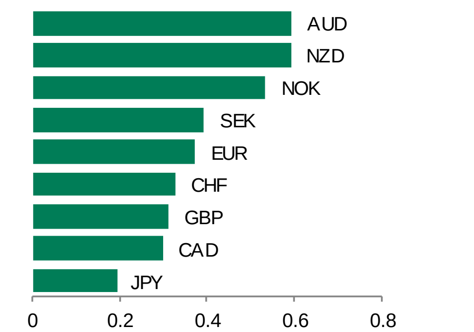
18 Oct – *FX Positioning: Buy the oversold JPY and CHF*

18 Oct – *FAST FX: Buy EUR/NOK, EUR/SEK & AUD/USD, but sell EUR/USD*

15 Oct – *FX Weekly: The GBP and the price of policy mistakes*

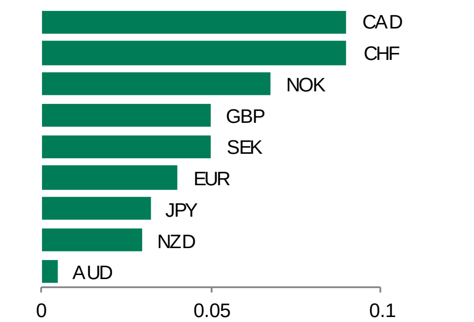
14 Oct – *FX Volatility Monitor: Is a taper tantrum inevitable?*

Overnight returns (%, vs USD)



Source: Bloomberg, Crédit Agricole CIB

1M implied volatility daily change (net, vs USD)



Source: Bloomberg, Crédit Agricole CIB

CRÉDIT AGRICOLE
CORPORATE & INVESTMENT BANK

levels in almost two years. In turn, the moves reflect the repricing of future ECB rate hikes with the Eurozone, with investors now expecting a 10bp hike in 2022 and attaching a c.80% chance to a 25bp hike by the end of 2023. That being said, some cautiousness maybe warranted on the EUR in the very near term, given that, on the day, focus will be on speeches by a number of ECB 'doves': Olli Rehn, Philip Lane, Mario Centeno and Fabio Panetta. Indications that some of the policymakers are pushing back against the latest repricing of ECB tightening risks can hold the latest EUR recovery in its tracks. Looking further ahead, however, our view remains that the ECB policy normalisation plans (expected to be announced in December) should make the EUR a less attractive funding currency without triggering a sharp selloff in the Eurozone stock markets or the high-yielding EGBs. We thus stick with our long EUR/JPY trade idea.