FX Daily: 75bp is the new normal

It's inflation day in the US, and consensus is centred around a further acceleration in the headline rate and modest slowdown in the core. A 75bp hike by the Fed in July is almost certain. This is also the case in Canada today after New Zealand delivered 50bp this morning. Elsewhere, EUR/USD remains at risk of a break below parity

USD: Another acceleration in headline inflation

The dollar gave up a portion of its recent gains yesterday against a pool of currencies which are generally driven by diverging factors. The high-beta Swedish krona, and Australian and New Zealand dollars rose along with the safe-haven yen, in what might have been a position-squaring dynamic.

Oil-sensitive currencies (Norway's krone and the Canadian dollar) came under pressure as crude prices plunged. Yesterday's price action in the oil market was peculiar, as the news that OPEC sees crude demand exceeding supply by one million barrels per day seemed to be completely overshadowed by growing recession fears, which pushed Brent back below the $100/bbl mark.

China’s growth concerns likely played a role in the oil slump – although surprisingly did not hit AUD and NZD – as a new rise in Covid cases in Shanghai is fuelling speculation that more restrictive measures will be put in place. The implications of another re-rating lower of China’s economic outlook may end up offering even more support to the dollar across the board.

Today, the focus will shift back to US data, as June's headline inflation is widely expected to have accelerated again. Our economics team expects an 8.7% year-on-year reading, as prices of gasoline, food, shelter and airline fares have all continued to rise. The core rate may instead decelerate to 5.8% from 6.0% YoY. Barring a sizeable contraction in inflation measures, it appears likely that today's numbers will do very little to dent the market expectations of a 75bp Fed hike in July. Later today, the Fed's Beige Book will be released.

We think the dollar could remain mostly a function of global dynamics today. With China's Covid numbers rising again, we suspect markets will stay mostly on the defensive side, and the dollar may consolidate around current levels. But if we see a break below parity in EUR/USD (a very big CPI figure could be the trigger), then we should see a ripple effect (dollar positive) across many USD crosses.

EUR: Risks of a break below parity still high

EUR/USD heavily tested the parity level yesterday, but to the best of our knowledge, the 1.00000 (unrounded) level did not print. Now, we are back where we were yesterday morning, around 40 pips above parity. After the final release of German inflation numbers this morning, which were in line with the previous reading, we should expect something similar for France and Spain later today, and no market impact. There are no other releases to highlight in the eurozone today, except for the rarely market-moving industrial production figures from the eurozone for May. To be sure, the region's growth sentiment has remained quite weak after yesterday's grim ZEW figures.

The dollar should remain largely supported today around the US CPI release, and a big jump in inflation (not our base case, but possible) may actually be the trigger for another round of USD appreciation and potentially for a break below parity in EUR/USD. On the European front, the lingering uncertainty around a potential reduction in gas supply from Russia may continue to prevent a recovery in the euro for now.

We continue to think that the chances of a break below parity are higher than a material rebound in EUR/USD. If we do see a break lower, we suspect that a further technical drop to the 0.9800-0.9900 area is possible.

Elsewhere in Europe, EUR/GBP has traded on the soft side as the euro remains in a fragile position, and UK industrial production figures for May beat expectations this morning. Yesterday, Bank of England Governor Andrew Bailey sounded quite hawkish as he suggested bigger rate hikes will be used if necessary to curb inflation. When it comes to the Tory leadership contest, Rishi Sunak appears to be consolidating his role as the front-runner, although the implications for FX markets appear quite limited for now. EUR/GBP could stay around 0.8400-0.84500 today, but downside risks would be magnified if EUR/USD breaks parity.

CAD: 75bp hike by the BoC today

The Bank of Canada will announce monetary policy today, and we expect a 75bp rate hike, in line with what is now widely expected to be the next Fed move. Here is our full preview of today's announcement.

The rate decision will be accompanied by the release of updated economic projections, and a press conference by Governor Tiff Macklem. Given the still good economic backdrop – a correction in employment figures last week did not dent the notion of a tight labour market – and the fastest inflation rate in three decades, we see no reason for the BoC to scale down the hawkishness of its policy message today.

Indeed, markets are fully pricing in a 75bp move today, and expect around 120bp of additional tightening for the rest of the year. Such rate expectations are definitely not too hawkish, in our view, as we believe that two more 50bp rate hikes in September and October, followed by 25bp in December are warranted.

As today's policy message by the BoC may not dent such rate expectations, we believe the overall impact on CAD should be rather limited or – if anything – slightly positive. At the moment, the prevalence of external factors is not boding too well for CAD as oil prices have come under fresh pressure, even though we expect the loonie to perform better than other oil currencies thanks to a still good domestic backdrop and aggressive BoC tightening. Spikes to the 1.31-1.33 area in the near term are possible in USD/CAD, but we still expect sub-1.25 levels by year-end.

Elsewhere in the commodity FX space, the Kiwi dollar was very little impacted by the RBNZ 50bp rate hike. Despite the Bank reiterating its hawkish message about more aggressive rate hikes, we see rising risks of a recalibration in the hawkish tone at the August meeting (or anyway before the end of the year) due to a falling housing market and worsening economic outlook. In any event, NZD/USD should remain driven by external factors for now, and 0.6000 might be tested in the coming weeks.

CEE: The region defies the strengthening dollar

Currencies in the Czech Republic, Hungary and Poland have now reached our levels for this week. What else will the rest of the week bring for the region? The koruna has stepped out of the shadows and become the star of the week. As we expected, the Czech National Bank likely moved its levels a bit lower and combined with the liquidation of short positions, the koruna reached EUR/CZK 24.40, the strongest level since late April. Today's release of June inflation leaves us hopeful that the koruna still has room to strengthen further towards 24.30. However, early data shows that in last week's FX intervention, the CNB spent as much as in May and June combined. In addition, we think the August CNB meeting will renew the pressure on the koruna to weaken. Thus, it is only a matter of time before intervention becomes too costly.

Meanwhile, the National Bank of Hungry delivered an interest rate hike yesterday as promised, which helped the forint for a while. Although the interest rate differential has reached new record levels and the NBH is the most open central bank in the region to further rate hikes, we believe the forint will soon return closer to the 410 EUR/HUF level and it remains our least favourite currency in the region. On the other hand, in Poland, the market has restored some of its hawkish expectations after misreading Governor Adam Glapinski's speech. In our view, this opens up room for the zloty to erase some of its current losses and return closer to 4.70.

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