FX Daily: Conflicting forces, but debt ceiling dominates

There is still a rather convincing bearish story on the dollar as US short-term rates remained under pressure on the back of Fed rate cut speculation. But FX is looking at the debt ceiling concerns, and the impact on sentiment, with more urgency and interest. Negotiations restart on Tuesday, but more upside risks for the dollar look to be on the cards

USD: Debt ceiling jitters raise upside potential in near term

The dollar enters a new week with a broadly unchanged set of sharply contrasting factors which saw it test the lows, first, and then rebound quite sharply in a rather eventful month of May. The two main opposing forces at the moment are the declining short-term US rates (as more Federal Reserve rate cuts are priced in) and the debt-ceiling impasse in Washington. The first force will be driven by data and Fedspeak today; the second by negotiations which should resume on Tuesday.

When it comes to data, the strong jobs figures for April were followed by inflation figures that did offer some tentative signs of cooling-off in service inflation, below-consensus PPI, and higher-than-expected jobless claims (a signal that lay-offs are surging). This week, we have retail sales and industrial production as the highlights. Our US economist thinks that retail sales will probably get a lift from the robust auto sales numbers for April, while industrial production will be held back by the fact that manufacturing surveys continue to point to falling production with lower energy prices limiting the upside for oil and gas extraction. Some specific focus will inevitably be on the new jobless claims report. Today, Empire manufacturing and TIC data are on the calendar.

The pricing for the December contract in the Fed funds futures market continues to oscillate between 65bp and 75bp of cuts. Of all data this week, jobless claims may be the bit that could move rate expectations more than the rest, but expect some sensitivity to Fed speakers as well. Today alone we'll hear from FOMC members Raphael Bostic, Austan Goolsbee, Neel Kashkari and Lisa Cook. The Fedspeak calendar peaks with a speech by Chair Jay Powell on Friday.

Some pushback against rate cut expectations may well be on the cards this week, and while this could offer the dollar some support, it's not the rate side that seems likely to be a sustainable positive driver for the dollar. Two-year dollar swap rates are still close to the lows, around 20bp above the key psychological 4.00% mark, and markets have shown a strong tendency to price in rate cuts quite aggressively.

What is really keeping the dollar afloat at this stage is the debt-ceiling impasse in Washington, in our view. Negotiations between President Biden and congressional leaders should resume on Tuesday, but unless we see truly encouraging progress, investors' fears may keep growing. Barring positive news on this end, we think the balance of risks remains tilted to the upside for the dollar for now, which should see safe-haven flows as risk sentiment stays subdued. The rebound in DXY could extend to the 103.50/104.00 area in the coming days.

Francesco Pesole

EUR: Looking across the Atlantic

In EUR/USD, the dollar leg will probably keep driving the majority of the moves. Admittedly, most of the interesting stories for the FX markets come from the US, with the debt-limit impasse in focus and markets quite active in speculating on the size of Fed easing later this year. Incidentally, the eurozone calendar is rather empty this week, except for the ZEW surveys and preliminary (second) 1Q GDP figures on Tuesday.

It will be interesting to hear what European Central Bank speakers have to say, although we recently noted how they have had a rather limited impact on the euro, and markets' pricing for the July meeting (the one after the well-telegraphed June hike) has been broadly unchanged since the ECB meeting, with around 15bp of extra tightening expected. We'll hear from arch-hawk Joachim Nagel today, and from President Christine Lagarde plus other Governing Council members later this week.

Our EUR/USD view for this week mirrors our USD view above, given we see limited domestic drivers in the eurozone. Downside risks persist for the pair on the back of the US debt ceiling impasse, and we could see a break below 1.0800 (a key level, also the 100-day moving average) followed by another leg lower to the 1.0700/1.0750 area should the risk environment deteriorate much further. Still, we don't expect EUR/USD weakness to last beyond the near term.

Francesco Pesole

GBP: Wage data is key for sterling

The Bank of England made quite clear that its next policy move in June will largely depend on two releases: wages and inflation data. The former will be released on Tuesday, and we must remember that the wages series has been rather volatile lately. This increases the range of outcomes for sterling, which will likely be ultra-sensitive to the releases.

Our economics team expect some moderation in the wage growth figure after last month's jump, which may ultimately push the MPC in the direction of a hold at the June meeting. Markets are pricing in 20bp of tightening, and the downside risks are quite material for sterling. We expect this to be mirrored in a higher EUR/GBP, which we expect to rebound to above 0.8800 by the end of this month.

Francesco Pesole

CEE: US dollar puts the region on the defensive

Today, we get the final inflation figures for Poland for April. It can be assumed that a flash print of 14.7% year-on-year will be confirmed. Tomorrow, GDP numbers across the region for 1Q will be released. We expect a drop in the YoY rate from 2.0% to -1.5% in Poland, from 0.4% to -0.8% in Hungary and from 4.5% to 3.7% in Romania. In Poland and Romania, our expectations are slightly below market expectations, and vice versa in Hungary. Also on Tuesday, we will see core inflation in Poland, which is expected at 12.2% YoY and thus remains very sticky. Wednesday will see the release of industrial production data in Romania and Thursday will see the release of industrial producer prices in the Czech Republic.

In the FX market, the lower EUR/USD has been dragging the entire region down for the last few days and the region is not expected to return to gains in the coming days either, in our view. And even on the local side, we can't expect much positive momentum given the negative GDP numbers released this week. At the moment, the Czech koruna is showing the highest beta against a strengthening US dollar, so it will continue to suffer and may likely test levels above 23.60 EUR/CZK again. The Hungarian forint, in our view, is reaching its current limits at 370 EUR/HUF and may suffer in the coming days due to the strong US dollar. And in our view, the Polish zloty is in a similar situation. While it still has a lot of room to catch up with the region, global conditions may put a foot on the brake and keep the zloty above 4.520 EUR/PLN.

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