

FX Daily: EUR/USD downside risks grow

Jay Powell's hawkish comments and a stronger case for an ECB October cut have prompted a rewidening of EUR:USD short-term rate spreads. With rising Middle East tensions and French political instability, EUR/USD is starting to look expensive above 1.110. Today, aside from eurozone-wide CPI, we'll be closely monitoring the US job openings data



With rising Middle East tensions and French political instability, EUR/USD is starting to look expensive. Pictured: Smoke seen rising above the city of Beirut

USD: Powell pushes back against 50bp hike

It's been a hectic start to the week in central bank news and geopolitics: Fed Chair Jerome Powell explicitly pushed back against a 50bp rate cut by year-end, and Israel started a ground offensive in Lebanon. In other conditions, the dollar would have rallied on such a combination of events, but sensitivity to Fed speak and Middle East turmoil has been reduced.

On the Fed side, the 50bp reduction in September means that market pricing is more structurally dovish-leaning, perhaps also on the premises that the Fed wouldn't want to underdeliver on easing should a 50bp move be priced in by the FOMC date. On Monday, Powell said the base case is two 25bp moves by year-end, which is unusually specific guidance that signals his discontent with market dovish pricing. Still, the Fed Funds Future curve is factoring in 70bp of cuts by December, effectively betting that soft data will force a September-like Fed surprise in one of the next two meetings. That signals the balance of risks in the very near term is probably skewed to the upside

for the dollar.

The geopolitics-FX link is also rather weak at the moment. Israel's ground raids in Lebanese territory were a highly-anticipated risk by US authorities, and the escalation was somewhat expected. The lack of substantial repercussions on commodities, with oil prices staying weak, means that FX markets are also not responding to the latest developments. There are upside risks for the dollar here too.

On the US data side, we'll see the August JOLTS job openings print today, which is expected at an unchanged 7673k after a surprise drop last month. Markets may be more sensitive to those job opening numbers than the ISM Manufacturing index, which is also expected to have stabilised around 47.5.

Francesco Pesole

⬇️ EUR: Heading back to 1.10?

The two-year EUR:USD swap rate continued to widen in favour of the dollar yesterday, and is now around -110bp, some 25bp below the -85bp mid-September levels. The notion that an inflation-concerned ECB would move more carefully than the Fed on easing is crumbling, as Powell continued to signal no interest to cut by 50bp again and inflation figures in Germany, France, Spain and Italy are all endorsing the [ECB doves' case for a cut in October](#). Even ECB President Christine Lagarde struck a more dovish tone yesterday as she pointed to greater confidence in disinflation, which will taken "into account in our next monetary policy meeting in October".

We'll be waiting for the eurozone-wide CPI numbers later today, where headline inflation is expected to slow below the 2% target (to 1.8%) and the core measure from 2.8% to 2.7%. It's looking increasingly likely that holding rates in October could mean cutting by 50bp in December, which explains market pricing for -52bp by year-end, with 22bp priced in for this month.

The large moves in the EUR:USD short-term rate differentials are pointing to a weaker EUR/USD now. Incidentally, we could see some fresh political risk premium being built into the euro as new French Prime Minister Michel Barnier is facing an [even worse than expected deficit situation](#), and a likely political battle ahead to push forward any budget consolidation measures. Our rates team does not expect any respite in French bond spreads. Barnier delivers a key Parliamentary speech at 3PM CET today: expect some debt market volatility spilling into the euro.

All in all, barring surprise in EZ and US data, we think EUR/USD can trade back below 1.110 in the next couple of days, and test 1.100 if US unemployment doesn't tick higher on Friday.

Francesco Pesole

⬇️ JPY: Conflicting domestic news

The yen would be the other go-to currency in a geopolitical risk escalation, but Japanese markets are currently trading mostly on domestic news. The Nikkei has rebounded after yesterday's selloff and short-term JPY swap rates are inching lower after the Bank of Japan (BoJ) summary of opinions was slightly hawkish, with one member explicitly signalling downside risks. This is partly offsetting bets that the new Prime Minister Shigeru Ishiba will favour fighting inflation.

Ultimately, our view on the BoJ remains more hawkish than the market's pricing for 13bp of

tightening over the next three meetings, so even if the tactical picture is turning more skewed to the upside for USD/JPY – not least because of risks of correction higher in USD rates – we are not ready to call for a sustained, multi-month JPY underperformance.

Francesco Pesole

➔ CEE: The sell-off continues but too soon to fade

Today we will have PMIs in the region and our economists expect a slight decline across the board following the weaker data from Germany released earlier. In the Czech Republic, we will see the release of the final GDP numbers for the second quarter, which will likely confirm the previous numbers, and the state budget performance for September, which will likely not yet show flood-related spending.

The FX market in the region was hit hard yesterday and came under pressure again. Although the entire EM universe weakened, CEE was the visible loss leader. The lower EUR/USD is understandably not helping, and the escalation in the Middle East has increased risk aversion. But even so, we don't see much reason on the local side. On the contrary, rates are rather supportive of CEE currencies.

Although it is probably too early to fade the move, we believe the market in the coming days may get good entry points for CEE FX again. EUR/PLN in particular is getting interesting ahead of Thursday's National Bank of Poland press conference. Yesterday's [inflation](#) confirmed a rise including core and given the dovish shift we saw last month from the governor, we may see a rather hawkish repricing supporting stronger FX this week.

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