

FX Daily: A day like no other for the euro

We expect the ECB to hike by 25bp today, but we cannot exclude 50bp. The fragmentation tool will be in focus especially as Italy's sovereign spreads may widen further now that early elections look almost inevitable. Capacity levels of the reopened Nord Stream pipeline will be monitored closely as gas crunch fears remain high. The euro faces downside risks



USD: Non-US events in focus

G10 FX volatility decreased significantly yesterday as markets started to take a wait-and-see approach ahead of today's key risk event: the ECB policy announcement. Arguably, developments in the US are playing a secondary role this week, with markets mostly focused on European events (political, geopolitical and economic). Still, US housing data continued to show signs of weakness as mortgage rates rose. Given that this sector accounts for 2.5% of the US economy and that housing transactions have a high correlation with retail sales, expect recent grim housing numbers to further fan recession talk.

Meanwhile, the two drivers of dollar weakness earlier this week – risk sentiment recovery and the shrinking Fed policy advantage vs other central banks – have started to fade, and the dollar has entered some stabilisation mode ahead of major events in Europe today. The only data releases in

the US today are the Philadelphia Fed Business Outlook and jobless claims, but expect very little market impact. As we expect the post-ECB reaction to trigger some EUR/USD weakness and given the other downside risks to the pair (Italian government collapse and curtailed Russian gas supply), we see room for some dollar rebound today. DXY could end the week in the 107-108 region.

Elsewhere, the Bank of Japan failed again to deliver any surprises at its rate announcement this morning. The policy message was a mere reiteration of the list of priorities for the BoJ: growth is more important than JPY weakness. With no support coming from a less dovish tone by the BoJ, risks of a move to 140+ in USD/JPY are non-negligible, especially if market sentiment stabilises and the Fed continues to put a floor under the dollar.

📌 EUR: Three events, three downside risks?

It's going to be a day like no other in the eurozone today, with three high-impact market events.

First, the European Central Bank will deliver its long-awaited first rate hike, and here's our [scenario analysis](#) ahead of today's decision. Our base case is the following: a 25bp rate hike today, openness to a 50bp move in September, only a slightly changed inflation and growth outlook (mounting downside risks should be highlighted for the latter), an anti-fragmentation tool without too many details and some degree of conditionality. It is therefore possible that the Bank will not shed light on whether a widening of sovereign spreads due to political events (like in Italy now) will be covered by the fragmentation tool. President Christine Lagarde will surely be asked about this, but may try to avoid giving a definitive answer.

The chances of a larger hike (50bp) appear to have risen after recent reports suggested this option was being seriously considered by the Governing Council. Markets are currently pricing in 38bp of tightening for today, and 200bp in total by March, which in our view is an overly hawkish expectation and may be revised lower today after the rate announcement. This leaves the euro vulnerable to some correction today in the event of 25bp, and may not receive very sustained support even in a 50bp scenario given the worsening macro picture.

The ECB is not the only downside risk to the euro today. [Italy's government is now on the brink of collapse](#), as two more parties (right-wing Lega and centre-right Forza Italia) boycotted another confidence vote on PM Mario Draghi yesterday. Now, hopes to rebuild the majority seem to have evaporated, and it's likely that Draghi will resign today and that President Mattarella will announce either early elections (more likely) or try to push for a new national unity government without Draghi (less likely).

The most likely date for election appears to be 2 October. Opinion polls suggest a populist right-wing coalition held by Fratelli d'Italia leader Giorgia Meloni is the most likely to win the election. As [discussed here](#), this is a scenario that may trigger a widening of 10Y BTP-Bund spreads beyond the 250bp mark unless the ECB steps in with some support. The negative impact on the euro could be quite significant and may be mostly channelled through EUR/CHF, which could drop below 0.9800 if sovereign spreads widen much further. The role of the ECB's fragmentation tool should, however, be key in managing the market reaction to the Italian political turmoil.

Finally, Russian gas supply concerns are likely to remain elevated today, as the Nord Stream 1 pipeline has reopened this morning after a planned closure. In the early hours, 30% capacity was reported, and while this number should rise during the day, EU members will monitor it very carefully to gauge any forced reduction in gas flows from the Russian side.

When taking these three factors into account, the balance of risks appears skewed to the downside for the euro today. Our base case is a return to the 1.0100 mark today, and a potential re-testing of parity over the coming days.

➔ GBP: Truss vs Sunak

Liz Truss and Rishi Sunak are heading to the run-off to replace Boris Johnson as UK prime minister. The two candidates will campaign for six weeks now, and markets will likely get a better idea of where they stand on the most sensitive points: fiscal support and relationships with the EU.

For now, the impact on sterling should remain secondary to macro and monetary policy factors. Expect some action in EUR/GBP today, with the post-ECB and Italy-related moves possibly putting some pressure on the pair.

⬇️ CZK: CNB will have to go to battle again soon

Preliminary data suggests that the Czech National Bank essentially did not need to intervene last week. As [we expected](#), EUR/CZK recently got close to 24.30, far from the central bank's levels, allowing it to take a break after a challenging week, which cost almost EUR9bn, the same as the cost of intervention in May and June combined. However, we believe the time when the CNB will have to fight the market again is coming.

On the global front, today's ECB meeting is crucial, and EUR/USD testing parity again would revive pressure on the region. On the local front, as across the region, market expectations of further monetary tightening are falling and the koruna is losing support. But most importantly, the August CNB meeting is coming, which we believe will disappoint the market and force the central bank to be much more active in the markets. So nothing changes [in our view](#). We continue to estimate the CNB level to be in the 24.60-70 range, but we cannot rule out another slide lower below 24.60. However, we think the next few days will show us the possible no-go level for central bank.

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