FX Daily: ECB hawkish pushback to face key inflation test

The ECB hawks have stepped in to revive depressed rate expectations, but markets are opting for data dependency, and EUR/USD is set to face two key risk events with eurozone inflation figures before the US payrolls this week. We expect core inflation will prove resilient enough to trigger another ECB hike, so see upside room for the pair

The relative strength in US activity indicators has kept the dollar in demand over the past few weeks

USD: Things will get hectic this week

It has been a slow start to the week for FX markets. Yesterday's closure of the UK's markets for a national holiday meant much thinner trading volumes, and the key data calendar was quite light. In the US, the only release to note was the Dallas Fed Manufacturing Index, which dropped slightly more than expected into contraction territory, confirming the slack in the manufacturing territory already signalled by other surveys (ISM, PMIs).

Still, the slowdown in manufacturing activity is hardly a US-only story. We have seen a deterioration in global forward-looking economic indicators in many developed economies recently, especially in Europe. The difference now is how the US service sector is appearing more resilient than the eurozone's, despite significantly tighter monetary policy in the US.

The relative strength in US activity indicators – compared to the rest of the world and to expectations – is what has kept the dollar in demand over the past few weeks, and should remain the number one driver of USD moves into year-end. That is because the disinflationary process appears to be cementing, allowing the Fed to halt hikes and focus on growth: until data turn for the worst, however, markets will not be pricing in more cuts, and a favourable real rate (the highest in the G10) will keep a floor under the dollar.

This week presents some important risk events for the dollar from this point of view. Today, the JOLTS job openings for July will be watched closely in search for signs that the labour market has started to cool off more drastically. The Conference Board consumer confidence index is also published, and expected to come in only marginally changed compared to July. Later in the week, we'll see ADP jobs numbers (they move the market, but tend to be unreliable), and the official payrolls report. Remember that payrolls through March were revised lower (although that is a preliminary revision) by 306,000, which probably adds extra heat to this week's release.

DXY is trading around the May-June 104.00 high area. Investors may want to wait for confirmation from jobs data to push the dollar significantly higher from these levels, and a wait-and-see, flat (or moderately offered) dollar environment could dominate FX markets into Friday's payrolls.

Francesco Pesole

EUR: Gearing up for the inflation test

We aren't surprised to hear the ECB hawks step in with some strong messaging in support of more tightening as the September policy meeting draws closer. Market pricing for the September meeting is probably what has been bothering the hawkish fringes of the Governing Council. Markets have been quite reluctant to fully price in one last ECB hike, and the implied probability of a September move has been stuck below 50%.

Governing Council member Robert Holzmann directly pointed out a high chance of raising rates again, but market pricing has not moved significantly. President Christine Lagarde herself held a generally hawkish tone at her Jackson Hole speech last week and seemed to put little emphasis on the mounting evidence that the eurozone's economy is rapidly slowing, and there is a need to stick with data dependency. It is clear now that markets are – that is admittedly not too common – fully embracing the data-dependent approach of the ECB policymakers, and are awaiting this week's inflation figures to make their final call on the September hike. It's important to set a timeline for this week's inflation releases: German figures are out tomorrow morning (along with Spain's), while Thursday sees the release of French, Italian, and then eurozone-wide figures.

Consensus expectations are for a slowdown from 5.5% to 5.3% in core CPI inflation, while our economists forecast 5.4%. That should, on the margin, be enough to trigger one last 25bp rate hike by the ECB in September, and we see upside risks for the euro in the near term. A return and stabilisation above 1.0950 and even retesting 1.10 is possible should inflation prove resilient, but much will also depend on US payroll numbers not exceeding expectations.

Francesco Pesole

GBP: Light calendar this week

The pound has started the week modestly stronger, partly helped by some hawkish comments over the week at Jackson Hole by Bank of England Deputy Governor Ben Broadbent, who stressed that inflation is unlikely to slow down as fast as it emerged and that monetary policy will need to remain in restrictive territory for some time.

Aside from that, the pound is being helped by a tentative risk-on/dollar-off as London markets re-open after yesterday's UK national holiday. This week's calendar in the UK is quite light, meaning that GBP will likely continue to be driven primarily by external factors. One event to keep an eye on is a speech by BoE Chief Economist Huw Pill on Thursday.

Cable could find support if we are right to think markets may scale back some bullish dollar positions before having confirmations from US payrolls. When it comes to EUR/GBP, it will be all about the EUR leg and the eurozone's inflation numbers this week. In line with our bullish euro call, we see a break above 0.8600 as very feasible.

Francesco Pesole

SEK: Growth picture slightly less grim

Sweden released better-than-expected GDP and retail sales data this morning, which are supporting the krona in early European trading. The Swedish economy contracted by 0.8% in the second quarter, less than the 1.3% consensus and quite a big revision from the preliminary -1.5% figure published last month. Retail sales for July surprisingly grew (by 1.0% month-on-month).

The growth picture clearly remains rather alarming when compared to other major economies, but the krona has already been pricing in a considerable amount of domestic economic underperformance (as well as real-estate-related risks).

There are other important data releases to keep an eye on this week in Sweden: wage figures and the economic tendency survey tomorrow, as well as some manufacturing surveys later in the week. Another potentially big risk event: Riksbank's member Anna Breman, one of the dovish dissenters at the April meeting, will participate in a panel discussion about inflation tomorrow morning.

EUR/SEK may face some upward pressure from the euro side if we are right about core inflation data boosting chances of a September ECB hike. Otherwise, some modestly improving external environment and better-than-expected Swedish data can help EUR/SEK trade a bit off from the highs for now.

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