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FX Daily: Dollar bid into CPI event risk

The dollar is going into today's US July CPI event risk not too far from its highs of the year. Consensus expects a sharp slowing in both headline and core rates from the 0.9% MoM gains seen in June. Any upside surprise could add to the views of truncated Fed tapering and earlier tightening. We thus see upside risks for the dollar today.

Source: Shutterstock

USD: Truncated tapering?

Measures of the trade-weighted dollar are barely 0.5% away from their highs of the year. Driving that move is a Fed acknowledging progress towards its goals, such that a decision on tapering of bond purchases can likely be taken over coming months. The question then moves on to the speed of tapering - will it be six, nine, or twelve months before tapering is concluded - and then the first Fed tightening. Fed Funds futures show the market pricing the first Fed hike being priced in December 2022 and struggles to see the Fed Funds rate barely above 1.00% over the next three years.

Whilst the market acknowledges that the Fed is very much focused on employment data, CPI data will shed light on how aggressive the Fed needs to be when it is ready to tighten. The consensus view is probably that it is still too early to get a good read on inflation as the economy is still suffering re-opening and supply bottleneck challenges. Yet the US rate market has seemed a little more responsive to macro data recently and upside surprise in CPI could push up rates towards the front-end of the curve. For example, 1m USD OIS rates priced three years forward are now 1.12% - below the mid-June high of 1.25% and way off April's 1.40% level. Should today's release of July CPI not see headline and core rates dropping to 0.5% and 0.4% respectively, US money market rates and the dollar could both see a leg higher.

This comes at a time of low volatility and equity markets nudging to new all-time highs. It also comes at a time of emerging markets, especially Asia, struggling with the Delta variant. The latter means it is hard to argue that the dollar has a bearish undercurrent from money being put to work in EM. We thus see CPI as a bullish event risk for the dollar, which certainly could see the low yielders (EUR and JPY) press the lows of this year's range, while the high beta NOK, ZAR and MXN as usual could be in the front line for some heavier losses.

EUR: Pressing the range lows

The trade-weighted EUR is now about 3.5% off the highs of the year seen in January. European equities are just about keeping gains with those in the US, but there has not been the clear outperformance that could have justified the rotation flows we had highlighted earlier in the year. This leaves EUR/USD near its low for the year at 1.1700. As above, the US CPI event risk is a threat to triggering a major range break-out, where 1.1600 would be an initial target though 1.1500 - a 50% retrace of last year's rally - would be very much in focus.

GBP: Waiting on Thursday's 2Q GDP data

We are a little surprised that EUR/GBP has not pushed too much lower after breaking the 0.8470 support zone over recent days. A move much lower maybe unlikely today - although EUR/USD could get hit harder than Cable on a strong US CPI figure. A greater chance of a decline comes tomorrow when the UK releases 2Q GDP, where we see upside risks to the 4.8% QoQ figure.

1.3730/3770 is the risk for Cable today around the US CPI.

ZAR: Looking more vulnerable now

Having been one of the best performing currencies this year on the back of the commodity boom, over the last week the ZAR has suffered the largest losses. No doubt this is down to the re-assessment of Chinese growth prospects, but also the broadly stronger dollar and rising US rates.

The ZAR has one of the tightest correlations with the CNH. Begging the question whether the PBOC creates the conditions to allow USD/CNH to trade substantially above 6.50. Such an outcome is not clear given that the PBOC is still in the mood to insulate the economy from this year's commodity price surge.

So whilst continued low volatility does favour the high yielders, today's US CPI risk, what it means for the dollar and US rates, plus the re-assessment of Chinese growth prospects all suggest caution on the ZAR. USD/ZAR punching through 15.00 - outside multi-day risk to 15.65 - could be a story for next week were US CPI to surprise.

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