FX Daily: Dollar correction shouldn't have legs

DXY has dropped nearly 3.0% since last week's highs, as global risk sentiment recovered and ISM manufacturing numbers disappointed. Still, the medium-term story remains USD-positive in our view, also due to the grim outlook for Europe. The fiscal U-turn in the UK may not offer sustained support to the pound, while the RBA may keep hiking by 25bp from now on

USD: Correction not very sustainable

The dollar has remained in correction mode at the start of this week, with DXY now trading nearly 3.0% off its 28 September peak. In our view, this has not been accompanied by a radical change in the medium-term narrative that has backed the dollar rally so far: despite somewhat weaker-than-expected ISM manufacturing figures yesterday, the US domestic story remains rather solid, leaving the Fed tightening prospects alive even if markets have recently revised the expected terminal rate to sub 4.50% levels. We see Friday's payrolls report as a potential trigger for a fresh hawkish re-pricing, and a positive event for the dollar.

Indeed, the fiscal developments in the UK (more in the GBP section below) appear to be having a rather widespread impact on global risk sentiment and have likely favoured a rebound in risk assets and bonds. There is still, however, a long way to go for European assets to regain the market's favour given the energy crisis and concerning geopolitical developments, so we continue to see any dollar contraction driven by a recovery in European sentiment as likely short-lived.

It is likely that after the ISM manufacturing miss, markets will increase scrutiny on incoming US data to gauge any downward trend in the economic outlook. Today's data is quite outdated (factory orders and JOLTS job openings for August), which could favour a slightly calmer market environment, but a lot of focus will be on tomorrow's ISM services index and ADP employment figures. We also have a rather long list of Fed speakers today.

We think the DXY downtrend will soon run out of steam, and some stronger support may already emerge at the 111.00 level. We struggle to see the macroeconomic justification for an extension of the drop below 110.00 at the moment.

Francesco Pesole

EUR: No idiosyncratic support

EUR/USD has largely benefitted from the improvement in global risk sentiment, the dollar correction and some positive spillovers from the fiscal U-turn in the UK, but the euro has still failed to show any substantial idiosyncratic bullish push. This is hardly surprising given the still very challenging outlook for the eurozone and elevated uncertainty about the energy crisis heading into the cold months.

Today's data calendar is quite light in the eurozone, with only the acceleration in August PPI inflation to keep an eye on. More focus should instead be on European Central Bank speakers as President Christine Lagarde will deliver some remarks this afternoon, following speeches by both Pablo de Cos and Mario Centeno.

In our view, the EUR/USD recovery is looking quite fragile, which means that any slight dollar recovery could trigger a wider correction in the pair. We still see a high risk of a return to 0.9500 over the coming weeks.

Francesco Pesole

GBP: Downside risks remain elevated

Cable has climbed back to the levels it was trading at before the mini-Budget announcement, but we struggle to see the current rally as sustainable. Firstly, our economics team does not see the fiscal U-turn as a game changer in terms of the country's finances, and the damage done by delivering ideological – and hardly justifiable economically – tax cuts in the first place is hard to repair. Secondly, there is still an elevated risk that the UK will face a rating downgrade.

There is undoubtedly an ongoing effort by the government to calm markets, and it's been reported this morning that Chancellor Kwasi Kwarteng is expected to bring forward his medium-term fiscal plan announcement, which was initially due on 23 November. However, the exact date hasn't been revealed just yet.

We think, however, the pound continues to face very significant downside risks as the large twin deficit, low market confidence in the new government and a grim outlook for Europe heading into winter all point to the unsustainability of 1.10+ levels in GBP/USD.

Francesco Pesole

AUD: RBA turns more cautious

The Reserve Bank of Australia hiked by 25bp this morning, surprising markets on the dovish side (expectations were for a half-point move). We don't see this as particularly surprising, as the RBA meets more than other developed central banks (once a month), which allows greater flexibility based on incoming data and global economic/financial conditions.

Indeed, the Bank highlighted how uncertainty over the economic outlook has increased and appeared somewhat concerned (not alarmed) about how Australian households will respond to tighter financial conditions, although the assessment of the domestic outlook has remained rather upbeat. Fears of a sharp housing market downturn are certainly on the rise.

We get two key data releases before the next RBA meeting on 1 November: employment figures for September and even more importantly the 3Q inflation report. Large surprises on the upside on both releases may open the way for a 50bp hike in November, but 25bp increases seem more likely from now on.

The AUD/USD negative reaction after the RBA announcement was quite short-lived, in line with the recent detachment of monetary policy and FX dynamics. The pair remains quite vulnerable at current levels given the risks of a USD restrengthening and challenging global risk outlook.

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