FX Daily: Dollar rally proves short-lived

The greenback has not held on to post-trade-deal gains for long, and while a soft CPI was the trigger for the correction, we think yesterday's moves signal a clear preference for strategic short-USD positioning ahead of US data deterioration. Today, there is a speech by Jay Powell, but very little on the data side. The dollar may stabilise after big swings

USD: Strategic USD shorts quickly re-emerge

The dollar gave back almost all of its post-China-deal gains in one session. We think there is still a significant bearish appetite towards the greenback, and a cooler-than-expected 0.2% month-on-month core CPI provided an opportunity to re-enter strategic shorts. There are likely lingering concerns that positive trade-related news may soon be outshadowed by hard evidence of the damage already done to the US economy, and there may not be enough incentive to chase dollar rebounds until clarity on the impact of tariffs has emerged. The fact that the 10-year USD swap spread (a measure of perceived Treasury market instability) has not tightened back below 50bp may still mirror concerns related to debt sustainability, and could be encouraging USD shorting.

Fed rate expectations haven't moved after yesterday's softer-than-expected CPI, likely because

April data still wasn't showing the inflationary impact of tariffs. Markets have resized their dovish bets significantly since the US-China weekend deal, and only 50bp are now priced in by year-end. However, given the lower inflationary risks, modest observed inflation in April, and the widely shared pessimistic view on US growth, the risks are likely skewed towards the dovish side, and that can contribute to keeping the dollar recovery capped.

The US data calendar is light today, but focus will be on Fed Chair Powell's remarks at a conference focused on the central bank's monetary policy review. However, Powell may not touch upon the more urgent topic of reduced tariffs on China and any monetary policy implications. It is surely possible that most FOMC speakers will be reluctant to send any dovish signals before seeing some key data first.

We think the dollar may stabilise today after two volatile days. We still expect to see a preference for high-beta commodity currencies over safe havens as markets regain risk appetite after the improved trade news.

Francesco Pesole

EUR: Not in a prime position to rally

EUR/USD is back to trading close to the 1.120 mark, entirely driven by the swings in the dollar following the US-China deal and CPI numbers. Our one-month target for the pair is 1.12, on the view that markets will retain interest on short-USD positioning ahead of expected US data deterioration, but that the euro is not particularly well positioned to benefit from it as the ECB continues to cut, and markets may look with more interest at higher beta currencies on the back of better risk sentiment.

In eurozone macro news, the ZEW expectations survey rebounded in May, showing increased hopes for US trade deals, although the current situation gauge failed to show any recovery.

The only data in the eurozone today are some final CPI prints, and we'll hear from the ECB's Escriva, Nagel, Villeroy and Holzmann. We expect some stabilisation around 1.120 in EUR/USD over the coming days.

Francesco Pesole

GBP: Eyeing a break higher

As discussed by our UK economist here, the US jobs market has continued to cool. However, there hasn't been any sign of material deterioration after the April employer tax hike, and wage growth remains too high to make the Bank of England shift to a faster gear with monetary easing. In short, the UK labour market is slowing, not collapsing, and that is translating into a steady fall in wage growth.

The Bank of England will want to see this trend continuing for a few more months before it becomes more confident on the wage story. Until then, next week's services inflation number will be much more consequential, given that April's data is when the big annual price hikes kick in. We think this could come in a little below the Bank's forecasts, which would help cement an August rate cut.

EUR/GBP has now approached 0.840, and we reiterate our call for a break lower ahead of EU-UK trade talks on Monday.

Francesco Pesole

CZK: Weaker koruna today, stronger tomorrow

Yesterday's inflation in the Czech Republic confirmed the flash headline inflation numbers at 1.8% year-on-year. However, a breakdown of the Czech National Bank (CNB) forecast showed that the entire surprise versus the central bank came from alcohol and tobacco prices, while fuel was in line with the forecast. In addition, the upward move in service prices is being driven by imputed rent, which accelerated again. Core inflation thus jumped to 2.6% from 2.4% YoY, fulfilling the CNB's concern of core inflation above target in the coming quarters.

Given that the CNB has moved into the neutral rate band as defined by board members as 3.25-3.50% after the last rate cut, higher core inflation numbers could trigger more hawkish views. Therefore, we believe we will only see one more rate cut in the base case scenario or rates may remain at current levels as a risk. Friday's minutes, which describe the Board's discussion from last week's meeting, should tell us more.

The Czech koruna has been our favourite currency within the CEE region for the past two months, as it has shown strong resilience to global events. We continue to view it as a high-quality choice, but the CNB's neutral stance on additional rate cuts has slightly dampened our optimism about the CZK last week. However, the market is still pricing in a terminal rate of around 3%, which is more rate cuts than in our forecast. Moreover, risks are building more on the hawkish side in terms of inflation and the economy. Although we could see a test of 25.00 in the coming days due to a jump in EUR rates, we retain a view that EUR/CZK will head lower in the coming months.

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