

FX Daily: Unloved EMFX finds a few friends despite the strong dollar

Ahead of central bank policy meetings in the US, the eurozone and Japan this week, it seems fair to characterise the mood in the FX market as 'mixed'. Higher US yields are keeping the dollar relatively strong against the low yielders, but we are starting to see investors return to a few unloved currencies in the EM space and seemingly, a return to sterling too



➔ USD: Holding pattern ahead of tomorrow's May CPI release

Casting around the world of FX it seems fair to describe the environment as 'mixed'. Core supportive factors for the dollar are still there - namely firm US rates and a very inverted US yield curve representing a Fed with its foot hard on the brakes. As we discuss in our preview for Wednesday's [FOMC decision](#), most scenarios tend to favour the dollar staying bid this week. At the other end of the spectrum, we have USD/CNH pushing higher as speculation builds that the People's Bank of China (PBOC) will cut its one-year Medium Term Lending Facility when it meets on Thursday.

In between those two extremes, we have unloved emerging market currencies such as the Brazilian real, South African rand, and Israeli shekel all making powerful come-backs. At the very least we can say investors are starting to position for a benign environment (future dollar weakness) and dropping their conviction that the strong dollar is going to break something. This

re-rating of unloved currencies is also extending to sterling - please see below.

What does this all mean for the short term? Low levels of FX volatility will continue to favour carry trade strategies unless we see some major dislocation in the US rates market or some financial system stress re-appear. Against that backdrop, the dollar should stay reasonably bid and its first major challenge this week will be tomorrow's May US CPI. Consensus expects a high 0.4% month-on-month core rate - with risks seen for a higher number. The CPI event, therefore, presents an upside risk to the dollar.

DXY should trade in a narrow range (103.30-104.00) into tomorrow's CPI number, with bigger moves coming later in the week when we hear from the Fed, the ECB, and the BoJ.

Chris Turner

➔ EUR: Spreads moving against EUR/USD again

EUR/USD is holding up quite well despite the higher US yield environment. Expectations of a hawkish Fed this week have seen two-year EUR:USD swap differentials widen out to levels last seen in early March. Despite this, EUR/USD continues to trade well above 1.07. What is going on? The good demand for commodity currencies (helped by rate hikes in Australia and Canada last week) plus a re-rating of the real, rand and shekel seem to suggest that investors could be moving onto their next big thing - which is the cyclical dollar decline in the second half of the year. That happens to be our baseline view and one of the reasons we think EUR/USD will find a base in the 1.05/1.07 area this month before pushing to 1.15+ by year-end.

Beyond the US data and the Fed meeting, this week's focus will be on [Thursday's ECB meeting](#). It seems too early for the ECB to drop its inflation guard, but a hawkish Fed story could be dominating and EUR/USD could see a retest of last week's low at 1.0635.

Elsewhere this week look out for EUR/SEK. Wednesday sees both May CPI and an extraordinary general meeting of Swedish landlord SBB. Both could prove negative event risks for the krona.

Chris Turner

➔ GBP: Tuesday will set the near term tone for sterling

Sterling is now the best-performing currency in the G10 space this year at +4.08%. Whether that rally represents more than a mere unwinding of short positions remains to be seen. But clearly, 4.75% implied GBP yields are helping.

The highlight for sterling this week will be tomorrow's release of April wage data and the employment report for May. Given that we hear so little from the Bank of England (BoE), the data has been the primary driver of sterling strength. We think softer wage and price data could emerge at any time and that market pricing of the Bank Rate (now at 5.50% for 24 January) is subject to a sharp downward revision. Let's see whether tomorrow's data gives BoE Governor Andrew Bailey the chance to push back against those aggressive tightening expectations when he testifies to a House of Lords committee tomorrow afternoon.

Expect sterling to hold onto its gains today, however. The only speaker of note is BoE hawk Catherine Mann at 1600 CET. EUR/GBP is currently testing big support at 0.8540/50 - levels we see as worthwhile to hedge GBP receivables.

Chris Turner

📌 CEE: Lower inflation may pressure koruna

Consumer inflation in the Czech Republic for May will be published today, the last key number before the Czech National Bank meeting next week. We expect a further drop from 12.7% to 10.7% year-on-year, slightly below market expectations. However, we see risks to the downside due to food and housing prices. Tomorrow we will see inflation for May in Romania. We also expect a decline from 11.2% to 10.3% YoY, slightly above market expectations. We'll also see Romanian labour market numbers as well as current account statistics in the Czech Republic and Poland. Industrial production in Romania will be published on Wednesday. On Thursday and Friday in Poland, the flash inflation estimate will be confirmed at 13.0% YoY and core inflation will fall from 12.2% to 11.7% in May, in our view.

In Poland on Thursday we will get the final verdict of the European Court of Justice (ECJ) in the FX mortgage dispute. We'll be keeping an eye on any changes from the court's previously published opinion in February this year. The main issue here is how much banks must set aside as provisions to cover coming costs. We could see decisions either way, but expectations are rather negative for the banking sector in Poland. In any case, we may see a lot of noise in the market.

In the FX market, the CEE region may benefit today from Friday's EUR/USD move higher, however, it cannot be considered a sustained boost. In the Czech Republic, a weaker inflation number can be expected to support the market in pricing in more monetary easing, which should push the koruna to weaker levels closer to 23.75 EUR/CZK. The Polish zloty touched its strongest levels since late 2020 on Friday and of course, the ECJ decision will be the main focus this week. If the decision is negative, we believe a lot of the bad news has already been priced in and equally, if more pressure on the zloty is seen, we can expect the MinFin to step up the exchange of EU funds in the market and offset any PLN depreciation pressure. In the event of a positive decision, we see heavy long positioning in the market as a problem. Thus, rather than direction, we see increased volatility in the Polish zloty this week.

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