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The central bank magic trick: turning a dove into a hawk in plain sight

Price action in G10 FX markets this week has been driven predominantly by pricing in bond markets and the actions of central banks. This dynamic is set to continue next week as the battle against rising inflation migrates from the Bank of Canada and the ECB to the Reserve Bank of Australia, the Federal Reserve, and the Bank of England. The RBA is up first and markets broadly expect the central bank to drop its yield curve control policy after the April 2024 bond, the last bond subject to YCC, rose above the 0.1% threshold on Friday and met no resistance from the central bank. The Federal Reserve is then set to taper its QE programme at a minimum on Wednesday night, before the much coveted Bank of England meeting on Thursday. Speculation is rife over whether the BoE will join the Norges Bank and Reserve Bank of New Zealand in hiking interest rates, but despite current market pricing we think the BoE will wait for more data and delay the 15bps hike until December.

Calendar (all times GMT)

Monday – 01/11

Monday's calendar is packed with Purchasing Managers' Index figures from Russia, the eurozone, UK, US and Canada. **The Russian manufacturing reading at 06:00** is set to print just above the 50-level expansionary threshold at 50.5, after last month's 49.8 reading. **At 08:45-08:55 and 09:30, PMI figures from the eurozone and the UK** are expected. These are unlikely to be too instrumental for markets given they are final releases. **At 14:00, US construction spending** will be eyed after the August print was unexpectedly flat. Spending in public sector projects increased but was offset by weakness in the private sector. Alongside it, the ISM employment and prices paid indices for October will be carefully watched for signs of wage and input cost pressures. **At 14:30 and 14:45, Canadian and US manufacturing PMIs** will be released respectively. Business confidence in the US and Canada may prove stronger according to the PMIs than in the eurozone given that the Covid developments in North America have eased while in Europe, talks about renewed restrictions are ongoing.

> However, the **manufacturing sector** is likely to share the pain of **supply-chain disruption**, which may cap how high the reading prints.

Tuesday – 02/11

The Reserve Bank of Australia's decision at 03:30 will be an eye-catcher for markets after stronger-than-expected inflation figures on Wednesday increased speculations that the interest rate may rise before 2024, which is when the RBA has been forecasting its first hike. The meeting will be of additional interest as the RBA refrained from intervening in the bond market on Friday and instead practically abandoned its yield curve control policy as yields on the April 2024 bond spiked above the 0.1% threshold. By waving the white flag, the RBA implied policy tightening will occur earlier than previously signalled. **At 21:45, New Zealand's unemployment rate** is likely to reflect the disruptions across the country through Q3 due to lockdowns in Auckland and elsewhere. With the border still closed, the labour market is also being weighed down by skills shortages with businesses unable to access migrant labour.

Wednesday – 03/11

Turkish inflation is set to print at 20.60% YoY on Wednesday at 07:00, according to the median of forecasts submitted to Bloomberg. This compares with a 19.58% increase last month. With inflation expected to increase even further this time around, markets will be even more wary as the CBRT has cut interest rates by another 200bps in October, meaning that real rates are now even further down in negative territory.

> "To add to the CBRT's woes, the **lira weakened over 7% in October**, which will only exert further upwards pressure on the inflation rate. An upward surprise is therefore likely to put even more pressure on the lira than previously."

At 09:00 and 09:30, final composite PMI figures from the eurozone and UK will be released respectively, but similar to Monday's PMIs, as these are final figures they will be of less interest to markets. **At 10:00, Eurozone unemployment** is expected to show a fall to 7.4% in September down from August's 7.5%. While the labour market is gradually improving in the eurozone, many of the national financial support measures expired at the end of September, which may mean that the labour market could see temporary bumps in its recovery in October. For that reason, markets may pay less attention to the September print as many of the government furlough schemes were still in place.

At 14:00, US factory orders for September are expected to have dropped by -0.1% MoM vs a 1.2% increase in August, as supply disruptions will likely have impacted the print. US durable goods are released at the same time, but this is a final print. The preliminary figure showed orders fell 0.4% in September, with much of the weakness being in autos and aircraft. Markets then turn to **Russian CPI inflation at 16:00** for October. Inflation surprised to the upside recently, which meant the Central Bank of Russia continued to sharply increase its interest rate last week, even though the CBR was one of the first to embark on a policy tightening cycle. Given the CBR's reiterated guidance for possible further hikes in the future and their signalling that surging inflation and inflation expectations are prioritised right now, this should shield the Russian ruble from upside surprises somewhat.

At 18:00, the Federal Reserve comes out with their policy decision and is set to bring their asset purchase programme to an end. Converging commentary from Fed members on a November taper confirms this view, while markets are also expecting fresh guidance on when purchases will ultimately stop (more on this below).

Also on Wednesday will be the **National Bank of Poland's rate announcement**, where the timing as always is unknown. Markets expect the NBP to hike interest rates by 25bp to bring the rate up to 0.75%. This would come after last month's hawkish surprise from the NBP where the central bank hiked rates by 40bps as it is now prioritising bringing inflation back to the target of 2.5% +/- 1pp.

Thursday – 04/11

German factory orders from September at 07:00 are expected to show a modest monthly increase of 0.4% after August's figure was severely hit by supply chain disruptions - especially the auto industry. After that, the **Norges Bank will announce its policy decision at 09:00**, but with them having started their tightening cycle in September already and practically having confirmed another rate hike by December, expectations for Thursday's meeting are at a bare minimum. The only FX impact may come from a slight change in wording. **At 12:00, the Bank of England** will then release its latest policy decision and accompanying forecasts. With speculation elevated over whether the Bank will raise rates by 15bps or not, the meeting is set to be a truly blockbuster event (more on this below).

Friday – 05/11

Friday's calendar starts with **German and French industrial production at 07:00 and 07:45** respectively. Both figures are expected to reflect the supply bottlenecks and disruptions that have continued over the last few months and in some sectors have accelerated, such as shipping, cargo and the auto industry. Markets may choose to trade in tight ranges throughout the morning however, given the important data releases from the US and Canada later in the afternoon. At **12:30, US Nonfarm Payrolls data and Canada's Labour Force Survey** are released. Last month, we highlighted how divergence in the September data would likely play out in a break lower in USDCAD, which ultimately occurred with the pair breaking below the 1.25 handle for the first time since September 3rd. This time around, the divergences are likely to be more discreet than altering surprises in net employment gains. Headwinds to the US figure have largely abated and the October net employment figure should show gains recorded in September that weren't visible in last month's data due to the early surveying window.

> However, Covid concerns and a sluggish adjustment to the expiry of the unemployment insurance top-up may result in **another downwards surprise**. Expectations sit at a 425k net employment gain, but the October print won't be the only metric in focus. Any upwards revision to September's 194k print will be highly anticipated too.

In Canada, net employment gains are set to slow again, but this won't be of concern now total employment has returned to pre-pandemic levels in most sectors. Underlying details of limited labour market slack will be more pivotal after last month's data saw average hours rise further towards pre-pandemic levels and heavy rotation from part-time to full-time employment. Wage growth is expected to still lag.

FOMC Preview

The first steps of normalisation

Markets have been gauging when the Federal Reserve will begin its QE tapering process since this year's June meeting where the Fed eyed exiting stimulus measures for the first time as inflation pressures heated up. While economists views varied on this over summer, converging commentary from FOMC members over the last two months or so mean a November taper announcement looks a forgone conclusion. September's FOMC minutes confirmed this as they outlined a potential timeline with purchases to be halted by June 2022. This would translate to a monthly reduction in asset purchases of $15bn starting in November, with $10bn coming from Treasuries and $5bn coming from Mortgage-Backed Securities.

"Despite the slowdown in growth in the third quarter, **markets and the Fed remain positive** about winding down stimulus, as evidenced by market pricing and recent Fed commentary."

Much of the fading momentum was due to the spread of the Delta variant and supply chain issues: restaurant booking and travel declined sharply, as consumers became more wary as Covid cases surged, while disruptions in supply chains and shortages in labour dampened overall output, which printed at 2% in Q3.

Looking to the final quarter of 2021, consumer activity should pick up as the domestic Covid situation has stabilised. Supply chain disruptions will be more difficult to tackle, however, other factors such as inventory rebuilding, the return of tourism, and the large expected spending on infrastructure will still play a prominent role in the economic expansion going forward.

Meanwhile, inflationary pressures have built up due to a number of drivers, including strong demand, lagging supply and base effects, suggesting the peak in headline CPI is yet to come.

In previous meetings, Fed Chair Powell stood by the narrative that inflationary pressures are transitory as improving supply-side conditions and workers returning to the labour force will help bring down inflation while favourable base effects filter out of the YoY data. However, at the moment it is difficult to reconcile with the data how transitory inflation actually is, especially with energy prices rising and supply chain disruptions remaining prominent. For this reason, should inflationary pressures remain more persistent and conditions in the labour market continue to improve, there is a risk of a more aggressive taper cycle by the Federal Reserve such that purchases will be cut in larger steps later on to end the balance sheet expansion earlier than June 2022. The Fed's messaging on this will be important in Wednesday's meeting.

A confirmation of market expectations may lead to a relief rally in the dollar, especially against lower yielding currencies such as EUR and JPY. However, any upside in the US dollar from a hawkish shift in the Fed is likely to be temporary, owing to the fact that markets have already priced in such a move and that the Fed is still likely to lag other G10 central banks due to their more tolerable inflation framework.

Sustained **dollar downside** is likely to be visible against currencies where hawkish adjustments to policy have been should the Fed not surprise with a more aggressive outlook for normalisation. Next week, **key RBA and BoE meetings** may thrust this dynamic into the spotlight.

Bank of England Preview

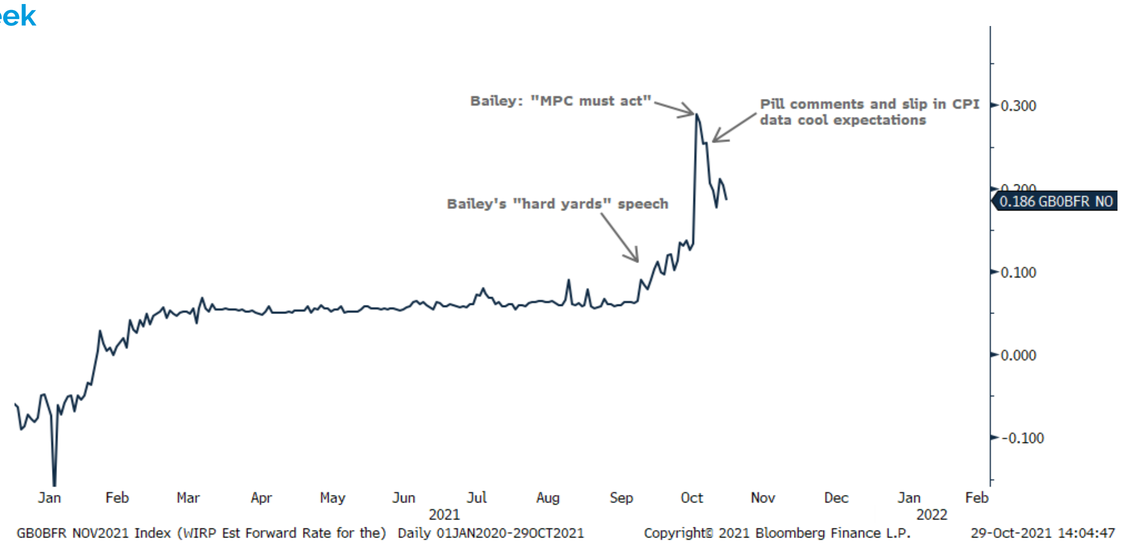
BoE to wait until December to hike as recent communications do their dirty work

The Bank of England's meeting on November 4th at 12:00 GMT has been thrust into the market spotlight ever since September's meeting minutes stated that initial policy tightening could become "appropriate before the end of the existing UK government bond asset purchase programme." With the APP expected to cease before the December 16th meeting, the initial tip of the hat by the BoE to a potential November rate hike set markets in action. Expectations of a rate hike in November have been rising ever since the September meeting (chart below) as policymakers showed increased sensitivity to the rise in inflation. More recently, commentary by Governor Bailey resulted in OIS pricing more than 15bps of hikes in for November's meeting, however, a less urgent assessment by the new Chief Economist, Huw Pill, and a below consensus September CPI reading reduced the market's level of conviction.

While money markets favour a 15bp interest rate hike from the Monetary Policy Committee, **we tend to disagree** and believe the latest commentary by BoE members in the public eye has done the dirty work of anchoring inflation expectations for the time being.

Instead, we believe the BoE will wait until December's meeting to hike rates to 0.25% in order to assess the impact of the furlough expiration and the economic damage inflicted by the recent rise in Covid cases. Such a decision would be befitting with the Bank's view that there is "high option value in waiting for that additional information before deciding if and when a tightening in monetary policy might be warranted", as outlined in their September minutes. However, it must be noted that we only marginally favour December's meeting for a rate hike, and should the BoE hike rates next week, a subsequent 25bps increase in December would be dependent on incoming inflation data and October's labour market data (released December 14th).

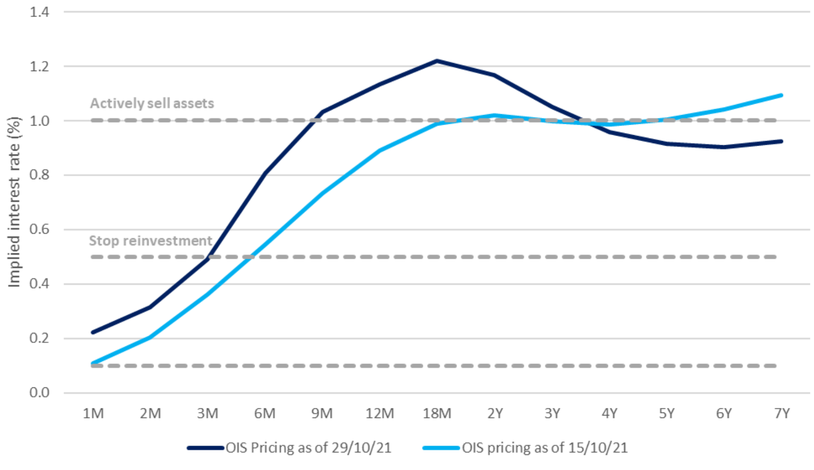
Chart: OIS implied rates for November meeting favour a 15bp rate hike next week



It's all about medium-term inflation expectations

Commentary by Governor Bailey over the past month or so has stressed that the MPC's concerns rest on current inflation rates lifting medium-term inflation expectations such that the transitory period of above-target inflation becomes more entrenched and the wage-price spiral is created. However, recent data suggests that a de-anchoring of medium-term inflation expectations isn't as much of a risk as expected earlier in the month. The most frequent poll of consumers, conducted by YouGov and Citi, saw inflation expectations for the 5-10 year horizon fall by 0.1pp to 3.7% in October despite upwards pressure on expectations stemming from rising energy and fuel prices. When coupled with the negative surprise in September's CPI data and evidence from XpertHR that the median pay settlement is only expected to rise to 2.5% in the coming year, a semblance of wiggle room has appeared for Monetary Policy Committee members that have remaining concerns about growth and employment. Concerns over the current state of the UK economy are shared in money markets too, as evidenced by the inversion of the current OIS curve – this highlights expectations that the BoE will have to reverse course in the next 2-3 years in order to support the economy as policy was tightened early and aggressively to combat the byproducts of inflation.

Chart: Implied rates in the OIS curve rose after Bailey's "MPC must act" article in the Financial Times (17/10), but inversion in the curve now shows concerns that policy may be tightened too soon and too aggressively



The latest data shows the UK economy is in a precarious position. While the composite PMI increased to a 3-month high of 56.8 in October, the GfK consumer confidence survey dropped 10 points in the past two months, highlighting the likely slowdown in activity in store for Q4 as the health backdrop deteriorates. This reduction in the GfK measure only occurred twice in the past decade; in 2011 when tight fiscal policy was combined with high inflation and in 2016 after the EU referendum. The latest money and credit data for September reiterated this hesitancy in consumer spending as household liquid deposits rose by a further £9.4bn in September.

> While some of the downwards pressure on forecasted GDP will be alleviated by the fiscal giveaway in the Autumn budget, we still expect the Bank to **downgrade its 2021 GDP projection** further following September's 1% adjustment to the Q3 forecast.

What next for rates, GBP and the Bank's balance sheet?

Explicit forward guidance from the BoE on Thursday with regards to rates is highly unlikely. The signal is therefore set to come from the Bank's economic projections. If the Bank still has inflation sitting at or above the 2% target in 2023 despite being conditioned on a much more hawkish Bank Rate path, it will confirm the view that consecutive interest rate hikes in 2022 such that the Bank Rate hits 1% are likely. However, if the Bank's forecasts based on current rates are above 2% in the medium-term, but the forecasts based upon the market implied path are below 2%, the Bank will be sending a message to financial markets that they have gone too far with their expectations.

> For sterling, the actual decision to raise rates or not on Thursday will be largely irrelevant, mainly because the Bank Rate is expected to close the year out at 0.25% at a minimum anyway.

Instead, how the Bank delivers the decision will be more deterministic. By choosing to hold rates in November but confirming to markets that sequential rate hikes are in store over the coming quarters, the pound is likely to benefit from rising front-end rates. The extent of the rally is likely to be more limited than in normal times, however, due to the uncertainty such a normalisation cycle will have on growth and the terminal rate this cycle.

Conversely, a rate hike in November but a semblance of caution in the manner in which it was delivered may cause the pound to slump as expectations of higher rates over the course of 2022 are unwound and front-end yields moderate. While the Bank Rate takes all of the market focus, the Bank's balance sheet remains a marginal tool in the tightening cycle. At 0.5%, the BoE has stated that it will stop reinvesting maturing securities such that the balance sheet begins to naturally contract. However, with a limited amount of Gilts set to mature in 2022, we don't think breaching this threshold will slow the hiking cycle too much.

Instead, economic activity and labour market metrics are likely to be more influential. Should the economy hold up the initial stages of the Bank's hiking cycle, and inflationary pressures remain a prominent risk to medium-term inflation expectations, the Bank is likely to continue hiking rates up the 1% ceiling over the course of 2022.

"At which point, we think the hiking cycle will pause while the Bank assesses the impact of its actions before embarking on further rate hikes and active asset sales."