FX Daily: EUR/USD can drop to 0.98

EUR/USD is trading a touch above parity, having reached a 1.0006 low yesterday. A break below parity looks more likely than a rebound, in our view, and if we do see such a technical break, an extension of the drop appears likely, with the options market suggesting the next support could be around the 0.98 area. Elsewhere, look for a 50bp rate hike by the RBNZ

USD: Untouched momentum

The dollar's bullish momentum remained fully intact at the start of the new week, as recession fears and some emergence of North American exceptionalism – the Canadian dollar's resilience may be a case in point – triggered another large dollar rally. EUR/USD has basically reached parity (we discuss this in detail in the section below), and this now paves the way for a technical extension of the downturn – which may well bring down other currencies with it.

It is clear that dollar positions are well into overbought territory, and the bigger the rally, the higher the chances (and potentially magnitude) of a long-squeeze. We still think, at this stage, that markets will need a trigger to enter position-squaring trades and offload some of their dollar positions. In other words, one of the drivers of recent dollar strength should show signs of abating or inverting. But we doubt that the narratives of aggressive Fed tightening and an economic slowdown (especially outside of the US) will be dented in the near term.

If anything, it could be the US earnings season – which has kicked off this week – which offers some sort of respite to the battered equity segment, and by extension take some steam out of the dollar rally. In this sense, the first earnings releases will be watched quite closely. But given the current environment, the chances of seeing a very strong earnings season do not appear very high. Despite the long rally, the probability of the US dollar staying bid in the coming days continues to outweigh the chances of a correction, in our view. A move to 110 in DXY over the coming weeks surely cannot be excluded.

Today, the US calendar only includes the NFIB Small Business Optimism index, while FOMC member Thomas Barkin will discuss recession risks at a conference. The Federal Reserve has so far held a relatively sanguine tone on the economic outlook: let's see if this starts to change, even though expectations around a 75bp hike in July are unlikely to change.

EUR: Bracing for a break below parity

EUR/USD is trading 30 pips above parity at the time of writing, having reached a 1.0006 low yesterday. The question now is whether the pair can find some support and stage at least a mini-rebound, or break below parity. If we look at the global economic picture, we believe the second option remains more likely, and even if we think that a return to 1.0500 in the autumn is still a tangible possibility, a short-lived dip to 0.9800-0.9900 in the coming days looks relatively likely.

The factors that hold the keys to the short-term outlook for EUR/USD are well known now: the risk of a fully-fledged energy crisis in Europe if Russia curbs gas supply, the consequent worsening outlook for the region's growth, a potential dovish re-pricing of European Central Bank rate expectations and – above all – the adverse global risk environment. Our impression is that the worst scenario for each of these factors has not been priced in yet, and given the pressure applied by the bullish USD environment, downside risks persist.

As discussed a few days ago in our article "FX: What happens when EUR/USD breaks parity?", given the importance of 1.0000 as a psychological level in EUR/USD, we suspect that a break lower could force a technical drop by one standard deviation, to the 0.9830-0.9870 area. The options market also suggests that a worst-case scenario (a two standard deviation drop) could see EUR/USD trade close to 0.9500-0.9550. In the same article, we highlighted which combination of global risk sentiment and Fed-ECB policy differential (measured by the MSCI World index and the 2-year EUR-USD swap spread, respectively) could cause a decisive break below parity. That scenario analysis implied quite a limited short-term risk premium in EUR/USD, but the growing tail risk of Russia halting gas flows to Europe means that that risk premium is now growing rapidly – and given the extraordinary nature of recent developments, may well prove stickier to be unwound that on other occasions.

It is no secret that the ECB dislikes a weak euro, and today we'll see whether one of the last governing council speakers before the "quiet period" – Francois Villeroy – addresses this topic. For now, it appears that the ability of the ECB to lift the currency is, however, quite limited. On the data side, the ZEW readings for July will be in focus, with a high chance of another big slump in both the "expectations" and "current situation" gauges, all of which should fuel fears of a major downturn in the eurozone.

GBP: New PM to be announced on 5 September

The Conservative leadership race is about to enter a key phase, as Tory MPs will whittle down a long list of candidates to just two over the next 10 days, with the aim of announcing the new prime minister on 5 September. Consensus appears to be that the former Chancellor Rishi Sunak is leading the race, but a good deal of caution is still warranted given we are at the very early stages of the process. Markets are, however, trying to gauge some policy implications – particularly on taxation and Brexit. In an interview, Sunak said that he would cut taxes only after inflation is under control, while the common belief is that he could hold a less confrontational stance with the EU on Brexit.

For now, we think the impact on sterling of the leadership contest will remain limited. GBP/USD remains strictly tied to dollar moves and external factors, and a further drop to the 1.16-1.17 area can't be excluded at this stage (especially if EUR/USD breaks lower). EUR/GBP may test 0.8400 if the EUR sees a larger technical drop vs the dollar, but the UK and the eurozone appear to be facing very similar challenges from a macro standpoint at the moment.

Today, the UK data calendar is very quiet, but keep an eye on Bank of England Governor Andrew Bailey's speech at 1800 BST.

NZD: RBNZ to hike by 50bp

The Reserve Bank of New Zealand announces monetary policy at 0300 BST tomorrow, and the chances of seeing anything different from another 50bp rate hike appear quite low. A half-point increase is in line with the latest bank projections as well as consensus and market expectations. The market reaction will therefore be mostly driven by the RBNZ's assessment of the economic outlook and forward-looking language.

As discussed in our RBNZ preview, a deteriorating economic outlook in New Zealand and signs of a rapidly contracting housing market both argue in favour of some kind of recalibration of the Bank's hawkishness. It may be too early to deliver a dovish shift this month, but we see rising risks of a revision lower in the rate projections at the August meeting.

Anyway, expect any impact of monetary policy on NZD/USD to remain very limited, as external factors remain centre stage. The pair may well test 0.6000 in the near term.

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