

FX Daily: Corrective forces continue

A holiday-shortened week starts with risk assets in demand as China marginally softens lockdown curbs and the pricing of a Fed pause allows interest to return to FX carry trades. That could see the dollar hand back a little more of its recent strength, although strong US data later in the week should limit the extent of the dollar's downside



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📉 USD: Interest in dollar-funded carry emerges

The dollar is now about 3% off its highs in early May. Driving that correction has certainly been the view that the Fed could pause its tightening cycle after hiking 50bp in both June and July. The Fed funds rate for the 21 September meeting is now priced at 2.15%. At the start of May, it was priced at 2.35%. Clearly, US data and Fed speak will have a big say in the pricing of that Fed cycle. Today US markets are closed for the US Memorial Day public holiday, but the big data point of the week, Friday's release of May nonfarm payrolls, will have an important say for the Fed. Here James Knightley looks for [another strong set of numbers](#), which should prove supportive for both US yields and the dollar.

Until then, the dollar remains subject to corrective forces on the back of renewed interest in carry trades. Here, one month USD/JPY implied volatility has sunk back below 10% to signal calmer market conditions and for us, Friday's standout move was the huge rally in the Mexican peso. The

peso is the big beast in the emerging market FX space and the USD/MXN drop to 19.50, the lowest level since early 2020, represents some confidence returning to the emerging market FX space. Indeed, some brave investors may be making the play that the dollar has topped and that putting money to work in EM local currency bonds can help cement the top in EM local rate cycles and trigger a virtuous cycle of gains in both the currency and the bond. For example, Mexican 10-year local currency bond yields have recently topped out at 9% and now trade at 8.50%. We think it is too early for those trades since both US yields and the dollar may well have another leg higher later this year, but this is a trend that certainly bears watching.

US holiday-thinned trading should keep FX subdued today, but some modest reopening in China and some healthy equity gains should maintain the slightly softer dollar bias for the next few days. DXY is undertaking a slightly deeper correction than we thought and can continue to drift down to the 101.00 area.

👆 EUR: Another high German CPI to keep hawks in the ascendency

EUR/USD continues to nudge higher as the Fed pause, marginally better risk environment and ECB hawkishness all combine. Recent reports suggest the speculative community has been cutting its short euro positions. Yet we do not think there are strong arguments for EUR/USD to move back to and above 1.10. After all, the surge in energy prices is being more keenly felt in Europe and the deterioration in Europe's terms of trade has damaged the euro's medium-term fair value. Our preference would be for this EUR/USD correction to top out near 1.08. But for the short term, the external environment will keep EUR/USD supported.

For today, we will get the first look at German inflation data for May. This is expected to push up to a new cycle high at 7.6% year-on-year and keep the hawks in the ascendency at the ECB. That said, the recent narrowing in the two-year Germany-US sovereign spread seems to have run its course and unless one expects the ECB to sound even more hawkish (four to five ECB hikes are already priced this year) or the Fed to turn decisively less hawkish, EUR/USD looks unlikely to get too much more support from the yield spread side.

➡ GBP: Quiet week for the sterling story

The UK data calendar is quite light this week. That leaves sterling mildly bid after last week's £15bn fiscal stimulus provided some support to otherwise fragile pricing of the BoE tightening cycle. The GBP/USD bounce has certainly been slightly stronger than we thought (we had thought 1.2600/2650 would be the corrective top) and a slightly negative dollar environment at the start of this week could see GBP/USD extend to 1.2730/2770. Longer term, we can still see GBP/USD heading back to the low 1.20s later this summer.

EUR/GBP looks set to gravitate around 0.8500 for a while.

👆 CEE: Return of a hawkish tone to tame inflation

In central and eastern Europe, the main event this week will be the Hungarian central bank meeting. This, [in our view](#), will bring a 60bp hike in the base rate to 6% and a 30bp increase in the deposit rate to 6.75%. However, the weak forint may force the central bank to make a bolder move. Across the region, a breakdown of 1Q GDP growth will be released, which surprised positively in the flash estimate, so the market will be watching the reason behind this and

indications for the second quarter. A piece to the puzzle will also come from the PMI for May, which like the eurozone should stagnate or fall just slightly. As always, Poland will be the first in the region to show the way for inflation. We expect it to rise from 11% to above 12.5% YoY, which should reignite the hawkish tone from the central bank, supporting higher rates and prompting the FX market to erase the losses of recent days.

Of course, the biggest focus this week will be on forint, which is within reach of all-time lows following recent government decisions. A possible market disappointment would thus bring a move towards the magic level of 400 EUR/HUF, but we assume that this is not the central bank's intention. The zloty reached its strongest levels since the start of the Ukrainian conflict at the end of the last week and a strong CPI number and higher rates should ensure that it holds onto its gains at least. The koruna remains under central bank control and despite the currency's weakening last week, we do not expect the Czech National Bank to allow a move towards 25 EUR/CZK territory.

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