FX Daily: Different speeds

The US and eurozone are travelling at different speeds both on the economic front (latest US data confirmed that) and on the monetary policy front. That second point could be confirmed this week as the ECB may simply reiterate plans for two 25bp rate hikes this year. Ultimately, all this should bring EUR/USD back to the 1.0500 mark, in our view

USD: Gearing up for a re-strengthening

Risk assets are starting the week on a strong footing, with Asian equities trading in positive territory and Western stock futures also in the green. Last week's legacy in global markets was the predominant message that the US growth story remains on solid ground for now, and that an even tighter than expected jobs market all but confirms aggressive Fed tightening.

The primary implication of this narrative in FX is – in our view – that the dollar's downside risks have shrunk, as speculation over a Fed pause appears objectively premature and the prospect of monetary tightening suggests (along with European geopolitics and China's slowdown) equities may continue to navigate rough waters for a little longer.

With this in mind, our base case is that we'll see the start of a dollar re-strengthening phase this week, to be followed by a period of consolidation during the summer as the Fed's 50bp hikes put a floor under the dollar. After recent data clearly pointed to good US economic momentum, the focus in the coming days will shift to the inflation story, with the US CPI report on Friday being the highlight of an otherwise quiet data calendar (also, Fed members are in the blackout period). The notion of peaking inflation may well be confirmed (core is expected to slow down), but it's unlikely this will have any substantial repercussions on the Fed's plans for the summer and – by extension – the dollar should not suffer any material setback on the back of that.

We think the gradual re-appreciation of the dollar should mostly come to the detriment of currencies with more uncertain growth prospects like most European currencies or the antipodeans (due to their exposure to China). Further weakness in the bond market will likely put additional pressure on the yen, with markets now testing the tolerance of the Japanese authorities before the prospect of FX intervention is put back on the table. Oil-sensitive currencies like Canada's dollar and Norway's krone may find some support given the re-pricing higher in the oil market. We expect the heavily euro-centred DXY to climb back to the 103.00-103.50 area in the run-up to next week's FOMC meeting.

EUR: High bar for a hawkish ECB surprise this week

For the euro, this week will be all about the European Central Bank meeting on Thursday. Markets are attaching a close-to-zero probability of a rate hike, which would be in contrast with recent ECB communication indicating July as the start of the tightening cycle. We agree a rate hike this week is highly unlikely, but the question of why the ECB is willing to wait another month despite rapidly rising inflation will likely be raised. As discussed by Carsten Brzeski in our ECB preview, it all boils down to the ECB's determination to maintain its credibility and sticking to the notion of "sequencing" (ending QE before hiking).

Another major focus will be on the updated staff projections. We think markets will mostly look at the 2024 inflation figures, while more short-dated projections will be flawed given that the EU oil embargo on Russia will not be embedded.

Indeed, with Chief Economist Philip Lane having explicitly pre-committed last week to a 25bp rate hike in July and another one in September, a hawkish surprise this week would likely require the open discussion of a 50bp hike by President Christine Lagarde. Even in such a scenario, the market's pricing for 118bp of tightening by year-end means that the room for the EUR to benefit from this is somewhat contained.

In our view, a reiteration of the recent pre-committed policy path looks more likely, and EUR/USD may slip back to the 1.0600 mark over the coming days.

GBP: No confidence vote on Johnson may not bother the pound

Political developments are taking centre stage again in the UK, as British markets reopen today after a long weekend. Prime Minister Boris Johnson is reportedly set to face a no confidence vote by the end of this week following accusations of having broken lockdown rules (the so-called "partygate"). Upcoming by-elections may also play a role.

The pound was notably unreactive to political noise back when the whole "partygate" scandal first exploded and Johnson appeared on the brink of resignation. While keeping in mind that the Prime Minister might survive a potential no-confidence vote, even the prospect of a change in leadership within the Conservative party may not have many implications policy-wise.

That said, the pound remains vulnerable in the short term given worsening growth prospects and a potential re-pricing of BoE rate expectations. A break below 1.2500 in cable could see the pair extend losses to the 1.2300-1.2350 area this week.

AUD: The RBA might go for 50bp tomorrow

The Reserve Bank of Australia is set to hike interest rates tomorrow morning, with the consensus seemingly centred around a 40bp move to bring rates to 0.75%. That would merely follow the notion that the RBA stands ready to do a little less than the Fed in the tightening cycle: after all, the inflation picture is not as concerning in Australia (the headline rate was at 5.1% in 1Q), and lockdowns in China are inevitably clouding the domestic economic picture.

While 40bp is our base case too, we see some non-negligible risk the RBA will actually go for a 50bp hike, and potentially slow down the pace of tightening compared to the Fed later in the summer. That would still keep the policy rate in Australia below the US one, and some front-loading could be a viable option at this stage.

The swap market indicates investors are pricing in 28bp of tightening tomorrow, which does leave some room for hawkish surprises. Still, any benefit to the Australian dollar should prove short-lived as the lingering uncertainty around Chinese activity should continue to weigh on the antipodeans. We still expect a return to the 0.7000 mark in AUD/USD over the coming weeks.

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