A Fed decision that could head to the history books is only hours away

16th September 2020

GBP

Sterling traded slightly higher against the euro overnight, extending its gains this morning. Inflation data for August was released by the Office for National Statistics and showed prices falling 0.4% on the month, bringing year on year inflation down to a mere 0.2%. Government meal subsidies and falling services prices appeared to have been the main driver of the sharp decline in prices in August, although the rate of Consumer Price Inflation excluding catering services was still slow at an annual 0.5% in August. The Bank of England will be anticipating the dip in inflation to be sustained for a few months, before prices accelerate again, so the release is unlikely to ruffle too many dovish feathers at this Thursday's Bank of England meeting. Health Secretary Matt Hancock said yesterday that the shortage of coronavirus tests that is currently hampering the nation's response would be resolved in a matter of weeks, having told the Health Select Committee a week ago the problem would be resolved within two weeks. Little firm news was available on the main theme of the week, the Government's Internal Markets Bill, although various news sources are reporting the Government is hoping to strike a deal with Conservative rebels ahead of votes on amendments next week.

EUR

The euro is trading in the red against the entire G10 this morning except the US dollar, as the dollar pared back yesterday's gains following China's relaxation of its grip on the yuan and the buildup to the FOMC tonight. Yesterday, the euro was being supported by upbeat data from Germany - the German ZEW Economic Sentiment unexpectedly rose to 77.4 in September up from August's 71.5, signalling a recovery for the bloc's largest economy. Eurozone ZEW Economic Sentiment climbed to 73.9, which also boded well for the euro, but a stronger rebound in the greenback during the late trading session quickly put a halt to the euro rally. Headlines remain sparse around the eurozone today and so do the bloc's economic data releases, but any comments from today's FOMC press conference that have not been accounted for by markets may still cause for some volatility in the euro.

USD

It's Fed day! That is right, the day for the history books, a day to get excited for. After announcing the shift towards an average inflation targeting framework, the Federal Reserve's long awaited framework review is likely to have concluded, with the results expected to be released as early as today. After the Jackson Hole Symposium, where the average inflation target was introduced, the dollar has traded on the back foot. Prospects of rate normalisation in the short-term have been left in tatters as the central bank leans towards running the economy hotter than it has done in the past, all in the name of raising inflation expectations. But the details around the implementation of such a policy have been left to the ambiguous, until tonight? In addition to these details, markets will be keeping a firm eye on the type of forward guidance the Fed tilts towards, whether it be calendar or event-based, with regards to their quantitative easing programme. Once chosen, what will the timeline look like for this forward guidance? Some things are already known despite the questions not being officially answered. The Fed is unlikely to move policy in the next year as inflation pressures remain lacklustre and the economy is embattled with the effects of the outbreak. That being said, markets are forward-looking, and explicit forward guidance coupled with fresh macro projections are likely to lead to some repricing in fixed income markets. If the Fed continues to shift back the fixed income markets expectations of policy normalisation, then the dollar is likely to feel the effects. This may cause headaches for other central banks, who have put increasing emphasis on the value of their respective currencies and the risks they pose towards their domestic economic recoveries, although this is unlikely to deter the Fed in their decision. However, despite markets sitting on tenterhooks for clarity on the above, the Fed may disappoint and opt to release the results of their review in the November meeting, allowing them some leeway before boxing in their policy decision. There is only one way to find out, but given the high probability of the Federal Reserve delivering big headlines tonight, markets are likely to trade in a very tentative manner in the run-up.

CAD

The loonies slight rally began to stall yesterday as the greenback showed a flurry of strength in the afternoon of the European session. The USDCAD pair has traded in a tight range this week, however, owing to the light data calendar in North America. That said, the thin trading range may be blown to smithereens tonight as the Federal Reserve could deliver policy tweaks that would go down in the history books, with many expecting them to announce the conclusion of their framework review. Divergence in the monetary policy stances is likely to be the main driver for USDCAD during the recovery phases. Should the Fed announce this afternoon that policy normalisation, in all senses, not just rate hikes, will be pushed further back relative to previous recoveries, USDCAD will likely break to the downside to test recent lows. While this is all speculation at present, the sanguine nature of USDCAD in the last few sessions suggests markets are priming for some fireworks later today as well.