

FX Daily: A dangerous correlation for the euro

Despite the treasury selloff and strong US data, the dollar has entered a correction, probably due to quarter-end flows. With personal spending and PCE figures potentially topping expectations today, we look for a USD restrengthening. The euro, instead, may feel increasing pain from Italian spreads now, although possibly mitigated by the TPI backstop



We are bullish on the greenback today

USD: Room for a rebound

G10 FX volatility has rebounded in the last week of this month/quarter after a sell-off in long-dated treasuries and peripheral eurozone bonds. The sub-consensus 204k US jobless claims figure yesterday kept pointing at a jobs market that is inconsistent with a peak inflation narrative, especially when adding the recent rise in oil prices. Markets are – like ourselves – sceptical that the Federal Reserve will raise rates again given the US government shutdown's prospected drag on growth, and this has been adding pressure on long-term treasuries. 10-year and 30-year treasuries are now yielding at 4.60% and 4.70%, the highest since 2007 and 2010 respectively.

With the 10-year BTP-bund spread briefly touching 200bp yesterday (more in the EUR section

below), everything seems to be pointing to a stronger dollar. However, the greenback moved in the opposite direction yesterday, entering a correction across the board. We suspect much of this counterintuitive move is due to quarter-end rebalancing, and because of the fact that the dollar had already rallied significantly ahead of yesterday's events.

Once the quarter-end adjustments are past us, the overall environment should favour another leg higher in the dollar. That is unless US data indicate otherwise, although the deterioration in the growth outlook in other alternative markets to the US has probably raised the bar for a negative US data surprise.

Anyway, today is the busiest day of this week in the US calendar, with August's personal income and PCE figures both set to be released. After a strong July, we expect to see weaker spending on goods coming through, especially in real terms. However, spending on tourism should be able to offset this, and we could see a slightly above-consensus read. Our economists also forecast a higher-than-consensus core PCE deflator (the Fed's preferred measure of inflation): 0.3% compared to the expected 0.2% month-on-month reading.

We could see a hawkish repricing in rate expectations coming to the dollar's help today, and we are bullish on the greenback today. A return to the 106.50/107.00 area in DXY in the near term seems plausible in the current market conditions.

Francesco Pesole

📌 EUR: TPI could partly mitigate the Italy spillover

The 10-year BTP-Bund spread touched 200bp yesterday in the aftermath of a decision by the Italian government to raise the projected 2023 fiscal deficit from 4.5% to 5.3%, essentially putting it on a collision course with a likely retightening of EU fiscal rules after the Covid-era suspension. The five-year Italy CDS also jumped from 87bp to 110bp in the past week: this is still a very low level compared to the post-2022 election 180bp peak, the pandemic 270bp peak or the 2012 560bp peak. Still, it tells us that some concerns over long-term debt sustainability are resurging.

Historically, the 200bp mark prompts the correlation between the euro and the BTP-Bund spread to pick up. Unlike previous instances, the ECB has the TPI in place and can use flexibility in its quantitative tightening programme to smoothen the impact on peripheral spreads. This means that the spillover into FX may be slower this time around.

Incidentally, the BTP sell-off has coincided with the release of key CPI figures in the eurozone. Quarter-end rebalancing and a dollar correction seemed to overshadow the slower-than-expected German inflation figures yesterday. Spanish core inflation also declined despite an expected jump in the headline rate. Today, French figures are released before the eurozone-wide estimates: consensus is for a decline in the headline figure to 4.5% and in core to 4.8%. ECB President Christine Lagarde will speak at an event on the energy transition, and we'll also hear from other Governing Council members (Vasle, Vuijcic, Kazaks, Visco).

A rebound in the dollar, lingering concerns on Italian bonds (even if with a smaller intensity than in previous instances) and a decline in core inflation point to downside risks to EUR/USD today. We expect 1.0500 to be retested soon.

Elsewhere in Europe, Norges Bank will release its October daily FX sales figures today. We estimate

another increase, from NOK 1.1bn to 1.2bn, which may well disrupt the krone's good performance recently.

Francesco Pesole

↓ **GBP: Chance of a further correction in EUR/GBP**

The Office for National Statistics confirmed the UK's GDP growth was 0.2% in the second quarter, while the year-on-year number was revised higher from 0.4% to 0.6% compared to the flash estimate.

GBP/USD has rallied in line with the dollar correction into this morning's market open, but there are no real UK-specific drivers that would justify a sustained GBP outperformance at this stage. EUR/GBP has eased back from the 0.8700 level, in line with our expectations, after the turmoil in Italian bonds and given the big bulk of dovish Bank of England repricing had already happened. There is probably still additional room for a correction in EUR/GBP should Italian spreads keep widening.

Francesco Pesole

→ **PLN: Key inflation print before next week's central bank meeting**

September inflation in Poland will be released today (it is always the first inflation number released in the CEE region) – a key piece of data ahead of next week's National Bank of Poland (NBP) meeting. Our economists expect a further decline from 10.1% to 8.3% YoY. Several factors are expected to contribute to disinflation in September apart from the high reference base from last year, when prices went up by 1.6% MoM. The outcome will certainly be a big focus for the market ahead of the upcoming NBP meeting. Moreover, the range of 8.0-8.9% indicates a large uncertainty in the estimates. For now, a 25bp rate cut seems the most likely scenario for us, but given the surprise at the last meeting with a 75bp cut, we can expect higher volatility in both FX and rates today.

The Polish zloty has stabilised slightly above 4.600 EUR/PLN in recent days. The market is pricing in a bigger rate cut at the moment and remains on the dovish side. Thus, the scope for repricing is more hawkish in case of a surprise, which could support the zloty. At the moment, however, we see higher volatility rather than direction for the Polish zloty, which should remain near current levels until next week's meeting.

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