FX Daily: Optimism re-priced

FX markets are being dominated by a position unwind as reflation trades continue to come under pressure. The good news is that the FOMC minutes did not show a particular urgency from the Fed to withdraw accommodation. We suspect investors will return to the commodity complex later this year, while 1.1700 may be the range low for EUR/USD this summer.

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USD: Nothing particularly hawkish in the FOMC minutes

Looking across asset markets it is clear that the reflation trades are coming under pressure. The US 2-10 year yield curve continues its bullish flattening - a move one would expect much later in an economic cycle. Commodities are generally softening and confirmation that the world economy is not a one-way recovery story comes from the news that the PBOC is considering a Reserve Requirement Ratio cut - to help lending for SMEs.

There briefly had been fears that the Fed could add to slow-down fears by pushing on regardless with its tightening plans - fears built by the aggressive Dot Plots released June 16th. Yet the FOMC minutes of that meeting released last night demonstrated a much more calm and patient tone than many had expected. Yes, a substantial majority of members noted upside risks to their inflation projections. Yet there was no suggestion that the Fed would be rushed into tapering, let alone tightening.

So those fears of a hawkish Fed look a little premature. And we can see that in US money markets, where 1 month USD OIS rates, priced two year forwards, have this week fallen from 0.82% to 0.73%. That is not a particularly bullish story for the dollar against the low-yielders is it? And it is probably one of the reasons why USD/JPY is falling for a change and a reason that EUR/USD should not be chased too much lower.

This begs the question - what next? Does the Delta-variant spread in the US and the last shoe to drop in the reflation unwind is an equity correction? We are a little more positive than that and would back growth in 3Q and a return to pro-cyclical currencies on any further near-term weakness. For today, the US focus will be on whether initial claims fall further and we could actually see DXY handing back some of this week's gains.

EUR: ECB strategy review in focus

At 13CET today the ECB will release its monetary policy strategy view. This is akin to the exercise the Fed undertook last year and resulted in the Fed's Average Inflation Targeting framework. Reports widely suggest the ECB will adopt a quasi symmetrical target - targeting inflation at 2% with occasional overshoots, rather than its current 'close to, but under 2%'. Like the Fed, an ECB preparing to run the economy hotter could point to lower EUR real rates and be negative for the EUR. For the time being, however, the markets price a very dovish ECB - no real tightening until late 23/24 - and today's announcement may not have a large impact on the EUR.

Instead as above, if the Fed cycle tightening cycle is being priced a little lower/later, EUR/USD need not necessarily drop to 1.1700. And the surprise could be EUR/USD turning back higher to the 1.1850 area.

Elsewhere, we do still like the commodity complex but acknowledge that it is a widely held, conviction call and pairs like USD/CAD may still need to move up to the 1.2630 area.

GBP: Focus on BoE credit conditions survey

England's football success has yet to have any material impact on GBP - though the pair is staying reasonably bid against the EUR. At the margin one could say that the ECB strategy review should be bearish for EUR/GBP - but that's a stretch.

Look out today for the BoE quarterly credit conditions survey - providing insights on lending volumes and credit spreads. It may be too early to expect lending volumes to have picked up. Current BoE pricing of the first 10bp hike in summer 2022 and the first full 25bp hike in March 23 feel about right - although could get pushed back a bit should the current unwind of optimism continue. 0.8535-0.8615 remains the EUR/GBP range - amidst a continued fall in traded volatility levels.

PLN: NBP staying patient

Poland's NBP meets today to set interest rates. Our Polish team believe today's meeting will be characterised by 1% upgrades to GDP and CPI forecasts, but also by an NBP that will not follow Hungary into early hikes. That said, we do favour the first hike as early as November this year, which should mean EUR/PLN ends the year near the 4.38/40 region.

Should the broad-based market position unwind continue - an unwind that has hit CEE FX - a still patient NBP could send EUR/PLN up to 4.56 and possibly 4.59. Yet expect good demand for PLN to resume at that area and EUR/PLN drift back to 4.50 through the summer as the NBP starts to drop hints that it could tighten later this year after all.

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