

FX Daily: Economic resilience keeps dollar 'expensive'

Our short-term fair value model indicates the dollar is overvalued against all G10 currencies, but recent price action suggests it will take some poor US activity data to prompt a USD correction. That may not happen this week, as developed market calendars are quite dry. Elsewhere, the Reserve Bank of Australia paused, but the AUD demise looks overdone



➔ USD: Comfortably overvalued

With US trading halted yesterday for the Labour Day holiday, global FX markets started the week on a very quiet tone after Friday's big swings. In short periods like this one where attention temporarily shifts away from the US, developments in China emerge as the main driver for global sentiment. Yesterday, hopes of fiscal stimulus triggered a rebound in Chinese property stocks, but a below-consensus read in the Caixin Services PMI overnight generated fresh pressure on Asian equities.

While the equity compartment appears to respond more symmetrically to good and bad news coming from China, the currency market remains more responsive to negative developments, as

the ongoing period of dollar strength contributes to limit gains for most Asian EMFX. More specifically, the renminbi still faces pressure from easing monetary policy in China, to which the People's Bank of China (PBoC) has recently paired a cut to the FX reserve ratio requirement to try and insulate the currency-depreciation effects. This morning, we are seeing USD/CNY trading higher after the poor PMIs and re-testing the 7.30 area, which has been the line in the sand for the PBoC.

On the US front, we discussed in yesterday's [FX Daily](#) how this week's data calendar looked unlikely to radically alter the narrative of US economic resilience, which has been the foundation of recent dollar strength. Today's calendar is quite light, only including July's factory orders.

From a technical point of view, we must note that the dollar's outperformance in August was not entirely justified by market drivers (i.e. relative rates, equity, and commodity dynamics). Our short-term fair value model shows some dollar short-term overvaluation against all G10 currencies, ranging from quite moderate for GBP (less than 1%) to quite stretched for Scandies (above 3%). Still, one characteristic of the recent dollar price action is that it has taken poor US data to initiate any substantial correction, and we suspect a deterioration in the economic outlook remains the only real path for the mis-valuation gap to be closed. What this gap is telling us now is that the dollar correction, once the US data turn, can be quite rapid and substantial.

Francesco Pesole

➔ EUR: Fragile before a potential ECB surprise

Aside from any potential revision in the PMIs (August's final release today), the eurozone's calendar is rather quiet on the data side. It will be, however, quite interesting to hear what ECB speakers will have to say about the latest inflation numbers in the last two days before the pre-meeting quiet period kicks in.

We'll hear from both sides of the spectrum today: the hawk Isabel Schnabel and the dove Ignazio Visco. Despite the resilience in headline inflation, markets focused on the consensus deceleration in August's core inflation and have cut back expectations of a rate hike in September, currently priced in with an approximate 25% probability.

Our economics team is calling for one last hike next week, meaning we are expecting a EUR/USD rally to materialise thanks to an ECB hawkish surprise, but before then EUR/USD looks quite fragile. We might see the 1.0700 support being tested before the ECB meeting, should risk sentiment stay soft.

Francesco Pesole

➔ GBP: Still digesting Pill's comments

With a UK calendar offering very little on the data side, sterling markets are still digesting last week's comments by Bank of England's Chief Economist Huw Pill who explicitly favoured a "higher for longer" approach over a "higher peak". Markets are currently pricing in a lower peak rate, at around 6.70% at the moment, although a September hike is fully priced in and is ING's base case too.

For now, EUR/GBP may stay around 0.8540/0.8570 given now major inputs in the eurozone and the UK calendar. However, in line with our call for an ECB surprise hike next week, we expect another

jump above 0.8600 next week.

Francesco Pesole

AUD: RBA paused, but kept the door open

The Aussie dollar has dropped below the key 0.6400 support following the combined impact of grim PMI figures out of China and the Reserve Bank of Australia (RBA) keeping rates on hold. But even when compounding these two drivers, the collapse in AUD/USD appears quite overdone.

The Aussie dollar is already pricing in a considerable amount of risk premium related to the slowdown in the Chinese economy, meaning it can show an asymmetrically positive response to any positive news (e.g. fiscal/monetary stimulus) moving on. Domestically, the RBA pause had more than one string attached. The last statement under Governor Philip Lowe (Michele Bullock will replace him in two weeks) kept the door well open to more tightening if needed, essentially reiterating a data-dependent approach that has so far been closely followed by the RBA.

Markets are not pricing in any more hikes by the RBA, meaning the room for any dovish surprises to hit AUD is small. Instead, we would be wary not to rule out any more hikes just yet. We see decent room for a recovery for the battered AUD.

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