

FX Daily: Equity divergence is becoming more relevant

Relative equity performance is becoming a bigger driver of FX moves, and the energy crisis in Europe does suggest EUR assets will struggle to regain the market's confidence. Elsewhere, the RBA 50bp hike is no game-changer for AUD, while the pound will keep being driven by new UK prime minister Liz Truss' policy proposals ahead of next week's BoE meeting



The pound is being driven by new prime minister Liz Truss' political agenda

We have just published our monthly update of FX views and forecasts: "[FX Talking: This is going to hurt](#)"

➔ USD: Equity divergence matters

US markets re-open after a long weekend today and futures currently point at a slightly positive open in the Dow Jones, despite yesterday's slump in European equities. Diverging US-European equity performance is becoming a relevant theme for FX as a driver of USD strength: in our EUR/USD short-term fair value model, the relative equity performance factor has seen its beta grow steadily since the start of July. Indeed, the ongoing energy crisis does suggest that it will take

time to restore trust in European assets. In the past three months, the Dow and S&P500 are both down -5%, while the DAX has lost 13% and Euro Stoxx 9%.

Expect a pick-up in volatility today after yesterday's rather muted trading. On the data side, markets will focus on the US ISM Service index, which is expected to have dropped after July's modest rebound. This is probably the most important piece of data before the CPI report on 13 September, and with markets still torn about the possibility of a 75bp Fed hike in two weeks (65bp is priced in), asset classes should prove quite sensitive to the release.

There are no scheduled Fed speakers today, but we'll hear from a plethora of members tomorrow and from Fed Chair Jerome Powell on Thursday.

Barring a major dovish repricing in Fed rate expectations, the strong dollar story should remain broadly untouched this week, as the energy supply crisis keeps markets away from most European currencies and may fuel safe-haven flows further. As we've highlighted in recent notes, the yen's role as a safe haven has been eroded by Japan's worsening trade position, and the USD/JPY rally may have further to go until Japanese authorities intervene.

Elsewhere in the APAC region, AUD had a relatively contained reaction to the RBA's 50bp rate hike. As [highlighted in our meeting review](#), a switch to 25bp rate increases now looks possible given the high frequency of RBA meetings, although that may be read as a dovish signal by markets and force some dovish repricing along the AUD curve. This, however, is far from being the biggest concern for AUD, which is set to remain heavily impacted by a challenging external environment. We don't expect any AUD/USD recovery to go much further than 0.70 before the end of the year.

Francesco Pesole

➡ EUR: Shrinking undervaluation

Germany's decision to keep two power plants open over the winter is a clear signal that the country had not managed to secure enough energy reserves before last week's Nord Stream shutdown. Talks among EU members this week are set to be quite crucial, as a bloc-wide cap on energy prices, a windfall tax on energy companies' profits, and potential intra-EU emergency gas flows are set to be discussed.

The energy crisis is set to keep EUR/USD capped for now, despite the short-term swap rate differential having continued to widen in favour of the euro and is at the highest in six months. In our short-term fair value model, the growing relevance of equity dynamics (which have moved against the euro) in determining EUR/USD swings now mean that the undervaluation has shrunk from the 5.5% peak two weeks ago to around 3.5% now despite the pair having fallen to 20-year lows.

The 0.9900 support appears to be a rather fragile one and was briefly broken yesterday, we could see 0.9850 or 0.9800 as the next key levels, although the worsening macro picture in Europe means that a further drop to the 0.9600-0.9650 supports cannot be excluded.

Francesco Pesole

⬆ GBP: Truss announces massive plan to fix energy bills

The pound rallied this morning on the back of some reports that the new UK Prime Minister Liz

Truss has drafted a £130bn plan to fix energy bills. The news appears to partially ease the market's concerns (that have weighed on GBP) that Truss' promised tax cuts would ultimately worsen the inflation picture.

The pound is set to face further volatility in the coming days as Truss' policy plans are outlined in greater detail and the Bank of England meeting (15 September) draws nearer. If tax cuts would likely argue in favour of larger BoE tightening, caps on energy bills might both reduce the risk of recession and trim inflation expectations: it will be interesting to see how the BoE addresses these policies. Yesterday, we heard some hawkish comments by MPC member Caroline Mann, and markets are closing in on pricing a 75bp move next week.

However, it looks like Truss' political agenda is what is driving the pound at the moment, and BoE tightening expectations are playing a secondary role. EUR/GBP is testing the 0.8600 support and may keep retreating on the back of encouraging news on the policy side.

Francesco Pesole

CEE: FX follows gas prices

Today, we will see the traditional data set of industrial production, construction and foreign trade in the Czech Republic. The main topic is of course automotive production, which is holding back the whole sector. Leading indicators suggest that the situation did not improve in July either and we should see a further slowdown.

The markets are dealing with the new gas price hike and so far it seems that yesterday's jump has been fully reflected in FX across the region, resulting in the expected weakness. However, risks remain and the gas story will be the main focus today. We still believe that further upward movement in gas prices will mainly hit the Hungarian forint, which has been copying the gas price in recent days with an almost perfect correlation. However, we also believe that the EU money theme should return to the headlines in mid-September, which should unlock the hidden potential of the forint. Although the initial reaction from the European Commission may not be 100% positive, our baseline assumes an agreement is found and the RRF money is released. On the other hand, the situation is escalating in Poland, where the government is likely to raise this issue and the upcoming elections may trigger an open conflict with the EU, which in turn spoils the prospects for the Polish zloty which should stay around 4.75 EUR/PLN in the rest of the year.

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