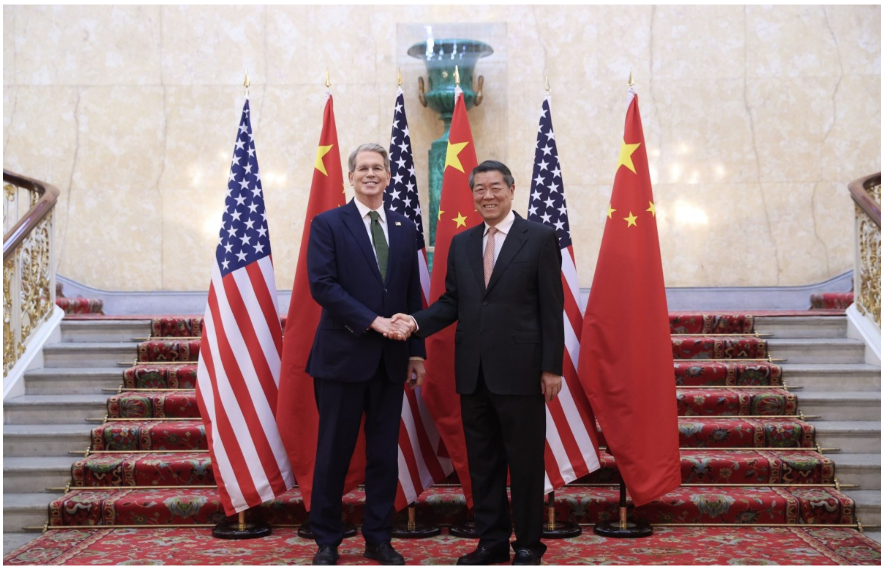
FX Daily: Dollar unimpressed by US-China agreement

The Sino-American trade negotiations in London have yielded plans to revive the flow of sensitive goods, but have failed to mark a breakthrough and leave the dollar still vulnerable to domestic fiscal concerns. Today, US core CPI (which we expect at 0.2% MoM) and a closely-watched 10-year UST auction bear downside risks for the dollar



The Sino-American trade talks in London have produced plans to resume the exchange of sensitive goods. Pictured: Chinese Vice Premier He Lifeng (R) and US Treasury Secretary Scott Bessent

USD: Inflation and 10-year auction in focus today

This week hasn't shown a clear direction for the dollar so far. Uncertainty around how far-reaching the US-China trade talks in London will be has left room for domestic factors to shape relative performance across G10 currencies. As of this morning, reports claim negotiators have agreed on a "framework" to restart the flow of sensitive goods, including rare earths, pending sign-off from Trump and Xi. From a market sentiment standpoint, this feels like a positive step toward de-escalation, but not a major breakthrough. China's refusal to commit to reducing its trade deficit still leaves plenty of ammo for trade hawks in Washington to resist any structural easing.

Markets are treating the London summit with some scepticism. The dollar remains one of the best gauges of trade sentiment. While it has held up generally well early this week, it hasn't built on the late-week momentum following the US-China meeting announcement. According to our short-term model, it's still about 3-4% undervalued against major G10 peers. US equity futures point to a soft open this morning following modest gains yesterday.

Domestic fiscal developments have also weighed on the dollar. A soft 3-year Treasury auction reversed some recent gains in US government bonds, which now face a dual test today with the highly watched 10-year auction and CPI data. We expect May's core inflation to come in at 0.2%, below the 0.3% consensus, which could ease pressure on Treasuries but might weigh on the dollar as chances of a September rate cut (now 50% priced in) fade. Later today, May's Federal budget balance data will also be released.

Our bias is bearish on the dollar today – not just because of our core CPI call, but also amid reports that Treasury Secretary Scott Bessent is being considered as Powell's Fed successor. The dollar strongly dislikes any threats to Fed independence. Add in that Bessent is likely to favour much lower rates (echoing Trump's rhetoric), and the greenback faces mostly downside risks from this story.

Francesco Pesole

EUR: ECB reinforcing hawkish tone

This week's moves are almost entirely driven by US-related events. The only euro input comes from scheduled ECB speeches, which so far have reinforced the less dovish tone set by President Christine Lagarde last week.

Croatia's central bank chief, Boris Vucic, confirmed the new consensus on the ECB yesterday, saying the bank is in a "very good position" and should wait for "another projection" – meaning September – before making its next move. Markets are pricing in 15bp for September, 17bp for October, and 30bp for December.

From an FX angle, the impact isn't huge. EUR/USD surged last week on the ECB's hawkish shift, but short-term rate differentials aren't driving G10 FX beyond central bank events. As noted, EUR/USD's direction today will be mostly set by the dollar, with some support likely near 1.1400 and a possible push above 1.1500 by the week's end.

Francesco Pesole

GBP: Spending Review not a game-changer

This is what our UK economist, James Smith, has to say about today's UK spending review announcement event. More background on the UK budget story here.

"Today's Spending Review shouldn't be a big moment for financial markets. We already know how quickly investment and departmental budgets will rise over the next few years, and today's announcement simply tells us how the overall pot gets divvied up. But it will emphasise that when it comes to day-to-day spending, there's not enough cash to go around, and more money will need to be found at the Autumn Budget. Added to which, we think the Treasury's slim fiscal headroom against its fiscal rules has fully evaporated and tax rises will be needed later this year to plug the gap."

The pound lost some steam after soft UK jobs data yesterday. Budget events often stir gilt market volatility, so EUR/GBP might get a bit of bullish momentum and test 0.850 in the coming days.

Francesco Pesole

CAD: Broadly unattractive

The Canadian dollar has been one of the best performers in the G10 over the past month, helped by some stronger-than-expected inflation and growth data that ultimately led to a Bank of Canada hold on 4 June.

While USD/CAD may still face periods of downward pressure on the back of lacklustre USD demand, the loonie does not look attractive in other G10 crosses. The new US metal tariff hikes disproportionally hit Canadian exporters, and there are no indications of imminent high-level trade negotiations with the US. Growth risks remain heavily tilted to the downside in Canada, and we believe the Bank of Canada will need to react, possibly by cutting rates as soon as July.

Markets are pricing in only 8bp for July, and 15bp for September, so we see scope for a dovish shift in the CAD curve that, when adding the risks of exposure to more potential deterioration in US sentiment, makes the loonie one of our least favourite currencies in G10 at the moment.

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