FX Daily: Dollar remains vulnerable as equities stabilise

US and in particular European equities aren't rebounding as fast as Japanese stocks, but global risk sentiment is indeed stabilising, which leaves room in FX to realign with the changes in rate spreads. The dollar is in a substantially weaker position than 10 days ago and is looking at an imminent decline against pro-cyclical currencies, in our view

USD: Softer rate position

Japanese equities continued to rebound this morning and futures are pointing to a positive open in US and European equities, with the latter having been a laggard in the recovery so far. From a purely macro angle, we remain cautious about big risk-on rallies before the key US CPI risk event (next Wednesday) is cleared. That said, a stabilisation after the big correction around the weekend should be enough for most FX pairs to start reconnecting with rate spreads and fundamentals.

From this perspective, the dollar looks vulnerable. We believe markets may be reluctant to take the year-end Fed policy rate much above 4.50%; that's because 100bp of easing is probably linked to US macro, with anything extra (which has now been priced out) linked to expectations for some sort of intervention by the Fed to help the stock market.

That means the rebound in USD 2-year OIS rates to 3.75-80% may struggle to find much more momentum, and the dollar may be left with a short-term rate advantage around 40bp lower compared to just 10 days ago. We expect this will drive the dollar lower against most pro-cyclical currencies amid a potential further stabilisation in risk sentiment and a lack of market-moving data this week.

The safe-haven Japanese yen and Swiss franc probably remain a bit vulnerable in the near term. It is now widely believed most JPY speculative shorts have been trimmed, and we wouldn't exclude the net positioning in USD/JPY may now be close to flat. That places the yen in a position to trade more on rates and global risk sentiment, and Bank of Japan Deputy Governor Shinichi Uchida's pledge not to hike rates if markets are unstable paves the way for more JPY weakness into next week's US CPI. We cannot exclude that USD/JPY tests the 150 mark before mid-next week.

Francesco Pesole

EUR: Set for a move to 1.10

The rebound in the EUR:USD 2-year swap spread may stall around -100bp. That would be entirely consistent with EUR/USD trading above 1.10 even when factoring in the softer risk sentiment (as measured by global stocks performance).

As discussed in the USD section above, markets may not take the hawkish re-adjustment in Fed expectations much further, while the same cannot be said about ECB pricing. The EUR OIS curve currently embeds 69bp of easing, which is largely a spillover from Fed pricing, as the latest inflation figures in the eurozone pointed to risks that the ECB may skip a cut in September. Risks are undoubtedly skewed to 50bp as opposed to 75bp by the ECB in the three meetings until year-end. We expect EUR/USD to test 1.10 before the US CPI event next week.

We incidentally favour a continuation of the rebound in Norway's krone and Sweden's krona among other high-beta currencies. NOK has particularly taken a major hit from the equity selloff and has plenty of room to recover ahead of a Norges Bank meeting next week which may well fail to endorse the market's dovish bets as policymakers may well focus on helping the battered currency.

Francesco Pesole

NZD: RBNZ cut not guaranteed

New Zealand released jobs figures overnight, and the results were not as grim as consensus expected. Unemployment rose less than projected from a revised 4.4% to 4.6% in 2Q, thanks to a surprising rise in both employment and the participation rate. Private wages also rose marginally to 0.9% quarter-on-quarter.

The Kiwi dollar is the best-performing G10 currency this morning on the back of those figures, as markets trimmed bets on a rate cut next week, which was almost fully priced in and has a 50% implied probability.

We are now inclined to call for a hold by the Reserve Bank of New Zealand next week. The dovish repricing in the NZD curve is more a consequence of Fed rate expectations as the RBNZ dovish tilt and inflation/jobs data do not justify the 84bp of easing priced in by year-end. We suspect the RBNZ may want to wait for the Fed to move first, and if anything deliver a 50bp cut at the October meeting. That said, next week looks close to a 50/50 call, and we think the meeting is accurately priced by the market.

Either way, we remain bullish on NZD/USD on the back of a significantly improved rate differential and stabilisation in risk sentiment which should unlock upside into 0.61+ in the pair after the recent break above 0.60.

Francesco Pesole

RON: Limited impact from the NBR decision on markets

Today's main event in the CEE region is the meeting of the National Bank of Romania. Our economists are forecasting rates unchanged at 6.75% (effective rate at 5.75%) in line with market expectations, but surveys are not uniform and as we discuss in our NBR preview, rate cuts may be discussed today as well. The NBR began its latest cutting cycle as the last one in the CEE region in July. In the baseline scenario, we expect a second rate cut in November, the last of the year. The central bank will also have a new forecast today that is likely to show lower inflation.

From a market perspective, EUR/RON remains in a narrow range of 4.966-4.977 and the central bank meeting won't change that today or later this year. In the Romanian government bond (ROMGB) world, we see only limited impact from today's decision. FX implied yields show that markets are largely expecting a rate cut today. On the other hand, as we discuss in the NBR preview, the ROMGB market is more likely to follow fiscal policy and high issuance today, where we want to see more progress before turning more positive on ROMGBs. This is also reflected in spread widening vs CEE peers in recent months.

Frantisek Taborsky

Authors

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com