FX Daily: Dovish ECB could keep euro gains in check

US Treasuries have stabilised. Global equity markets are performing well. But judging from the FX options market, investors are wary about another trade or bond flare-up in July. Today, the focus is on the widely expected 25bp ECB rate cut, which might weigh on the euro in an otherwise offered dollar environment. Elsewhere, the Korean won is rallying

A dovish ECB today could weigh on the euro. Pictured: ECB President Christine Lagarde

USD: 'Slightly pessimistic and uncertain'

"Slightly pessimistic and uncertain" was the characterisation of the US outlook expressed in the Fed's Beige Book released last night and ahead of the next FOMC meeting on 19 June. Yet business sentiment did not show any clear deterioration over prior Beige Books, and the report also noted that "there were widespread reports of contacts expecting costs and prices to rise at a faster rate going forward". This latter point is keeping the Fed resistant to growing political pressure to cut rates. That pressure broadened from the President himself to other appointees yesterday, with the Director of the Federal Housing Finance Agency, Bill Pulte, also calling for an immediate rate cut. This followed some soft ADP jobs data and preceded a soft ISM services release.

Softer US data has weighed on the dollar a little, even as the trade war has had a relatively quiet week. Instead, there continues to be focus on the progress – or otherwise – of President Trump's tax bill. In an update yesterday, the Congressional Budget Office now expects the bill to add $2.4tr to the US budget deficit over the next decade. Despite this, the US Treasury market is calmer. The 10-year swap spread (representing credit risk of the US sovereign) has narrowed back to 52bp. And bond market volatility is dropping. However, next week's auctions of three and 10-year Treasuries could easily refocus on market stress. We're also looking out for whether political pressure on the Fed to cut rates increases the term or risk premium in Treasuries. That would be a dollar negative. This also serves as a reminder that the end of Fed Chair Powell's tenure in May next year could be a difficult time for both bond markets and the dollar.

Despite this week's relative calm – including the MSCI world equity index pushing up to a new all-time high – traded FX volatility remains relatively high. These levels for EUR/USD and USD/JPY are still trading above 8% and 11% respectively for the one month. And, notably, the term structure of the traded volatility curve shows a kink in the two-month tenor – no doubt wary that President Trump's 90-day pause on 'Liberation Day' tariffs ends on 9 July and could be followed by another wave of harsh tariff rhetoric.

This all leaves the dollar gently offered and susceptible to further downside should US data point in that direction. Today's narrowing in the April trade data should actually be a positive for 2Q GDP, but the market will probably take more notice of the initial weekly jobless claims data, given that investors are on the lookout for signs of layoffs. FX moves may be muted, however, in advance of tomorrow's NFP data.

DXY should stay soft in a 98.50-99.50 range, but could get a small lift if a dovish ECB today knocks EUR/USD (see below).

Chris Turner

EUR: Dovish ECB could keep euro gains in check

The ECB is widely expected to cut rates by 25bp today. This will take the deposit rate to 2.00%. The market currently prices a further 25bp cut by the 30 October meeting. We see the risk of the pricing of the next cut, after today, being brought forward to the 11 September meeting. As our team discusses in our ECB cheat sheet and preview, the ECB is widely expected to be dovish today. And there could be some big downward revisions to the inflation forecasts, which would argue that the policy rate needs to go below neutral and into the accommodative area. Currently, the 1m EUR ESTR rate priced one year forward sits at 1.60%. This could easily dip back to the 1.50% area and had seen 1.40% priced amid the April trade tumult.

The euro has been a slight laggard in the soft dollar environment, and actually the G10 commodity currencies have been the best performers against the dollar over the last week. A dovish ECB today could briefly send EUR/USD back to the 1.1330/1360 area today, but we would expect more buying to emerge there ahead of what could be dollar bearish NFP release tomorrow.

Chris Turner

CEE: Central banks becoming hawkish again

Yesterday's inflation in the Czech Republic really drew attention to what had so far been an unexceptional Czech National Bank story. Headline inflation surprised to the upside above all market estimates (2.4% vs 2.0%). This moves us from a -0.2pp to +0.1pp deviation from the central bank's inflation forecast. What's more interesting is core inflation, which is pointing to 2.8-2.9% based on flash numbers. We'll see a detailed breakdown next week, but it seems that the risks I mentioned here yesterday are starting to materialise, while economic data continues to surprise on the upside, such as yesterday's retail sales.

The CZK rates curve has moved roughly 6-8bp higher in the front-end, but the market is still pricing in almost two rate cuts. With June expected to show a stronger inflation number again, it's now clear that June is out of the question for the Czech National Bank, while we may question the August meeting as well, especially if we see another upside surprise in inflation. As we said previously, the CZK has been our favourite currency in the CEE region for some time and after yesterday's move, EUR/CZK is the lowest since June last year. We remain bullish, only yesterday's move seems too fast and would not be surprised by a correction to 24.850 before EUR/CZK goes further lower.

In Poland, the National Bank of Poland's statement brought nothing new, which in itself is rather hawkish. In recent weeks, we have seen a reduction in household gas tariffs and a lower April print, which the statement did not mention at all. Therefore, our best guess is that today's press conference will be similar to May's, which in the context of the change in inflation profile could come off as neutral or slightly hawkish if anything. EUR/PLN yesterday peaked closer to 4.290. At the same time, rates still point to levels around 4.260. We see a 0.5% difference in the political discount after the election, and unless we see more escalation on the political side, EUR/PLN should head lower to 4.260, possibly even lower if the NBP surprises on the hawkish side.

Frantisek Taborsky

KRW: The won starts to shine

EMFX has been doing relatively well over the last month. EM high yielders in Latam and South Africa are in demand and, as above, the Czech koruna is favoured too. But this week's political developments in Korea now make the won the second-best performing EM currency over the last month. As Min Joo Kang discusses here, South Korea's new president inherits a weak economy. However, a more settled political environment and the prospect of fiscal stimulus look encouraging for portfolio investments and the won.

In addition, Korea is currently involved in trade talks with the US Treasury and speculation will continue that Korean officials will be asked to allow the won to strengthen should market forces dictate such a move. Korean equities are up 4% this week and the USD/KRW move looks like it can extend sub 1350.

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