FX Daily: Dollar bears may have jumped the gun

The dollar plummeted yesterday after a softer-than-expected US CPI reading. But we still think a turn in activity data - more than the disinflation story - is needed to take the dollar sustainably lower, and the move appears overdone also from a short-term valuation perspective. US retail sales will tell us whether the dollar can start to recover today

USD: Dollar slump looks overdone

We had pointed to the risk of a USD correction yesterday given the chances of a soft CPI reading, and the tendency of the dollar to underperform after key US data releases/events. The move was, however, quite extreme. If position-squaring did play a role in exacerbating the size of the dollar correction, the depth of the drop in Treasury yields means the FX shifts have taken their cues from a substantial repricing of monetary policy expectations.

The Fed funds futures curve erased any residual bet of monetary tightening after the lower-than-expected October inflation report, and now prices in the start of the easing cycle in June and 50bp of cuts by July. We have no reason to argue against this pricing from a macro perspective: our US economist discusses here how disinflation has much further to go, and we currently forecast 150bp of Fed cuts in 2024, still more dovish than the 97bp priced in by the market. However, we'd be wary of jumping too aggressively on a dollar bear trend now.

First of all, markets have moved a lot after a softer inflation reading, even though the narrative of disinflation being well underway is something that would hardly surprise the Fed. The month-on-month core print, by the way, came in at 0.227%, not too far from a rounded consensus 0.3%. Resilient growth is what's been keeping the dollar stronger, and while we expect the US to head into recession in 2024, there is no hard evidence just yet. In other words, strong US activity figures remain a very clear possibility in the near term and could trigger an inversion in the US bear run.

Secondly, rates have moved significantly, but not enough to justify the huge dollar drop. According to our short-term fair value model, the dollar has moved into undervaluation (after the US CPI release) against all G10 currencies except for the Japanese yen, Canadian dollar and Norwegian krone. This is quite remarkable given the dollar had been generally overvalued in the short term for many months.

Today, October retail sales will be watched closely after coming in very strong in September. Consensus is for a 0.3% MoM decline in the headline figure but a 0.2% increase in the index excluding auto and gas. The dollar should be very sensitive to the release. A soft reading may fuel speculation that softer growth is coming through and could add to disinflation to trigger more Fed dovish bets. However, US activity data has had a tendency to surprise on the upside, if anything, and it may be too early to see a slew of soft readings. Our view is that this USD bear run is overdone, and we expect another, or a few more rounds of dollar resilience into the New Year before a clear-cut dollar decline can emerge.

PPI data will also be watched for confirmation that the disinflation process effectively accelerated in October. On the geopolitical side, keep an eye on headlines from the Biden-Xi Jinping meeting at the APEC summit.

Francesco Pesole

EUR: Eurozone tiptoeing into slightly better data

It is hard to argue that the huge EUR/USD jump had much to do with the euro itself yesterday. In the havoc of a huge dollar correction, markets flooded into high-beta currencies, and in Europe Scandinavian currencies (Swedish krona and Norwegian krone) were naturally favoured to the more defensive euro. Still, before the US CPI figures, EUR/USD was finding some support after ZEW expectations surprised on the upside in Germany with a bounce from -1 to 10 (first positive reading since April). The same index for the whole euro area reached the highest level since February. That probably puts more emphasis on upcoming data to gauge whether there are any more tentative signals of “peak pessimism” that may bring along some idiosyncratic EUR support.

Today, eurozone industrial production figures for September should be largely overlooked, but some greater focus will be on the EU Commission's economic forecasts. There are no scheduled European Central Bank speakers today before two consecutive days of President Christine Lagarde speeches.

In line with our dollar view discussed above, we are inclined to think a pull-back to the 1.0800 mark is appropriate given short-term valuation (EUR/USD 1.5% overvalued). Conversely, a break above

1.0900 (probably on more US data weakness) would be significant and make 1.1000 the next key resistance.

Francesco Pesole

GBP: Softer services inflation rules out BoE December surprise

The chances of a Bank of England surprise hike in December were already very low, but this morning's UK inflation figures for October are further helping a dovish case. Headline inflation dropped from 6.7% to 4.6%, and core from 6.1% to 5.7%: a slightly faster deceleration than consensus in both rates.

We know the BoE primarily looks at services inflation, which noticeably undershot the Bank's forecast (6.9%) by coming in at 6.6%. There are no other CPI releases before the next meeting, so along with the markets sticking to their view for a pause, there may be mounting speculation the BoE might soften its stance towards future policy direction.

As we write this report this morning, markets are close to pricing in a first rate cut in the UK in June (23bp). We keep pointing to the fact that pricing in the Sonia curve appears a bit too conservative compared to that of the US and the eurozone in pricing monetary easing and that raises the risk of GBP underperformance as the UK economic outlook deteriorates.

The combination of a tentative improvement in eurozone data and soft inflation figures in the UK should help build a floor around 0.8700 in EUR/GBP.

Francesco Pesole

CEE: Good news for PLN, not that much for CZK

Yesterday's US inflation numbers moved the central and eastern European currencies as well as the entire emerging market space. Obviously, a higher EUR/USD is good news for the region, but it seems the move was too much, and we may see some corrections today. Poland's zloty benefited the most from the move yesterday, briefly touching 4.40 EUR/PLN, the lowest since July. Core rates moved PLN rates down too but we would expect some rebound here given the tone of the National Bank of Poland. Therefore, we expect the smallest correction in the region and EUR/PLN should hold in the 4.40-4.42 range.

On the other hand, in the Czech Republic, the market does not seem so mispriced as far as monetary policy is concerned and unlike Poland, yesterday's trading already showed a weaker interest rate differential, negative for the koruna. Thus, we think we will see EUR/CZK above 24.500.

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