FX Daily: Dollar close to peak risk premium

The dollar is being hit by a combination of soft data (ISM manufacturing) and more bond market concerns. However, the risk premium is not far from the peaks seen in April, and soft data may not be enough to justify EUR/USD rallying much higher than 1.15 unless the Treasury market sells off more aggressively. The market is absorbing the election win in Poland

USD: Testing short tolerance levels

The dollar's slide accelerated at the start of the week, driven by two main factors: growing trade uncertainty and rising concerns from bond vigilantes over the US deficit. Yesterday's ISM manufacturing surveys delivered a negative surprise, reversing the recent trend of resilient US data. The drop in the export gauge to a five-year low may be a signal that retaliatory measures are biting, adding weight to the broader manufacturing complex that is hit by trade policy uncertainty and softer consumption.

Today's spotlight is on April's JOLTS report, where job openings and layoffs will be scrutinised closely. Durable goods orders for April are also expected to have taken a hit. Another round of soft data, particularly in the labour market, can push the dollar back to its April lows.

That said, the fragile US bond market remains the bigger story. We see the USD risk premium in the DXY index below 98.0 as hard to justify on weak growth expectations alone — it would likely need further weakness in Treasuries to move lower.

Trade developments remain crucial. Reports suggest China is gaining leverage over the US through its control of chip supply chains and rare earths. Trump and Xi Jinping are set to speak this week, and past direct talks have sometimes eased tensions. That leaves room for a positive surprise that could help the dollar at some point this week.

Francesco Pesole

EUR: Close to a peak?

The eurozone's flash inflation estimates for May are published this morning. Germany reported a consensus 2.1% headline rate, while France and Spain's prices both dropped surprisingly on a month-on-month basis. Consensus is centred for a slowdown to 2.0% in headline and 2.4% in core.

The ECB is widely expected to revise its projections lower as it cuts rates this week and should signal the 2% target will be met sustainably earlier than predicted in March. The CPI release today will not alter well-cemented expectations for a cut on Thursday, but may increase speculation of a more dovish message by President Lagarde. Markets are pricing in 55bp of cuts by year-end, with the de-escalation in trade tensions perhaps capping dovish bets, but markets may now start to bet more heavily and more aggressively on a 1.50% year-end rate.

Given our dollar view above, we don't see EUR/USD pushing into the 1.15-1.20 range unless we see more material Treasury instability. For now, our baseline expectation is that the rally will lose steam close to 1.15.

Francesco Pesole

PLN: The market absorbs the election result

Markets reacted to Poland's presidential election much like the first round, with a broad sell-off across rates, bonds, and FX. However, the market quickly began to correct the initial move and rates and FX remained essentially unchanged yesterday. Polish government bonds, however, remained 4-5bp higher. As we mentioned yesterday and our economists discussed in the post-election report, the main impact of the election should be seen on fiscal policy for years to come. Political uncertainty and a lack of power to push things through the legislative process should undermine consolidation efforts. Therefore, we see higher yields and wider asset spreads as a logical consequence and will likely see more in the days ahead.

In the FX space, EUR/PLN touched 4.270 and subsequently returned to 4.250. Still, as we mentioned yesterday, the rate differential after Friday's inflation and yesterday's unchanged close points to levels around 4.260-270. Therefore, we expect FX pressure to return and see EUR/PLN back in the 4.270-280 range. Obviously, the main driver will be politics in the coming days and how fragile the government coalition is. On Thursday, the National Bank of Poland governor is set to speak, likely signalling the next rate move following new gas tariffs, easing May inflation, and the presidential election.

Frantisek Taborsky

TRY: Return of the disinflation process

Today's headline number in the CEE region is May inflation in Turkey. After April's strong month-on-month growth, we expect May to show a return to disinflation again with MoM close to 2.0% vs 3.0% last month. This should translate to a drop from 37.9% to 36.0% in year-on-year terms. We believe the market has lost confidence in disinflation and expect higher inflation than our forecast for this year. Thus, today's number should help return market interest after the March sell-off and April's stronger inflation number.

Still, more numbers will be needed to restore confidence in a lower inflation profile, but May's number could be a good start. The front of the bond curve and FX implied yield are still trading at elevated levels compared to March, indicating cheap valuations. At the same time, today's number should give a clue as to how close we are to the Central Bank of Turkey resuming its cutting cycle. USD/TRY remains on its usual upward trajectory and we do not expect any changes here until at least the end of the summer. At the same time, TRY continues to provide a fat carry beating depreciation trend and remains our favourite carry currency.

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