FX Daily: Dollar stays vulnerable as downgrade sinks in

Moody's one notch downgrade of the US sovereign rating on Friday perhaps was no surprise, but serves as a reminder of the fiscal risks US assets are facing this summer. Today, expect plenty of focus on European politics, especially in the UK, Romania and Poland. Overall, it's a relatively quiet week on the calendar, but the dollar still looks vulnerable

USD: Dollar stays soft post Moody's downgrade

Late on Friday, the rating agency Moody's downgraded the US sovereign rating one notch to Aa1, having had the US on a negative outlook for a year. The reasons for the downgrade - the failure of successive administrations to tackle deteriorating fiscal and debt metrics - are very familiar to financial markets by now. And this comes in a week when the Trump administration is trying to push another tax-cutting package through the House. Estimates suggest that this new bill will add another $3-5trn to the US debt stock over the next 10 years. Treasuries are a little softer on the news, as are US equities and the dollar. The US 10-year Treasury swap spread has drifted back out to 54bp, but is some way from the extreme 60bp reading seen in mid-April.

The link between US sovereign risk, Treasuries, and the dollar is one of capital flight. Are global investors shifting their portfolios away from the US? Data on this comes out with a lag, and Friday's release of US Treasury TIC data for March provided few clues. Foreigners were still healthy buyers of US asset markets in March, with foreign official accounts increasing their holdings of US Treasuries by $26bn. Within that, however, China's holdings of US Treasury securities fell by $19bn. Understandably, the TIC data covering events in April will be eagerly awaited when it is released in mid-June. On the subject of Treasuries, the market will be on the lookout for demand for the auction of $16bn of 20-year US Treasuries, which takes place on Wednesday.

Looking ahead this week, the US data calendar is relatively light. There are plenty of Federal Reserve speakers but given much uncertainty, we doubt they will shift current market pricing of two 25bp Fed cuts this year, starting in September.

Expect a risk premium to stay in the dollar this week, with investors also on the lookout for any currency references in trade deals currently being negotiated with Asia. We've also got a G7 Finance Ministers and Central Bank governors meeting taking place in Canada on Tuesday. It seems very unlikely, but any changes to the FX reference in their Communique - driven by the US Treasury - would pose a big downside risk to the dollar.

DXY has intra-day support at 100.20/25, below which 99.20 is the risk.

Chris Turner

EUR: Politics is a positive

Not that it is normally a big driver of the euro exchange rate, but the outcome of the Romanian presidential election will be welcome news in Brussels as it prevents a further splintering of the bloc. Developments in Poland will be more worrying, however - see below. In terms of the eurozone data calendar this week, the big focus will be on Thursday's flash PMI releases for May. So far, European business sentiment has been holding up relatively well. Should it continue to do so, the euro should stay supported as the liquid alternative to the dollar.

1.1265 is the intra-day resistance EUR/USD needs to break to open the topside once again.

In the UK, there is much focus on the UK-EU summit. It seems here that expectations - especially in the press - have got far ahead of themselves. Initially, the summit was largely focused on defence. Now, any failure to agree on deals on food checks at the border or youth mobility will be seen as a big disappointment. That said, we do see the overall closer UK-EU alignment as a sterling positive, with any surprise progress sending EUR/GBP sub 0.8400 and GBP/USD to 1.3360/3400.

Tomorrow, however, sterling faces some downside risk from the April services CPI figure. Here, a downside surprise could firm up expectations for two 25bp Bank of England cuts this year. The market is currently pricing 44bp in total.

Chris Turner

CEE: Quiet week to absorb election results

This week in the region is expected to be quieter than the past two, as we transition into the latter half of the month, which traditionally sees a lighter event schedule. Markets today will have a chance to absorb the election results in Poland and Romania this weekend. The first key data release of the week comes on Wednesday in Poland, featuring April's industrial production and wage figures. Hungary's calendar includes speakers from the central bank and government at a local conference. On Friday, the Central Bank of Turkey will publish an inflation report.

In Romania, the result of the second round of the presidential election brought reassurance to financial markets, indicated by the RON rallying below 5.050 per euro for the first time since the result of the first round two weeks ago. We should see a similar reaction in the forwards and bond markets this morning. However, the markets were positioning for this outcome already on Friday, which should limit today's rally in the bond market. Looking ahead, after the initial bond rally, we believe the market will want to see more action from the government on the fiscal side to stave off negative views from rating agencies. On the flip side, FX should be the biggest beneficiary from the end of political uncertainty, with 5.05 as the new line in the sand.

In Poland, the first round of the presidential election brought the expected candidates to the second round, but the gap between the candidates is significantly narrower than the polls suggested. Thus, the market may see political uncertainty as a negative for PLN assets, and FX may see some pressure to weaken this morning. On the other hand, we saw some PLN weakness already on Friday, and earlier we said EUR/PLN was too low after the National Bank of Poland meeting in May. So we could see more of an adjustment back to the 4.270-290 range today.

Frantisek Taborsky

AUD: RBA set to cut 25bp early Tuesday

The Reserve Bank of Australia is widely expected to cut rates tomorrow morning (06.30 CET). Markets had previously speculated on a 50bp move, but the US-China deal and a slower inflation decline compared to expectations have cemented the 25bp call. We believe the RBA will retain a good deal of caution on forward guidance, but should sound a bit more dovish, implicitly endorsing market expectations for two additional cuts in 2025 after this one. We still see room for AUD/USD upside on the back of domestic US negatives and improved risk sentiment. We target a return to 0.650, and don't think this RBA cut will get in the way.

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