

## FX Daily: Brazil set to start its easing cycle

Markets were taken aback by Fitch's downgrade of US debt yesterday. EUR/USD rose, but the greenback is enjoying safe-haven demand to the detriment of high-beta currencies. We doubt this will be a long-lasting driver for FX markets and the focus will rapidly shift back to data. In Brazil, the central bank should start cutting rates today: we expect 25bp



Central Bank of Brazil  
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### USD: Downgrade unlikely to be long-lasting driver

The dollar resilience was untouched by the soft block of data released yesterday, where the ISM manufacturing rebounded less than expected and remained quite deep in contractionary territory, and JOLTS figures showed a bigger than anticipated drop in job openings. Markets are clearly turning a blind eye to second-tier activity figures, and expectations that jobs figures will still be robust this week likely prevented any further dovish repricing in the USD curve, and left other factors (mostly weak data from China) to keep the dollar supported.

A surprise development that shook FX markets late in the US session yesterday was the announcement that Fitch downgraded the US from AAA to AA+, with a stable outlook. Fitch

mentions the fiscal deterioration over “the next three” years and elevated government debt as the main reasons for the downgrade, which is the first one since 1994. This puts the US fiscal discussion back in scope for investors after the debt ceiling saga was quickly put on the back burner. EUR/USD jumped on the news, but high-beta currencies suffered, and the dollar seems to have been shielded by safe-haven demand.

Will this prove to be a driver for the FX market beyond the knee-jerk reaction? We doubt that. Treasury Secretary Janet Yellen described the downgrade as “outdated”, and markets will likely see it in a similar way (i.e. strictly tied to the debt ceiling standoff) especially in a week full of important data releases and with the next Federal Reserve rate hike hanging in the balance. Today, the ADP employment figures are the key highlight on the data front. In July, ADP figures more than doubled consensus estimates (almost 500k) but the official payroll print was a more modest 209k.

*Francesco Pesole*

## ➔ EUR: ECB radio silence not helping the euro

EUR/USD remains a dollar story and with the US data calendar about to pick up (ADP, ISM services, payrolls), the dollar leg should remain dominant given that most key eurozone data was already published earlier this week.

We discussed yesterday the market’s reluctance to price in more than a 50% chance of another hike by the ECB, despite sticky core inflation. One thing missing may be the lack of the usual post-ECB communication re-tuning by governing council members (due to the summer season, more than anything else). The calendar of ECB speakers continues to show only Fabio Panetta tomorrow, and he is the most dovish voice, so unlikely to lift rate expectations.

The US credit downgrade helped EUR/USD avert a move below 1.0950, but more pressure on the pair is definitely on the cards should US data prove robust. A test of 1.0900 by the end of the week seems feasible.

*Francesco Pesole*

## ⬇ NZD: Jobs data allows RBNZ to stay put

New Zealand released 2Q jobs data overnight, and while the labour market clearly remained quite tight, the Reserve Bank will likely welcome tentative signs of loosening conditions. The unemployment rate rose a tad more than expected, from 3.4% to 3.6%, and while hiring was strong, wage growth eased off a bit from 4.5.% to 4.3%.

The RBNZ is facing a situation where the latest CPI numbers came in below their forecasts, but showed signs of stickiness in the core measures, putting a greater focus on labour dynamics. The quite outdated labour statistics released overnight moved in the right direction and allow the RBNZ to keep its messaging unchanged at the August meeting. However, we continue to see risks the Bank is underestimating the domestic inflation risks and markets are underestimating the risks of another hike before year-end.

NZD is dropping in line with other pro-cyclical currencies this morning after the US credit downgrade, but we think the Kiwi dollar has now priced in much of the negative news (China growth repricing, RBNZ pause) and is emerging as an attractive option in August should a stable

risk environment and subdued FX volatility favour carry trades and recovery in undervalued currencies. We still expect a recovery to 0.63 in NZD/USD by the autumn.

*Francesco Pesole*

## ➔ BRL: 25bp or 50bp to start the easing cycle?

There is fevered speculation that Brazil's central bank, BCB, will start its easing cycle later today. Having been pressured by the Lula administration for most of the year to cut rates, it now seems the BCB has sufficient ammunition to deliver a credible rate cut. Brazil's congress has passed important fiscal reforms (fiscal policy always proving Brazil's Achilles Heel) and a sharp decline in inflation has allowed inflation expectations to drop close to BCB's target near the 3.50% area.

The only question it seems for the market is whether the BCB will kick off the cycle with a 25bp or 50bp cut. Historically, when BCB makes the decision to adjust policy, it moves in large increments. Equally, BCB has been fighting the government all year and with two new additions to its board may not want to be seen as acting overly aggressively. Even though BCB has not provided much signalling on this easing (unlike the recent telegraphed cuts in Chile), we would not rule out a 50bp rate cut. The interest rates market already prices close to 500bp of easing over the next year – so may not drop too much further – but we think the Brazilian real may not need to sell off too harshly. After all, real interest rates remain hugely in positive territory and a recent sovereign rating upgrade – and lower volatility – suggest the Brazilian real will continue to be a recipient of carry trade flow.

*Chris Turner*

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