

FX Daily: Currencies starting to detach from bond dynamics

Volatility in long-dated sovereign bonds has remained elevated, but that has almost only been mirrored in a weaker yen in FX since the start of the week. The currency market is starting to detach from short-term bond swings, but the dollar's newfound resilience could still consolidate into Thursday's US inflation numbers



USD/JPY is the most exposed G10 pair to the ongoing bond market instability

➔ USD: Wait and see

It's been a slow start to the week in the currency market, with the dollar being mixed but generally supported yesterday and in today's Asian session. We continue to observe rather elevated volatility in bond markets, with long-dated Treasury yields rising again: unsurprisingly, the only notable move in FX since the weekend has been another leg higher in USD/JPY.

With the Bank of Japan normalisation still looking too remote to temper bearish pressure on the yen, USD/JPY is the most exposed G10 pair to the ongoing bond market instability, especially given some signs of resilience in US equities, which limited losses in high-beta currencies.

The US data calendar only includes second-tier releases until Thursday's CPI figures. Today, the key highlights are the NFIB Small Business Confidence Optimism Index – which is expected to rise very marginally from June – trade balance figures from June, and final wholesale inventory numbers. It will be interesting to hear what FOMC members Patrick Harker and Thomas Barkin say about the

economy in two separate speeches today, especially following last week's slightly weaker-than-expected headline payroll figures.

With the exception of the yen, it appears that most G10 currencies are losing their direct exposure to swings in US bond yields. At this stage, it would probably take a larger swing in yields to cause a substantial spill-over into FX than it did before the US credit downgrade by Fitch. Still, we expect some consolidation of the dollar around current levels into Thursday's inflation numbers.

Francesco Pesole

➔ EUR: Hard to see it trade out of range

According to our short-term fair value model, EUR/USD's equilibrium level currently sits around 1.0950, quite close to spot. The pair remains overbought according to CFTC positioning data (+23% of open interest), but there are clear indications that the process of adding EUR longs/building USD net shorts has stalled again in July.

All in all, it appears that EUR/USD has managed to navigate the worst (barring new volatility peaks) of the US bond sell-off relatively easily, a sign that markets remain reluctant to let go of a cyclical currency like the euro in the current market environment (despite a deteriorating outlook for the eurozone economy) and the room for a big dollar recovery remains still narrow given markets now expect the Fed to be done with monetary tightening.

We had warned our readers that August might well have been a directionless month for EUR/USD: things can change (developments in the Russia-Ukraine conflict should be followed closely, to name one), but we have not received any strong indication so far that EUR/USD may materially drift away from a 1.09-1.11 range this month.

Today, some focus will be on the ECB's Consumer Expectation Survey, which includes inflation expectation figures, and final CPI numbers for July in Germany and other EU countries.

Francesco Pesole

➔ GBP: Starting on the right foot

The pound has had a good start to the week, outpacing other G10 currencies: EUR/GBP was pressing the 0.8600 support yesterday. Interestingly, this was not driven by a rebound in the Bank of England rate expectations (peak rate still seen around 5.70-5.75% in January): it appeared, instead, a mirror of supported sentiment in FX, and the pound showing its ever-increasing sensitivity to risk.

There will be very little on the domestic side for GBP until Friday when GDP figures are released. Expect the pound's beta-to-risk sentiment to remain elevated for now: in the longer run, we still think markets are overestimating BoE tightening, will have to scale down expectations and EUR/GBP can climb back to 0.87-0.88

Francesco Pesole

➔ CEE: Inflation in Hungary finally below 20%

Yesterday's meeting of [the National Bank of Romania](#) (NBR) was as expected and there were no

surprises. Tomorrow, the NBR will present a new inflation report, however, for now we have silence from this side. This morning, July inflation in Hungary was released, posting a drop from 20.1% to 17.6% year-on-year. This is 0.1pp below market expectations and 0.1pp above central bank expectations. While inflation remains by far the highest in the CEE region, it is below 20% for the first time since last September and we expect it to be in single-digit territory by the end of the year. This is good news for the economy and the central bank, but also good news for the forint. Without many surprises, the market has no reason to push the central bank to cut rates faster, undermining the main attraction – FX carry. This, despite the decline in recent weeks, is one of the highest in the emerging market universe and by far the highest in the CEE region.

Later today we will also get the Hungarian state budget result for July. [The last two months](#) show signs of stabilisation of the deficit at 85% of this year's target. State budgets are showing bad numbers across the region. However, in the Czech Republic, we have already seen the trend turn over, and in Romania, the government is trying to come up with a revision of the state budget in an attempt to keep the numbers under control. Today, we expect the deficit in Hungary to remain roughly unchanged. This should be good news for Hungarian government bonds. However, in case of a negative surprise, we could also see a spillover into FX due to the higher market attention. Moreover, this topic is of course linked to the EU money issue, which we expect to be back on the table in the coming weeks.

So overall, everything revolves around the Hungarian forint at the moment. Values around 390 EUR/HUF open the question of whether we will hear some comments from the National Bank of Hungary, given that we are entering sensitive waters. Market positioning is probably rather balanced after the sell-off over the last few days, so we believe this leg of the move-up is over. But it is also hard to see a quick recovery. Despite a lot of local story, the correlation with the US dollar has been almost perfect for the past month. In other words, the main driver in our view is global factors and we don't see too much potential either way on this into US inflation numbers. So EUR/HUF may try to lower levels but we don't expect a big rebound after today's numbers.

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