

## Liquid Insight

## Do rates still matter for FX?

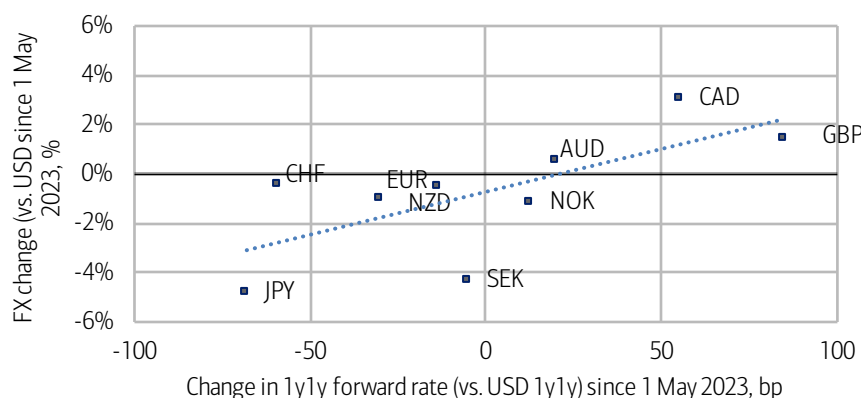
## Key takeaways

- FX markets are struggling to disentangle the short-term risk of higher terminal rates vs. medium term recession risk...
- ... evident in muted FX responses to recent hawkish surprises, as well as the decoupling of FX vs. rates volatility.
- Despite this, we show that G10 FX moves have been largely consistent with historical betas to front end rate differentials.

## By Adarsh Sinha

## Chart of the Day: G10 FX vs. 1y1y changes (relative to USD) since 1 May 2023

G10 FX changes largely consistent with shifts in front end rate differentials



Source: Bloomberg

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## Do rates still matter for FX?

Rates and FX markets are grappling with the short-term risk of higher terminal rates vs. medium term recession risk (and potential rate cuts further out). While this clearly translates to deeper curve inversion in rates, the implications for FX can be harder to disentangle. This was evident in last week's muted FX response to hawkish central bank surprises, as well as the decoupling of FX vs. rates volatility. That said, the Chart of the Day shows relative FX performance has been largely consistent with shifts in front end rate differentials and we show these are commensurate to what historical betas would imply, with the exception of SEK weakness. While JPY also screens as weak relative to rate differentials, the divergence is not yet sufficient to imply it is not "reflecting fundamentals" – a likely precondition for any FX intervention.

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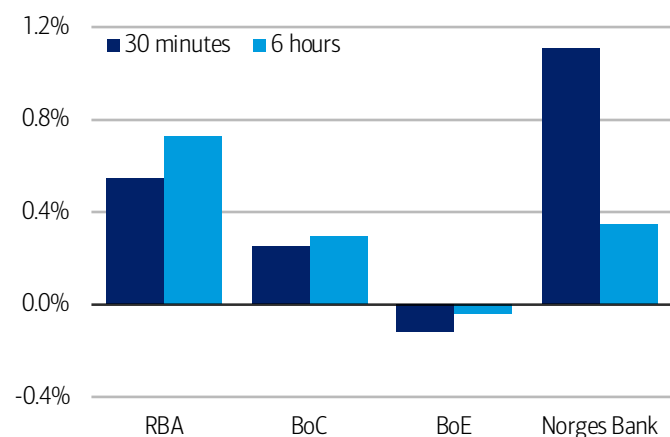
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## G10 central banks continue to surprise hawkishly

While we are in the ballpark of terminal rates for most central banks, surprise rate hikes by the Reserve Bank of Australia and Bank of Canada earlier this month were reminders of the commitment to achieving inflation targets, not to mention that pause  $\neq$  terminal. Last week, two more central banks surprised relative to consensus expectations the Bank of England and Norges Bank hiked 50bp (consensus 25bp). Exhibit 1 shows that these surprises generally mattered for FX, although the limited GBP reaction (due to dovish guidance) and large retracement of NOK gains have raised questions around the significance of higher front end rates for FX markets.

### Exhibit 1: June central bank surprises – mixed reactions

Currency response (vs. EUR) after surprise rate hikes

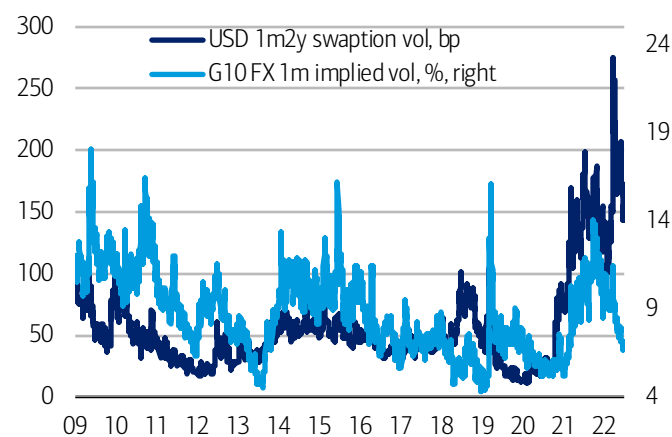


Source: Bloomberg, Note: currency response shown vs. EUR to disentangle from broader USD dynamics

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### Exhibit 2: 1m implied volatility – G10 FX vs. 2y USD IRS

FX vol is subdued relative to rates volatility



Source: Bloomberg

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## But FX volatility is subdued relative to rates volatility

Exhibit 2 illustrates this from an implied volatility perspective. Short-dated FX implied vol has remained subdued relative to still high USD swaption vol, reflecting divergent realized volatility in underlying markets over the past month. A non-exhaustive list of reasons include:

- **Positioning/technicals:** This is the most straightforward explanation – positioning in rates was more crowded relative to FX ([FX and Rates Sentiment Survey 09 June 2023](#)), with subsequent position cutting leading to greater rates vs. FX volatility.
- **Interest rate differentials:** Given the uniform rise in front end rates across markets, rate differentials have been somewhat less volatile than absolute levels, translating to lower FX vol. However, there are nuances that we discuss in more detail below.
- **Growth vs. rates:** Both rates and FX markets are grappling with the short-term risk of higher rates vs. medium term recession risk (and potential rate cuts further out). While this translates cleanly to deeper curve inversion in rates, the implication for FX can be more ambiguous.

## G10 FX moves largely consistent with rate differentials

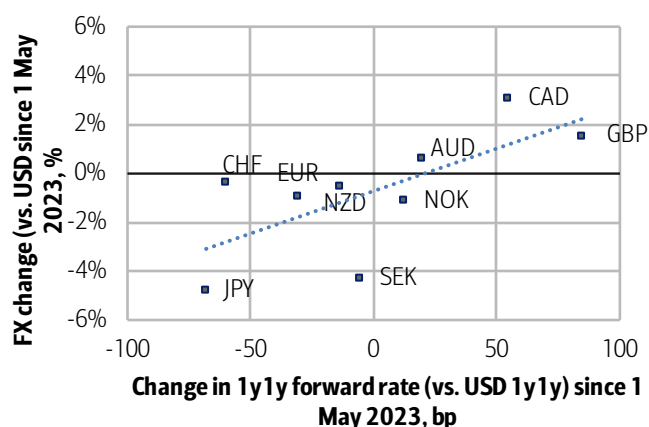
Despite the factors discussed above, we would not conclude that the recent back up in front-end rates has been irrelevant for FX. On the contrary, Exhibit 3 shows that relative moves in G10 currencies (vs. USD) since May have been reasonably consistent with shifts in front end rate differentials, specifically 1y1y forward rates that capture the tug-of-war between near-term rate hikes and medium-term recession risk. SEK weakness stands out relative to a mostly unchanged rate differential with the US, perhaps symptomatic of the higher interest rate sensitivity of Swedish household and property sectors.

While the scatterplot shows consistency of currency moves **relative** to each other, they don't tell us much about the consistency of **absolute** FX changes. But a simple exercise shows that despite low FX volatility, the absolute changes since May were mostly in line with their historical sensitivity to front end differentials. Exhibit 4 shows the actual vs. estimated changes using long-term regression betas (past 10 years) of G10 FX to 1y1y forward rate differentials. We highlight the following:

- Similar to the scatterplot, SEK stands out as the weakest relative to its usual beta to rates.
- GBP and NOK are both slightly weaker than implied by the rates beta – this is consistent with the perception that last week's hawkish surprises had muted FX impact.
- JPY is roughly 1.5% weaker than estimated – as Japan's currency rhetoric escalates, an important question is whether the yen is "reflecting fundamentals". While there is some divergence emerging, we do not think this is sufficient for actual intervention at this point.

### Exhibit 3: FX vs. 1y1y changes (relative to USD) since 1 May 2023

FX moves generally consistent with changes in 1y1y differentials...

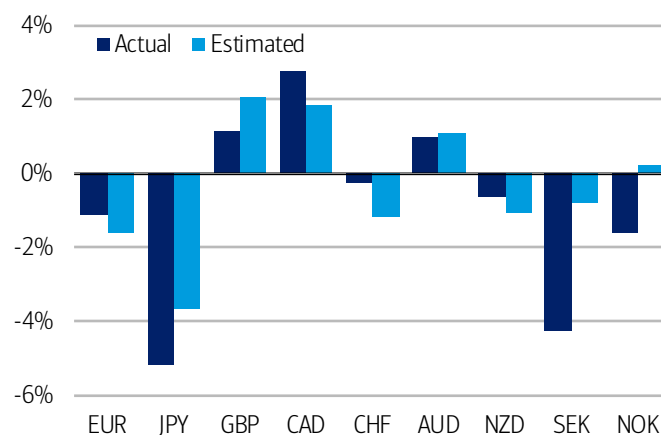


Source: Bloomberg

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### Exhibit 4: Actual FX changes vs. estimated based on 1y1y betas

... with the clear exception of SEK



Source: Bloomberg

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## Notable Rates and FX Research

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- **Global Rates, FX & EM Year Ahead 2023** – [Year Ahead 2023: Pivot ≠ Peak](#), 20 Nov 2022
- [The curious case of r\\*\\*](#) **Global FX Weekly**, 23 June 2023
- [High hurdles](#) **Global Rates Weekly**, 23 June 2023
- [USD under pressure again](#), **Liquid Cross Border Flows**, 19 June 2023

## Rates, FX & EM trades for 2023

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For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

[Global FX weekly: The curious case of r\\*\\* 23 June 2023](#)

[Global Rates Weekly: High hurdles 23 June 2023](#)

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