FX Daily: Diverging G3 trends dominate

Closing the week, we have the Japanese yen a little stronger as the BoJ softens up YCC control, the dollar is steady-to-stronger on good US activity data, and the euro is weaker as the ECB throws a September rate hike into doubt. After the BoJ press conference, today's highlight will be the US Employment Cost Index data. A soft number could hit the dollar

Kazuo Ueda, governor of the Bank of Japan

USD: The ECI will be in focus today

The combination of some stronger US activity data and some independent euro weakness on the back of yesterday's ECB meeting has seen the trade-weighted DXY dollar push a little higher. DXY would be even higher were it not for the lower USD/JPY we have seen today on the back of the Bank of Japan's tweak to its Yield Curve Control (YCC) target.

Regarding the BoJ, we think the market is right to have taken USD/JPY a little lower after this surprise adjustment to how it manages its 10-year Japanese government bond (JGB) yield target. What has probably prevented USD/JPY from dropping harder are the new BoJ core CPI forecasts, where FY24 and FY25 CPI are still only forecast at 1.9% (April forecast 2.0%) and 1.6% (1.6%) respectively. This hardly provides a firm foundation to conclude that CPI will now sustainably run near 2.0%. Instead, the tweak to the YCC programme may reflect BoJ Governor

Kazuo Ueda's preference to take baby steps away from the heavy control of the JGB market - i.e. maybe he's more of a free marketeer.

However, we do think the drop in USD/JPY might get some support from the dollar side today. Undoubtedly, US activity data has been holding up well, and based purely on the activity data alone one would argue that the Fed had the strongest case for another rate hike, yet Fed Chair Jerome Powell acknowledges that US monetary policy is already in restrictive territory and the focus is on disinflation.

On Wednesday, Powell said there would be important data prints before the September FOMC meeting – two CPI prints, two jobs reports and the Employment Cost Index (ECI). Well the second-quarter ECI figure is released today and is expected at 1.1% – a drop from 1.2% in the first quarter and a peak of 1.4% in the first quarter of 2022. My colleague James Knightley thinks the risks are skewed to a sub-consensus 1.0% reading today given the softer average hourly earnings and survey evidence both from the Fed's Beige Book as well as the NFIB data that the US labour market is coming better into balance.

A soft ECI number can wipe out the final 8bp that is priced for the US tightening cycle this year and will probably knock the dollar 0.5-1.0% lower. This would be a good story for risk assets, where both the Fed and seemingly the ECB would be closer to ending tightening cycles. If we are right with our call on the ECI, DXY could head back to yesterday's low near 100.50.

Chris Turner

EUR: ECI to the rescue

Thursday proved a bad day back in the office for EUR/USD. The ECB press conference proved a negative for the euro as ECB President Lagarde backed away from a September rate hike and seemed to acknowledge both softer activity data and welcome disinflation. This was not really a bloodbath for the euro – indeed the trade-weighted euro did not move too much, nor did two-year rate differentials. It just so happened that we had some strong US data coming out at the same time. If we are right today with our call for a soft ECI number, we could see EUR/USD breaking back above 1.1000 and starting to trace out the kind of 1.1000-1.1150 range over the coming sessions.

Chris Turner

As usual this week, the calendar in the CEE region doesn't have much to offer. But still, like yesterday, CEE will have to consume the global story, which brought a lot of new news again. The main news here is of course the lower EUR/USD, which complicates the positive picture we described yesterday for CEE FX. But on the other hand, positive market sentiment is going full speed ahead with the end of the global hiking cycle in sight. Thus, FX in the region has every right to be confused about which direction to go now. We are leaning more on the bullish side again, but EUR/USD will be a problem and hold back further gains for CEE FX today.

Frantisek Taborsky

CLP: The start of the easing cycle

Looking around the world, Latam has suffered some of the larger spikes in inflation over the last couple of years and has responded with some of the larger tightening cycles. They have also seen some heavy disinflation this year and may be the first to embark on large-scale easing cycles –

hence all the interest in local bond markets and widespread receiver trades amongst the hedge fund community.

Later today we could see the first big cut in the region, in Chile. Here the central bank has said it will be starting its easing cycle soon and expectations are that the policy rate will be cut by 75bp today to 10.50%. We doubt that will weigh on the Chilean peso (CLP). But equally, we have been forecasting that the CLP lags the currency rally in Brazil and especially in Mexico because FX reserves are too low in Chile. In June, Chile announced that it would start a new FX reserve rebuilding programme – ostensibly to redress last year's massive FX support programme for the peso, which saw FX reserves halve. In short, we doubt USD/CLP trades below 800 on a sustained basis.

Chris Turner

TRY: Further moves towards policy orthodoxy

In a further move towards policy orthodoxy, yesterday the Central Bank of Turkey presented its latest inflation report which saw its 2023 inflation forecast double. Our chief economist in Turkey, Muhammet Mercan, wrote a detailed review of this report here. The new inflation forecasts take on board developments in Turkey this year and have generally been received positively by the markets. In addition, three new deputy governors were appointed to the CBT last night – a move we also suspect will be welcomed by the markets.

Clearly, the very high inflation in Turkey will pose many challenges to Turkish asset markets amidst this transition to policy orthodoxy, but this week's developments look consistent with the recent narrowing of Turkey's sovereign risk premium, where the five-year sovereign Credit Default swap dipped from 700bp in May to 430bp this week.

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