FX Daily: Don't forget policy divergence

We see French election defensive positioning favouring a lower EUR/USD before Friday's US PCE. Elsewhere, a rate hike in Australia now looks more likely after another hot CPI read, and while the Fed sounds cautious, the ECB's Rehn has endorsed market easing bets. Policy divergence should regain traction after the French vote: AUD is in a strong position

USD: A quiet day before major action

A short bullish run at the start of this week waned yesterday and overnight, which we see as a symptom of the market's caution on risk assets ahead of the French vote on Sunday. We retain a moderately bullish bias on the dollar for today and tomorrow on the back of this, although the core PCE event on Friday may well prove to be a catalyst for Federal Reserve dovish repricing and some dollar weakness.

Today is a quiet day in markets ahead of the busy latter part of the week, which also includes the first Biden-Trump debate tomorrow. Data releases this week have so far failed to convey any compelling story in US macro: consumer confidence was a bit weaker than expected yesterday, but stable from May, and a soft Richmond Fed Manufacturing index was in line with an ISM manufacturing in contraction territory.

Today's data calendar is light in the US, and there are no scheduled Fed speakers. Yesterday, Michelle Bowman's call for no cuts in 2024 confirmed her position as the most hawkish member of the FOMC. Fed members are being generally cautious about jumping into disinflation optimism, and while we expect an encouraging 0.1% month-on-month core PCE on Friday, the narrative may not turn more dovish unless the June CPI (out 11 July) cools off too. Market pricing continues to hover around 45-50bp of easing by year-end, which sounds quite dovish compared to recent Fed communication but is not inconsistent with the latest data, in our view.

With European currencies still trapped by French political risk, we have recently emphasised the upside potential for more insulated currencies like the Australian dollar. Overnight, another above-consensus acceleration in Australia's monthly CPI (from 3.6% to 4.0% year-on-year in May) reinforced our bullish call on AUD for this summer. As our economist Rob Carnell explains here, the case for another rate hike is getting stronger. If June/2Q CPI also comes in hotter on 31 July, then the Reserve Bank may well raise rates again on 6 August.

Markets have moved to price in some tightening in the AUD curve, with 8bp expected for August and 13bp by November. What is clear is that, even if the RBA doesn't hike in August, it will remain a hawkish standout in the G10, all to the benefit of the Aussie dollar, on which we had a 0.68 mid-summer target in our latest FX monthly update. The risks now are skewed to the 0.685 December highs to be re-tested before the US election risk kicks in.

Francesco Pesole

EUR: Rehn gives a nudge to market doves

EUR/USD is back around 1.07 following a soft session for risk sentiment yesterday. The OAT:Bund 10-year spread continues to hover around 75-80bp, which may well be the level at which it will approach the French election on Sunday. A poll of polls by Bloomberg published yesterday sees a widening of Marine Le Pen National Rally's lead to over 35% with the leftist New Popular Front alliance stable at 28%.

Markets appear to be making peace with the prospect of a National Rally victory and parliamentary gridlock, especially after Le Pen's party attempted to ease market concerns on the fiscal side. We suspect investors remain way more sensitive to a better-than-expected result by the New Popular Front, which recently announced a EUR 25bn spending plan for 2024, followed by another 150bn by 2027, and is now perceived in markets as a greater threat from a fiscal stability perspective.

In other eurozone news, ECB official Olli Rehn sounded relatively dovish (he is considered a generally neutral figure) in an interview this morning, saying that market pricing for two more rate cuts in 2024 looked "reasonable". Markets have been revamping rate cut bets in the eurozone over the past two weeks, with the December OIS contract back at pricing in 45bp of easing after as little as 30bp on 10 June.

While investors aren't hugely hinging on ECB communication at the current juncture, Rehn's words were a signal of tolerance towards inflation bumps, which is a euro negative. Still, EUR/USD price action into the weekend will be determined by French election positioning and Friday's US PCE. We have a bias for a weakening in the pair today and tomorrow back to June's lows (1.0670), before a rebound on Friday on encouraging PCE figures.

Francesco Pesole

CEE: Worsening conditions and more risks on the horizon

Global conditions for Central and Eastern Europe and the entire emerging markets space deteriorated again yesterday, worsening the overall picture. EUR/USD has reverted back to 1.070 after some signs of relief for CEE. Moreover, sentiment also dropped and turned a bit more risk-off again, making it complicated for the region. Also on the local side, it is hard to look for any positives for the days ahead. Rates saw a decent rally yesterday outperforming core markets and leading to a widening of rate differentials across the board.

Poland's zloty and Hungary's forint already showed some losses yesterday and we are turning more neutral on CEE under these conditions. Still, in line with our comments on Monday, we see HUF as the most resilient in these conditions given its cushion coming from a hawkish central bank meeting last week. Therefore, we see EUR/HUF more at 394 levels like yesterday's lows or even a bit lower. However, a further deterioration in global sentiment or a stronger US dollar could reverse direction.

EUR/PLN looks like a similar story but with the rate differential movement here even more pronounced, widening for a second day in a row. Therefore, we expect rather a stagnation at current levels here. At the same time, we expect another weaker-than-expected inflation number on Friday which could again undermine market pricing and PLN in the short term.

And not to be short on negative news, as we move into the second half of the week, market focus on the French elections may increase risk aversion and negatively impact CEE FX. Thus, overall, the coming days will show increased volatility in any case.

Frantisek Taborsky

CZK: The day before the CNB meeting FX remains mixed

Tomorrow we will see a meeting of the Czech National Bank and a decision on rate cuts. Clearly 25bp or 50bp is on the table. The main variable here seems to be EUR/CZK given that the rest of the picture has been a given for some time. The EUR/CZK did almost touch 25.00 twice in the last three trading days but has been moving lower since the start of the week. Thus, the dynamics of CZK depreciation over the past week show the market's sensitivity to the decision itself and reduce the chances of a 50bp rate cut tomorrow in our view. On the other hand, the strengthening CZK may in turn reassure the board and clearly increases the chance of a 50bp move. So with the current level, we would say that on a net basis the chance for a 50bp has increased.

We have 25bp as a base case scenario for tomorrow and there is no point in changing anything here at the moment, but it is clear that tomorrow will be a very close call for the central bank. Still, there is some time left and EUR/CZK may surprise. As we mentioned in the CEE section above, global FX conditions are deteriorating and the rates market rally was most pronounced in the CZK market. The rate differential has tightened here to almost the lowest levels since May and we expect a renewed weakening, and EUR/CZK to follow today towards 24.90. It is hard to say if this gives more clarity on the CNB decision itself or if we actually know even less than before.

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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit http://www.ing.com.