FX Daily: Dollar rally pauses for breath

Some support measures for the Chinese economy and some stability in the Chinese renminbi have helped usher in a period of consolidation in FX markets. This may well last into next week, although we would consider this a pause not a reversal in the dollar's bull trend. The stronger dollar is also exporting Fed hikes around the world

Not until the Fed pours cold water on tightening expectations should the dollar build a top

USD: Some consolidation is in order

The dollar is now about 2% off its highs seen late last week. Driving that move has probably been some position liquidation and a preference for currencies like the Japanese yen (JPY) and the Swiss franc (CHF) during turbulent times in global equity markets. In fact, yesterday's FX activity looked like the big sell-off in EUR/CHF on Swiss National Bank (SNB) comments which triggered downside stops in USD/CHF and prompted a slightly broader dollar adjustment.

Also helping this period of consolidation has been this week's stability in the Chinese renminbi (CNY). The overnight 15bp cut in the 5-year Loan Prime Rate – aimed at supporting the property sector – has instilled a little more confidence in Chinese assets markets. However, we cannot see USD/CNY heading straight back to 6.50. Instead, a 6.65-6.80 trading range may be developing after the recent CNY devaluation.

However, the emerging market environment still looks challenged given that the stronger dollar is effectively exporting tighter Fed policy around the world. Yesterday we saw rate hikes in Egypt, South Africa, and the Philippines. After devaluing the Egyptian pound by 15% in March, authorities there are very much struggling with the external environment. This has seen Egypt's 5-year Sovereign Credit Default swap rise to news highs of 940bp and is a reminder of the challenge North Africa faces from surging food prices.

For today, the data calendar is relatively quiet and there may be some interest in what G7 finance ministers and central bank governors have to say after their meeting in Bonn. Reports suggest Japan would like some tweaks to the final G7 communique, but we very much doubt there will be any change in the core FX language that FX rates be market-determined and that excessive volatility and disorderly moves be avoided.

DXY could correct a little lower to 102.30, but we see this as bull market consolidation, rather than top-building activity. Not until the Fed pours cold water on tightening expectations should the dollar build a top. And yesterday Fed hawk, Esther George, said that even this 'rough week' in equity markets would not blow the Fed off course.

EUR: ECB hawks in control

Minutes of the April ECB meeting released yesterday show that the hawks are calling the shots. The market now prices a 31/32bp ECB rate hike at the 21 July ECB meeting – pricing which has plenty of scope to bounce between +25bp and +50bp over the next two months. This could drag EUR/USD back to the 1.0650/70 area over the coming days – helped by brief periods of calm in the external environment – but as above we would see this as a bear market bounce. Our core EUR/USD view for 2H22 is one of heightened volatility and probably EUR/USD getting close to parity in 3Q22 when expectations of the Fed tightening cycle could be at their zenith.

GBP: April retail sales provide a reprieve

UK retail sales have come in a little better than expected and break/suspend the narrative that the cost of living squeeze is large enough to derail the Bank of England tightening cycle. We would not get carried away with the sterling recovery, however. Sterling is showing a high correlation with risk assets – trading as a growth currency – and the outlook for risk assets will remain challenging for the next three to six months probably. Here's what our credit strategy team thinks of the European outlook.

Cable may struggle to breach the 1.2500/2550 area and 1.20 levels are very possible over the coming months. New-found hawkishness at the ECB means that EUR/GBP may struggle to sustain a move below 0.8450 before returning to 0.8600.

CHF: SNB policy makes the case for EUR/CHF sub 1.00 next year

As we discuss in an article released yesterday, it looks like the SNB is targeting a stable real exchange rate to fight inflation. Given that Switzerland's inflation is roughly 4% lower than key trading partners, a stable real exchange rate means that the nominal exchange rate needs to be 4% stronger. This will be an added factor supporting the CHF over the coming months and may start to generate interest in trades positioning for a lower GBP/CHF. 1.2080 is a big support level but 1.1860 looks like the near-term target.

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