FX Daily: Euro political risk premium abates, for now

The euro has enjoyed a breather since the start of the week as French bonds showed signs of stabilisation. We estimate that the political risk premium on EUR/USD shrunk from 2.4% to 1.6% from Friday to Monday. The focus will also be on US retail sales today. Elsewhere, a hawkish RBA meeting this morning bodes well for a summer rally in the Aussie dollar

The euro is stabilising following a calmer Monday for French bond markets

USD: Policy versus politics

The dollar started the week moderately offered as market concerns about EU political developments seemed to have temporarily abated. We doubt, however, this week will bring significant relief to investors ahead of the 30 June first round parliamentary vote in France, and it would probably take US domestic developments to take the dollar much lower.

This dichotomy between macro (in the US) and politics (in the EU) will remain a key theme for FX into the summer. As discussed in our June edition of FX Talking, published yesterday, we'll be looking for local stories more than any clear-cut trend in the coming weeks. In the G10, the Australian and New Zealand dollar look in a good position to benefit from further disinflation news in the US, thanks to hawkish domestic central banks (more on the RBA below) and distance from the EU political turmoil.

The highlight of the day in markets is the May retail sales print out of the US. Consensus is relatively upbeat, centred for a 0.3% month-on-month headline read figure and 0.4% MoM in the ex-auto and gas gauge. There are also a few Federal Reserve speakers to keep an eye out for. Thomas Barkin, Alberto Musalem and Adriana Kugler (the latter considered a dove) are all due to touch upon monetary policy in their speeches.

Unless we get a soft retail sales print today, we see DXY holding above 105.0 this week as markets may remain biased to defensive positions and fading EUR rallies.

Francesco Pesole

EUR: French bonds stabilising for now

The euro is stabilising as French bond markets enjoyed a calmer day on Monday. The 10-year OAT-Bund spread remains around 30bp wider than before the snap election announcement in France, but it appeared to be lacking steam to widen much beyond 80bp – which may turn out to be a key benchmark level moving on.

We estimate the risk premium (i.e., short-term undervaluation) in EUR/USD at 1.6% at yesterday's close, compared to 2.4% as of Friday's close. This adds to indications that the FX market's concerns about French politics may have reached a peak – at least for now. When looking at the option market, the EUR/USD 25-delta risk reversal has also halted its slump, although at -1.5 it remains the lowest since late 2022.

The swing in option positioning and EUR/USD undervaluation suggest that, should markets scale back political risk premium, there would be a substantial room for rebound in the pair. However, we doubt this may happen before the 30 June first round parliamentary vote in France, and the euro should remain a laggard in any USD-negative dynamics.

On the data side, the eurozone calendar includes June's ZEW survey results and the final May CPI figures. Data is, however, playing a clearly secondary role for the euro at this stage, and the focus will instead be on any signs of further stabilisation in the French bond market, which a hold above 1.0700 in EUR/USD primarily relies on at this stage.

Francesco Pesole

AUD: RBA stays hawkish

The Reserve Bank of Australia kept rates unchanged at 4.35% as expected this morning, but accompanying communication was generally hawkish. The Board noted the lingering upside risks to inflation and how the disinflation process has been slower than previously anticipated.

The statement stresses a "determination to return inflation to target" and that the central bank "will do what is necessary to achieve that outcome". And while Governor Michele Bullock said the case for another rate hike has not increased during the press conference, she admitted that the Board discussed raising rates at this meeting and the RBA is not ruling anything in or out in terms of further moves.

The Aussie dollar is the best performer in G10 this morning following the hawkish RBA hold. This has reinforced our preference for AUD to outperform in the coming weeks, should US data continue to favour a rotation into high-beta currencies. As discussed in the USD section, AUD and NZD have the advantage of having hawkish domestic central banks and being distant from the EU political turmoil, which may see them attract the market's interest in the currently unstable environment for EU currencies.

We still see a potential move to 0.68 this summer in AUD/USD, before US election risks weigh on China-exposed currencies in the autumn.

Francesco Pesole

HUF: Last cut for a while or not

We see the National Bank of Hungary slowing down the pace of rate cuts to 25bp today. This would take the interest rate to 7.00%. While inflation has surprised to the downside in Hungary in recent months, the surprises are driven by non-core elements. Wage growth surprises to the upside, however, which limits the decline in services inflation. Other parts of the picture are also mixed. On the one hand, the economy is not recovering as expected; on the other, loose fiscal policy is supporting further inflationary pressures. However, the main hot topic is again FX. EUR/HUF touched 398 on Friday, the first time since March. In our view, this should be enough warning for the central bank not to consider a 50bp rate cut, which is the second option for today's meeting.

In our view, the central bank will have to deliver a hawkish message to avoid triggering further HUF weakness today. More than the decision itself, it is probably an indication of further rate cuts for the rest of the year that are more important. We don't expect any rate cuts in the forecast, but inflation surprising to the downside opens the door for some easing. The global relief for EM markets indicated yesterday is of course supportive for HUF, and would dampen the sell-off if a bigger cut is made – but we would still likely test 400 EUR/HUF. Otherwise, as in our base case scenario, we see HUF stronger at the end of today with levels around 392-393.

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