FX Daily: Asymmetrical upside risks for the dollar today

Today's US CPI report looks like a rather binary event for markets. With the deflationary story having come under increased scrutiny, we suspect that a consensus 0.4% MoM read in core inflation may be enough to weigh on risk assets and support the dollar. We still see room for USD outperformance in the near term. In the UK, wage data endorsed a BoE march hike

US consumer spending slowed sharply in the fourth quarter of 2022

USD: A consensus reading may be enough to support the dollar

We are a bit surprised to see markets have started the week with some (cautious) optimism despite the big risk event represented by today's US inflation report. A rise in global equities meant the dollar is trading weaker across the board with the exception of the yen, which continues to see elevated volatility as markets struggle to assess the implications of the Bank of Japan appointing – now officially – Kazuo Ueda as next governor. We expect JPY volatility to stay high as Ueda may refrain from offering clear direction on any policy shift before taking the role in April. For now, there are no indications he will favour an abrupt end to the BoJ's ultra-dovish policy stance.

Back to the US, January's inflation report will be an important litmus test for the disinflation story that has driven the slowdown in Federal Reserve tightening. The market's reaction will likely be driven once again by the month-on-month figure, which our economist expects to match consensus expectations at 0.5% for the headline rate and 0.4% for core inflation. This should translate into year-on-year reads of around 6.2% and 5.5%, respectively.

Such a consensus read may be enough to weigh on risk assets and support the dollar, as it should allow markets to fully price in 50bp of additional tightening by the Fed and offer the chance to scale back rate cut expectations (around 50bp priced in for 2H23). Given that core inflation in December came in at 0.3%, a 0.2% print (or below) today should be enough to trigger a dollar correction, and a 0.5% (or above) could trigger a dollar rally.

We'll be paying close attention to the details of today's releases. Auto sales and shelter are two components that may contribute to a higher reading. The former may boost the CPI number on the back of a reported jump in auto auction prices by 2.5%: this may translate into 0.15pp added to MoM core CPI, given the high weighting of this component on the reference basket. Shelter accounts for approximately a third of the inflation basket and may prove sticky given the lagged effect on data of contracting house prices and new rental agreements. We still think these two components will drive a big chunk of the deflationary effect from the second quarter, but for now may work against any dovish narrative.

We see the balance of risks as tilted to the upside for the dollar and to the downside for pro-cyclical currencies. A return to the 2023 highs in DXY (at 105.00) is still a tangible possibility in the near term, even though we continue to favour USD underperformance in the remainder of this year.

Francesco Pesole

EUR: No other drivers than US CPI

EUR/USD should be moved almost solely by the US inflation report today, as the preliminary (i.e. second) release of eurozone growth numbers looks unlikely to impact markets and there is only one scheduled European Central Bank speaker (Gabriel Makhlouf). As discussed in recent notes, we expect to see a rather contained impact from additional ECB commentaries (even from those by Christine Lagarde tomorrow) from now on, as markets have probably absorbed in full the pushback against the dovish reaction to the February ECB press conference and are now switching their focus to key data releases.

In line with our dollar view ahead of today's US CPI, EUR/USD may slip back to 1.0650/1.0700 should core inflation come in at 0.4% or 0.5% MoM. Anything above that would likely trigger a larger contraction and 1.0600 should be tested. We continue to see downside risks for EUR/USD in the very near term as US data may endorse further Fed hikes and the euro lacks any solid domestic support.

Francesco Pesole

GBP: Sticky wages cement BoE March hike expectations

Wage data released this morning in the UK came in higher than expected, lifting the pound. The Bank of England's preferred measure of wage growth, the 3-month/3-month annualised change has now been consistently above 7% for a few months, and there is very little evidence of that wage slowdown suggested by some surveys.

Tomorrow's CPI release will be another key event for the pound, but we think that given the increased focus of the Bank of England on wage dynamics, today's data strongly endorses a March 25bp rate hike (which is our base case). EUR/GBP may well break below 0.8800 this week, while GBP/USD could fall back below 1.2100 after the US CPI print.

Francesco Pesole

CEE: Break-up within the region

Before we see any key releases on a global level, the CEE region also has something to say today. We will see GDP numbers across the region for the fourth quarter and an inflation number for January in Romania. The main focus will of course be on the confirmation of the technical recession in Hungary but also on the consumer side of GDP across the region given that January inflation has already surprised to the upside in Hungary and the Czech Republic.

In the FX market, the Polish zloty and Hungarian forint secured the main attention at the start of the week. The zloty reached its weakest levels since mid-October last year weighed down by negative EU money prospects and Thursday's looming European Court of Justice (ECJ) ruling in the FX mortgage case. For now, we have not heard from officials how long it will take for the Constitutional Court to review the legislation after President Duda said he would not sign the bill and sent it instead to the court for review. However, the likelihood is growing that Poland will not get EU money before the October general elections. Moreover, there is a risk that Thursday's ECJ ruling will impose additional costs on the banking sector. Overall, it will thus be difficult for the Polish zloty to resist further losses in the days ahead. For now, we expect the zloty to test 4.80 EUR/PLN.

On the other hand, the Hungarian forint has reached its strongest levels since last May. Drivers are the same as in recent weeks in our view - falling gas prices and by far the highest carry in the region. In particular, after Friday's upside inflation surprise, the short end of the IRS curve is up roughly 50-60bps, which has brought the interest rate differential back to levels seen at the start of the year and erased bets on an early central bank rate cut. Although in our view, heavy long positioning on HUF is still the main risk and profit-taking cannot be ruled out, we remain bullish on the forint. We expect further gains to be slower, however, the mentioned conditions should persist at least until the March National Bank of Hungary meeting. Thus, we see a good chance for the forint to beat our forecast of 385 EUR/HUF at the end of the quarter.

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