

Can the Fed surprise as much as the ECB this week?

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Last week's ECB meeting caught the market off guard with ECB President Draghi's powerfully dovish message pounding the euro for steep losses. Mr. Draghi explicitly indicated that the ECB will "re-examine" its QE programme and announce something new in December. As well, his indication in the Q&A that the ECB governing council discussed further lowering the already negative -0.2% deposit facility rate saw a powerful acceleration in euro selling, with EURUSD ended trading last week near the 1.10 level for the first time since August.

The ECB has limited room to innovate with its current available policy toolbox, and I am somewhat surprised at the vehemence of the euro selling in the wake of this meeting. But perhaps there is room to drive the euro somewhat weaker across the board if the ECB increases the pace and mix of QE bond buying, cuts rates and extends the horizon of the programme out into perhaps "mid-2017" or later. But down the road, as I also discussed last week, any durable move higher in Euro Zone inflation will likely require fiscal expansion from EU member states, something Draghi is virtually begging them to do, as the ECB is already buying more bonds than required to finance all Euro Zone deficits. As for the euro, and particularly, the EURUSD exchange rate, we'll need to see expectations for a more hawkish Fed coming back into play to continue to drive the EURUSD exchange rate lower.

Cue tomorrow's US Federal Reserve's FOMC meeting, one of the meetings that merely sees the release of a new monetary policy statement, with no accompanying press conference or set of Fed forecasts. Since the release of the second weak employment report in a row released in early October, the market has adjusted its expectations for Fed rate hikes to new lows for the cycle, such that the first Fed rate hike is not fully priced in until late next summer. In that light, it will be virtually impossible for tomorrow's FOMC statement to surprise on the dovish side.

After last week's ECB meeting and on the other side of tomorrow's FOMC meeting, we are set for considerable volatility potential in the currency market for the rest of year. Sure, EURUSD might remain in the 1.05-1.15

range for some time if the next couple of US data points disappoint. But it is likely that the FOMC statement this week shows the Fed wants to keep a December rate hike on the table. The market is not at all prepared for that, nor the most minor of upside surprises to this Friday's US inflation data, and most importantly, nor is it ready for a strong October payrolls report (a strong report next Friday, Nov 6 is overdue as other indicators are suggesting ongoing strength in the US jobs market). If rebounding US data and a more hawkish Fed is back on the table in the weeks ahead, we might have a EURUSD parity exchange rate on the table ahead of the New Year.