FX Daily: First inflation test of the week

US PPI data will be the first inflation-related test of this week for global equities (which have continued to recover) before tomorrow's key CPI figures. We expect 0.2% month-on-month prints to keep investors' nerves relaxed and favour an orderly USD decline

We have seen a continuation of the USD/JPY recovery

We have published the August edition of FX Talking: Has the Fed overcooked the tightening cycle?, with our latest FX views and forecasts.

USD: First hurdle of the week

The most noteworthy development in an otherwise quiet start to the week in FX has been the continuation of the USD/JPY recovery. Interestingly, the high-carry Mexican peso has been the other major loser since the weekend, signalling that the JPY correction is more macro- and equity-driven than caused by a rebuilding of carry trades. We expect macro to be the key driver of the yen in the coming months, especially now that speculative positioning has flattened and the Bank of Japan hike has dented the funding appeal of the yen. As discussed in the G10 section of FX Talking, an orderly USD/JPY decline is one of our key calls for the month ahead.

Today, one key test for USD/JPY and the broader FX market is the release of July's US PPI report. We expect a consensus 0.2% MoM print across headline and core measures to ease market nerves about a round of higher CPI/PCE that would deliver a hard hit to the risk sentiment just as global stock indices finalise their recovery of recent losses. We could see USD/JPY halt its rally after the release today and the dollar trade generally on the soft side across the board as some pre-inflation data defensive positioning is scaled back. Another important release is the NFIB Small Business Optimism report for July. The hiring plans sub-index is one of the most reliable predictors of private payrolls three months ahead: a resumption of the early 2024 decline following a recent rebound would fuel jobs market concerns.

Tomorrow's CPI will undoubtedly generate higher FX volatility with markets likely to focus on the second percentage point decimal in the MoM print (consensus is 0.2%). We are generally optimistic that data will fall in line with consensus expectations and continue to endorse market pricing for 100bp of Fed cuts by year-end. An orderly USD decline is our baseline scenario for this and the next few weeks.

Francesco Pesole

EUR: Still on track to 1.10

The ZEW survey of economists and analysts is the first activity indicator to be released in Germany every month and can help build expectations ahead of the Ifo and PMI indices, which instead track business sentiment. Last month, the drop in the ZEW expectations index was followed by similarly grim reads in the Ifo and PMIs. Today, expectations are for another sizeable drop in both the expectations and the current ZEW indices.

We are well aware that our bullish EUR/USD view cannot rely on growth optimism in the eurozone, but that factor is also largely priced in by the market, and stickier-than-expected inflation is preventing large dovish repricing in the EUR curve. This is what matters the most for EUR/USD in the near term, along with risk sentiment which has continued to improve after the recent selloff.

We remain confident about a break above 1.10 in EUR/USD in line with our call for a softer USD into a 50bp September Fed cut. We incidentally continue to see good downside potential for EUR/NOK, as the equity stabilisation/recovery should allow the very high-beta NOK to recover recent losses and Norges Bank will, in our view, remain hawkish on Thursday.

Francesco Pesole

GBP: Unemployment drop looks like a fluke

The surprise drop in the UK unemployment rate from 4.4% to 4.2% reported this morning will probably raise more concerns about data quality rather than offering clarity to the Bank of England. It is widely known that the survey used to calculate the unemployment rate has had very low response rates.

The rest of the jobs report is less surprising. The slowdown in wage growth is primarily due to the base effect and was generally in line with consensus. The MoM figures in the private sector continued to show some strength though.

Our UK economist notes that the overall message from today's report is that the jobs market is still cooling (declining vacancies are the main symptom of this), but there is probably enough to keep the Bank of England generally cautious on rate cuts. September still looks more likely to be a hold than a cut, but markets are pricing in around 10bp worth of easing for the upcoming meeting, and 45bp in total by year-end.

Sterling is trading on the strong side after the release, likely due to the surprise drop in unemployment. EUR/GBP is attempting another move below 0.855, but we think the downside is probably limited as the pair was already trading generally on the cheap side relative to its rate differential.

Francesco Pesole

CEE: FX took advantage of the space it got from rates and captured new profits

Yesterday's inflation numbers in the Czech Republic and Romania were higher than expected (forecast: 2.0% vs 2.2% and 5.1% vs 5.4%), again showing that strong dovish market expectations are probably too far. Today's calendar is less interesting in the CEE region with mainly current account data for June in Poland, the Czech Republic, Romania and Turkey.

Our bullish view for the CEE region has worked in recent days with yesterday's gains mainly in the PLN and CZK market. We maintain this view for the next few days as well but for further gains we will need to see more repricing on the dovish side of the market and we should see more payers rather than receiver trades in CEE. For now, the gaps have closed between FX and rates except for HUF where we still see room for a rally even with current market pricing, but ultimately we think EUR/HUF can return to 390 later, especially if EUR/USD continues to head higher.

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