FX Daily: Don't chase the dollar correction

The dollar continues to trade on the softer side after Friday's soft US January retail sales questioned the strength of US activity. USD/JPY has been in the vanguard of this dollar correction and Japan's stronger GDP data is helping today. However, speculators are now getting reasonably long JPY again. Overall we see no reason for a much weaker dollar

The dollar is a little softer, but we doubt the correction needs to extend far

USD: Sizing the correction

The DXY dollar index is down just over 3% from its early January high. There is a sense that US President Donald Trump's bark is worse than his bite when it comes to trade (Mexico and Canada given a temporary reprieve on tariffs) plus Friday's release of January US retail sales data warns that US growth is starting 2025 on a softer footing. At the same time, some overseas economies – such as Japan – have been showing better-than-expected growth. However, it may not be lost on the White House that a lot of that fourth-quarter Japanese growth was driven by net exports. This will add to the view that trading partners are dining out on US demand. For reference, Japan comprised $68bn of the $1.2tr US goods trade deficit in 2024.

The question is: how much further does the dollar need to correct? We are in the camp answering: 'not much'. It is clear that the threat of tariffs has not receded and that the broad foundations laid for 'reciprocal' tariffs announced last week mean that substantial tariffs will be coming probably in the second quarter. Tariffs are positive for the dollar – even though the dollar already rallied 10% between October and January.

Unless you have a strong conviction that US activity data is going to decelerate sharply from here, to us it looks like we're getting towards the end of this dollar correction. We suspect that something like the 106.00/106.35 area will mark the low point for DXY in the first quarter. Please see our latest edition of FX talking for all our latest FX forecasts.

In terms of events this week and after today's Presidents' Day US public holiday, attention will turn to events in Saudi Arabia and Europe as US, Russian, and European leaders discuss how to end the war in Ukraine. The US data calendar is pretty light this week, with just FOMC minutes on Wednesday and business and consumer confidence figures on Friday standing out.

Chris Turner

EUR: Soul-searching

There is a lot of soul-searching underway in European capitals as leaders come to terms with last week's shock new direction for US foreign policy. Having been shut out of negotiations in Saudi Arabia this week, European leaders are meeting in Paris to define a position. One of the big questions will be what to do about defence spending. Will they target 3.0/3.5% of GDP on defence spending and suspend fiscal rules to allow that to happen? If so, that should mean higher long-term European interest rates, and perhaps there were some early signs of that on Friday when European bond yields did not follow US Treasury yields lower on the softer US retail sales data.

While moves towards a ceasefire in Ukraine have been helping EUR/USD at the margin, the prospect of increased US isolationism certainly does not look a positive for the euro. And a much higher EUR/USD from here probably requires a conviction on some much softer US activity data – a conviction we do not have.

We remain of the view that this EUR/USD correction will probably peter out somewhere in the 1.0535/75 area and stick with the view that EUR/USD will be back at 1.03 in a month's time.

On the eurozone calendar this week are consumer confidence on Thursday and the flash February PMIs on Friday. The focus will also be on the run-up to the weekend elections in Germany, where a very tight result and a delay in forming a coalition would likely be seen as a euro negative given the lack of leadership in Europe currently.

Chris Turner

GBP: Focus on Tuesday's jobs data

This year's FX markets have told us not to chase big definitive headlines or range breakouts. We think this applies to GBP/USD at 1.2600/2610. We think this is an important resistant area. Rather than pushing strongly ahead, we suspect GBP/USD gains will fade and these levels will be looked back on as an area to increase sterling hedge ratios for the year.

Away from the politics of US foreign policy, sterling's focus this week will be on jobs data, CPI and a speech from Bank of England Governor, Andrew Bailey, tomorrow morning. Expect more focus on the jobs data given Monetary Policy Committee former hawk Catherine Mann's focus on a 'nonlinear' adjustment in UK employment.

We continue to doubt that GBP/USD can sustain gains over 1.26 and expect it to be trading back at 1.24 by the end of March.

Chris Turner

CEE: Peace deal may also imply ultimately weaker FX rates

After several busy weeks in Central and Eastern Europe, this week should be quieter at least on the macro side. Today sees the release of the Czech PPI, which has surprised to the upside in the last two releases. The central bank is also watching rising agriculture prices, opening up risk to food prices.

On Thursday, Poland will release labour market data including wages and industrial production. While recent PMI readings give some ground for optimism, industrial activity remains subdued and the ongoing recession in Germany is weighing on Polish manufacturing. Industrial output remains stagnant, with annual changes swinging from positive to negative, depending on the calendar effect. On Friday we will see consumer confidence in the Czech Republic.

On the political side, we'll mainly be watching developments around the Ukraine peace deal, which is currently the main driver for the markets. And in Hungary, we'll be watching the annual Fidesz party congress on Tuesday and Wednesday, where we'll hear what to expect this year to support weak economic growth and plans for next year's elections, often watched by financial markets.

Markets have clearly been focused on the Ukraine peace deal for the last two weeks and that should probably be the case this week as well. We think that in the short term, positive sentiment will continue to support stronger FX. But once sentiment calms down, markets are indicating tighter rate differentials across the board. Should the war in Ukraine end, CEE countries should get a boost from lower energy and food prices, which should allow for more rate cuts from central banks. At least that is the narrative the market will trade looking forward. Expectations of lower rates should also mean weaker FX at the end of the day. Of course, this is not the story now – but we think there will be a moment where the current strong FX levels in the CEE region begin to fade.

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