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FX Flash

Fed's Signals and Current FX Plays

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Fed Hikes 25bps, Signals Pause

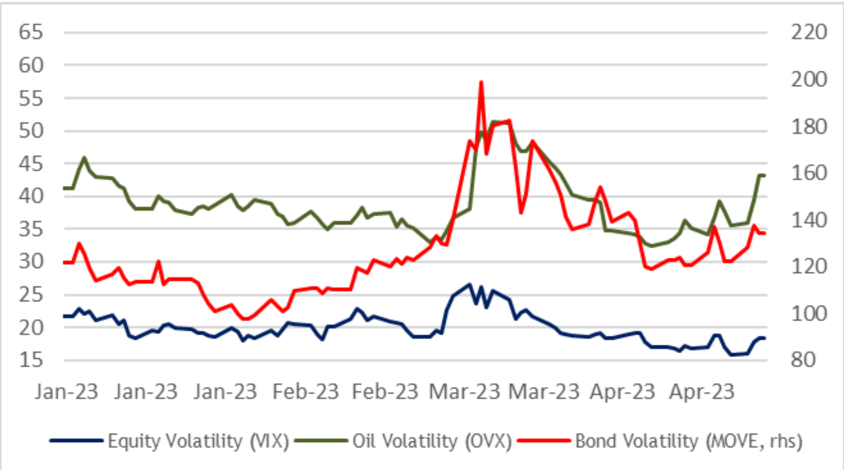
The FOMC voted unanimously to raise Fed Fund Target rate by 25bps to 5.00-5.25% last night, noting still robust job gains and elevated inflation. Key takeaway from the statement was the omission of the phrase "The committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time" that was present in the Mar FOMC statement, providing the signal that the Fed could be at peak policy rate settings.

Future policy path, according to Powell's press conference, would be data dependent, specifically economic indicators of inflation, labour-market and credit conditions. Apart from the restraints from high interest rates, the Fed acknowledged that recent banking events have exacerbated credit conditions for households and businesses. Economic activity, labour market conditions and inflation should be affected but the extent at this point remains uncertain.

Powell retained a hawkish stance nonetheless, reiterating that the Fed is "prepared to do more if greater monetary policy restraint is warranted". In addition, he noted that it is an "ongoing assessment" on whether the Fed policy rates are "sufficiently restrictive", a sign that he wants to keep the option of more rate hikes on the table. He also mentioned that inflation is not forecasted to ease quickly and it would not be appropriate to cut rates in such an environment. With regards to the debt ceiling issues, Powell opined that it is "essential" for the debt ceiling to be raised and that a US government default could be quite adverse.

Taken together, the Fed managed to deliver the expected. Peak rate of 5.00-5.25% was the median projection from the Summary of Economic Projections indicated in Mar as well as in Dec 2022 and a signal of a pause today is a nod to that and is in line with market expectations. As a result, market volatility remained subdued for most asset classes in spite of the rate hike.

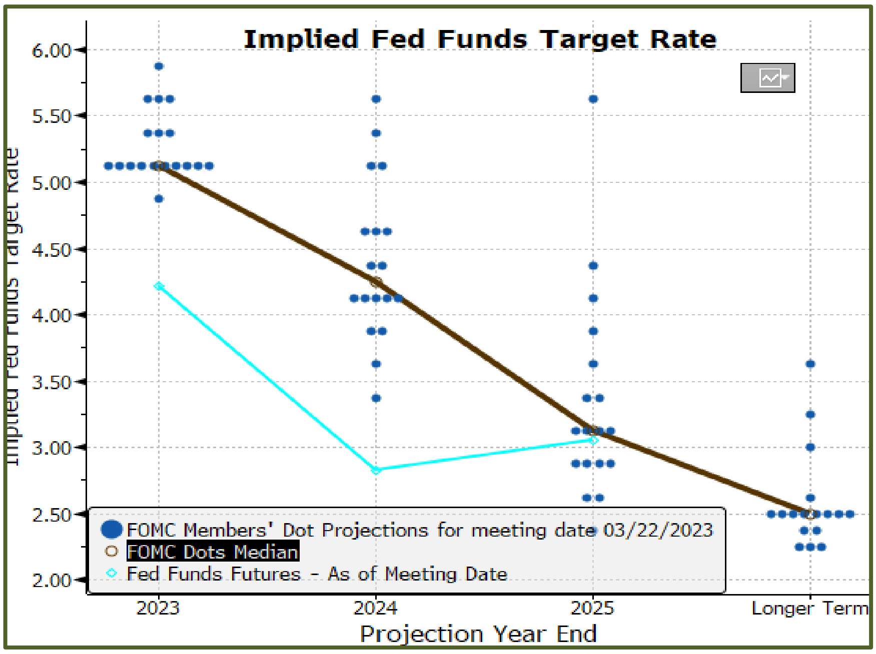
Chart 1: Market Volatility was Little Aggravated



Source: Bloomberg Maybank FX Research

Fed Fund Futures now price in 88bps cut through Dec 2023 from current effective rate of around 5.1%. In line with our expectations, even as Powell tried to push back on rate cuts, markets still expect least three cuts this year.

Chart 2: Big Disparity Between Market Expectations Vs. Fed projections

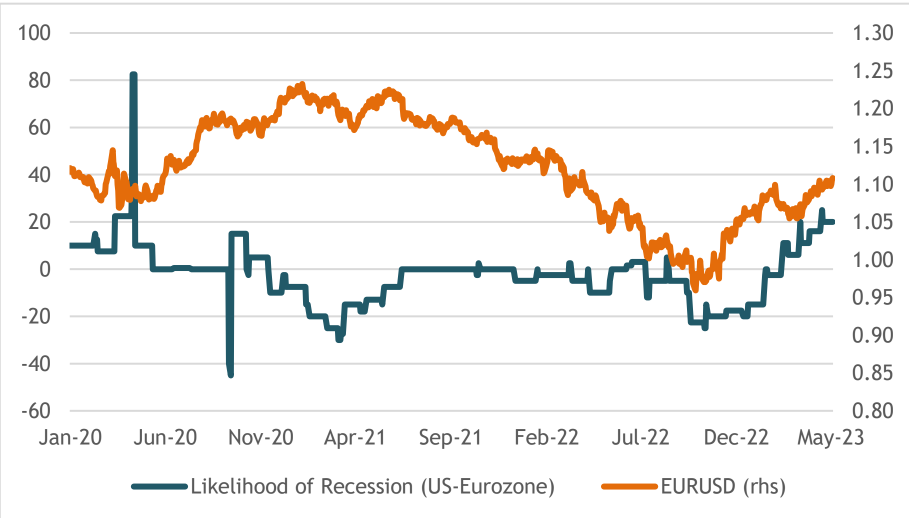


Source: Bloomberg

Market Reactions

The USD was already on the slide ahead of the decision as markets began positioning for a pause amid concerns that more regional banks in the US would be under pressure after the failure of a third US bank (First Republic Bank). The DXY index was down 0.5%. Gold was up 0.7% and Brent crude oil remained under pressure, down 4.0% within the session. To be clear, the policy divergence between the Fed and ECB could have exacerbated the weakness of the USD. Afterall, based on Bloomberg estimations, the probability of US entering a recession has become higher than that of the Eurozone.

Chart 3: Probability of Eurozone Entering Recession is Less Than the US, EUR Strengthens

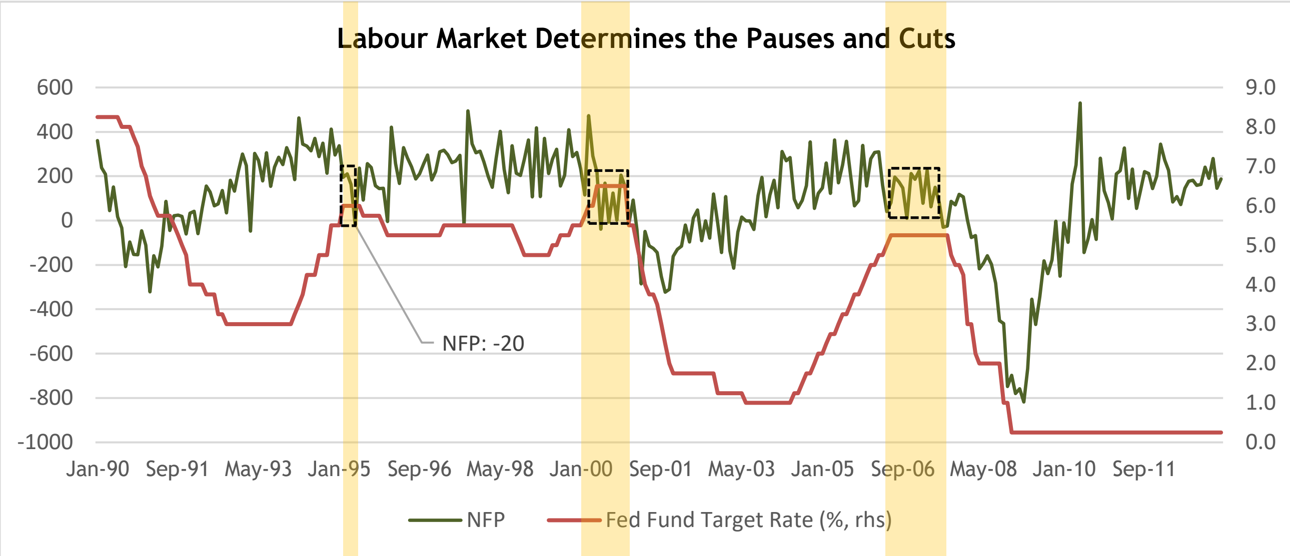


Source: Bloomberg, Maybank FX Research & Strategy

Our Thoughts

Like the rest of the markets, we do think that the Fed could be close to a pause given the recent performance of the labour market. Based on past cycles (with the exception of 2019), the Fed tends to pause when NFP drops under the 200K and starts to cut when NFP turns negative.

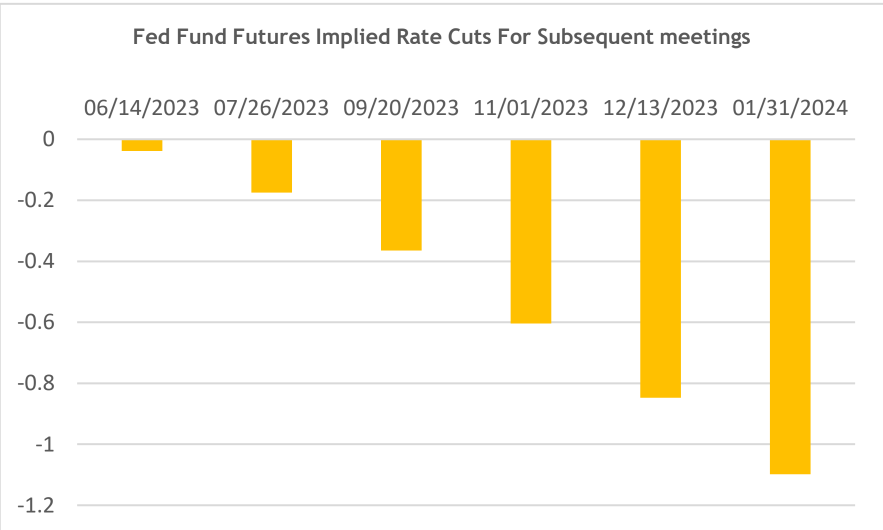
Chart 4: Labour Market and Fed Fund Target Rate



Source: Bloomberg, Maybank FX Research & Strategy

A steep drop in **Apr NFP this Fri, below 200K** would thus hasten expectations for a rate cut. At this point, the first full cut of 25bps is expected to come as soon as Sep 2023 according to Fed Fund Futures this morning in the chart below.

Chart 5: Fed Fund Futures Implied Rate Cuts for Subsequent Meetings



Source: Bloomberg, Maybank FX Research & Strategy

FX Thematic Plays

With inflation still elevated in some parts of the world, the monetary policy divergence play could still benefit currencies with central banks that still have some tightening runway such as the EUR and GBP. We do not rule out potential for some dovish pivot at some point as economic indicators start to deteriorate under the weight of rising borrowing costs. At that point, gains for the EUR and GBP could start to slow.

Chart 6: GBP, EUR Can Continue to Outperform USD, CAD, AUD

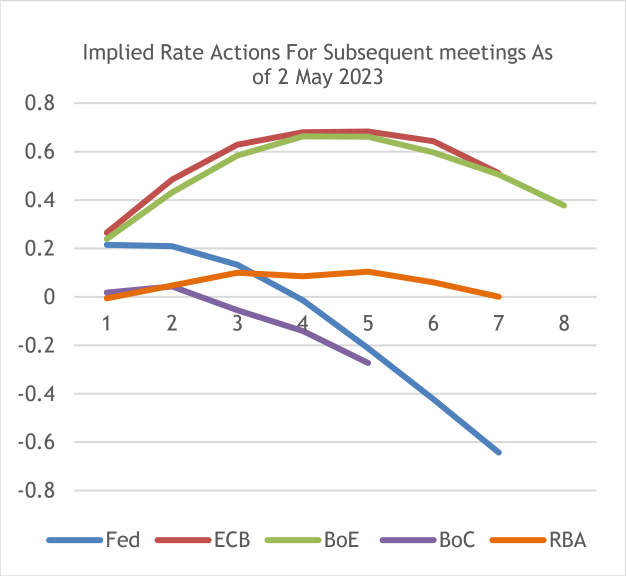
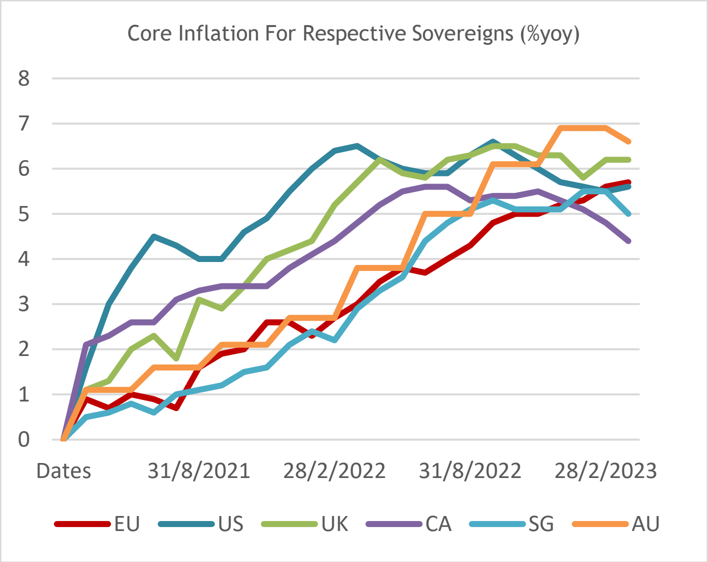


Chart 7: Core Inflation Turns Lower, But Still Elevated



Note: Implied Pricings were taken as of 2 May, before the latest Fed decision for better comparison

Source: Bloomberg, Maybank FX Research & Strategy

We are in a late cycle with oil coming under pressure as growth outlook softens. Oil-linked currencies such as the CAD and MYR could thus be weighed a tad as investors continue to fret over recession possibilities. Pro-cyclical currencies such as the AUD and NZD could see their gains checked in the interim, especially in the absence of strong growth recovery in China.

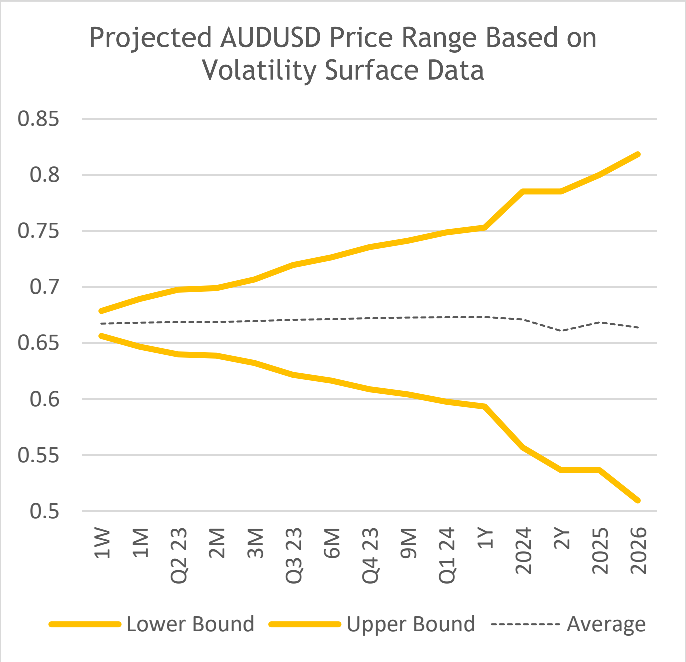
Currencies with dovish central banks as well as lower yielders will experience some relief vs. the USD but less against the EUR and GBP. These include TWD and KRW. High carry IDR, INR may continue to benefit as long as volatility remains subdued.

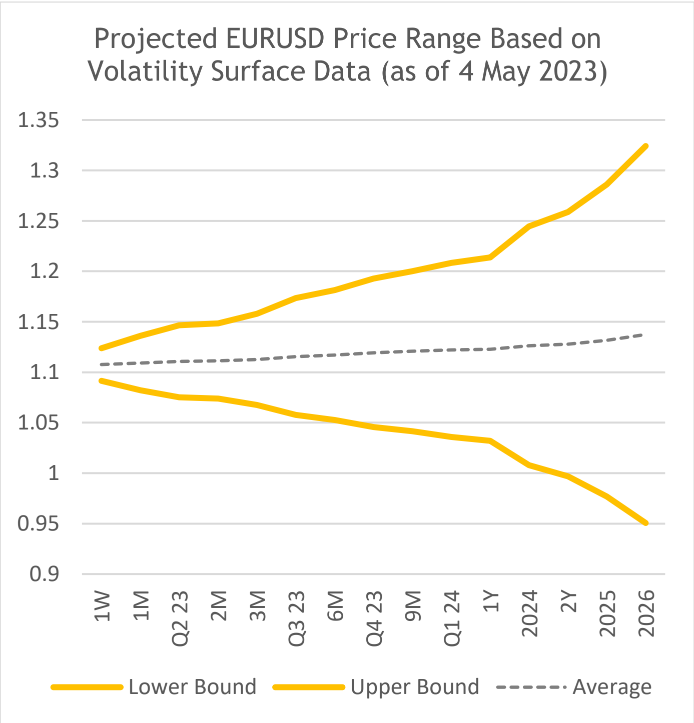
Safe havens and safe haven proxies will remain resilient as the macro economic outlook becomes less certain. As a result, JPY would be key beneficiary, especially propelled by narrowing UST-JGB differential. Gold will rise further as real yields are likely to fall. While MAS has halted its tightening cycle, current policy dictates SGDNEER to remain on an appreciation path and that could continue to give SGD some kind of resilience in an environment of weaker growth outlook.

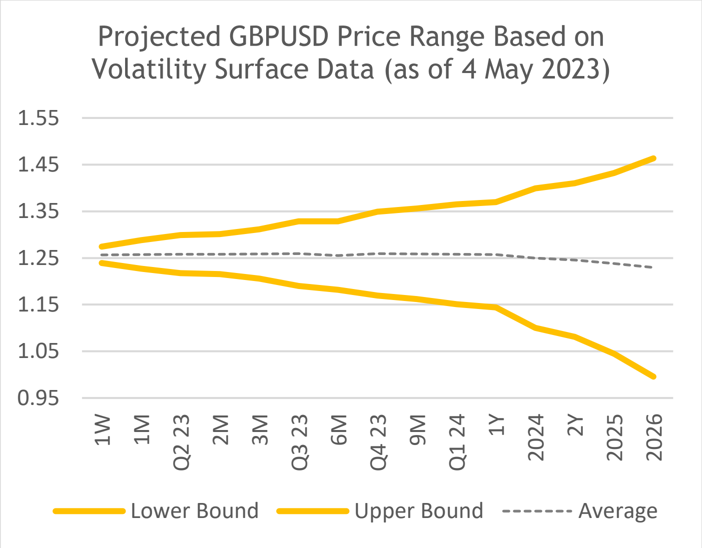
We caution that this thematic play may see some shift once China's recovery become more prominent. The scenario of risk-on play could start to strengthen pro-cyclical currencies such as the AUD, NZD, CAD, KRW and to some extent TWD.

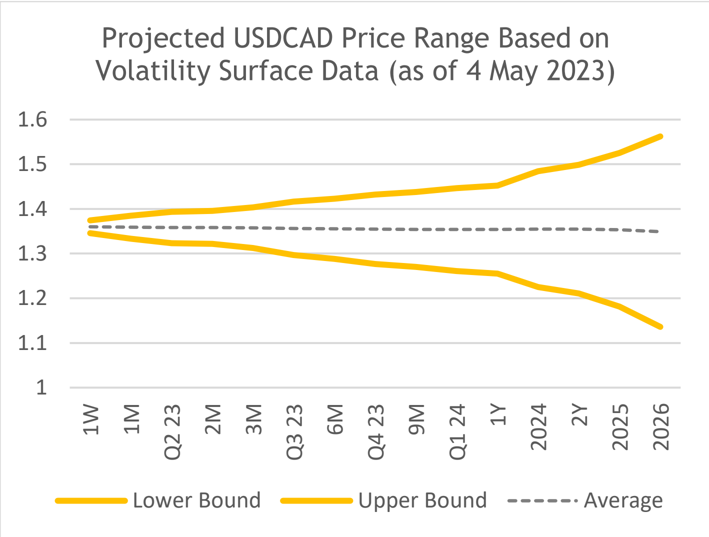
Implied FX Ranges Based on Volatility Surface Data (1 standard deviation)

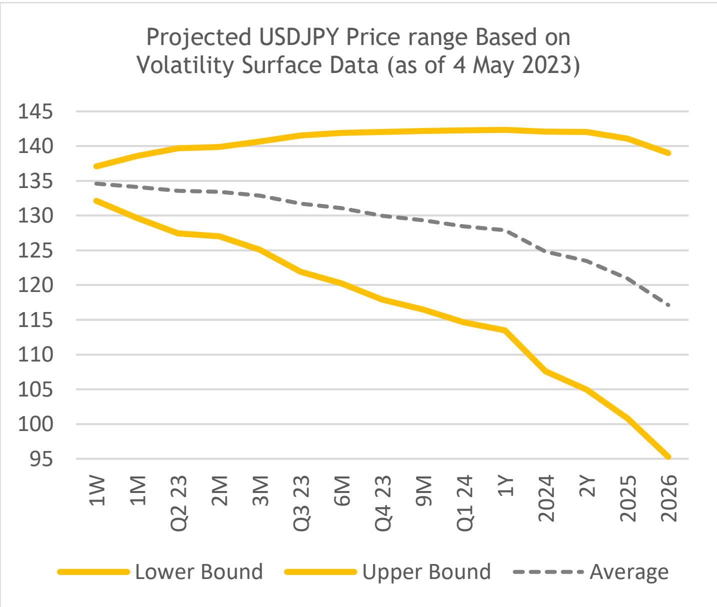
Source: Bloomberg, Maybank FX Research & Strategy






Projected GBPUSD Price Range Based on Volatility Surface Data (as of 4 May 2023)
1.55
1.45
1.35
1.25
1.15
1.05
0.95
1W
1M
Q2 23
2M
3M
Q3 23
6M
Q4 23
9M
Q1 24
1Y
2024
2Y
2025
2026
Lower Bound
Upper Bound
Average


Projected USDCAD Price Range Based on Volatility Surface Data (as of 4 May 2023)
1.6
1.5
1.4
1.3
1.2
1.1
1
1W
1M
Q2 23
2M
3M
Q3 23
6M
Q4 23
9M
Q1 24
1Y
2024
2Y
2025
2026
Lower Bound
Upper Bound
Average


Projected USDJPY Price range Based on Volatility Surface Data (as of 4 May 2023)
145
140
135
130
125
120
115
110
105
100
95
1W
1M
Q2 23
2M
3M
Q3 23
6M
Q4 23
9M
Q1 24
1Y
2024
2Y
2025
2026
Lower Bound
Upper Bound
Average

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