# FX Daily: Fiscal risk premium to go into the euro

The standout move in overnight FX markets has been the drop in USD/JPY close to 150 as traders get excited about another hike from the Bank of Japan. Expect USD/JPY to stay offered today before tomorrow's January CPI data release. Elsewhere, we think a new fiscal risk premium could emerge in the euro as national bond markets take the strain of defence spending

The euro is looking soft on the crosses

## USD: The Fed doesn't seem worried about the consumer

The DXY dollar index is a little softer. Yet this is not a broad-based decline but is largely led by developments in Japan. Here, local investors seem impressed that there has been little official push-back against the recent rise in JGB yields and that the Bank Of Japan may hike again this summer. The OIS market prices 21bp of a 25bp hike in July – which would take the policy rate to 0.75%. We have been surprised by the yen's strength in response to these relatively modest moves in Japanese interest rates. And we do note that speculative positioning is now quite long for the yen. However, we don't want to stand in the way of further short-term term USD/JPY losses, because tomorrow's January Japan CPI release could trigger another leg lower. That said, we are not looking for a sizable USD/JPY move sub-150 and instead prefer yen out-performance on the crosses – especially against the euro (see below).

When it comes to the dollar, we largely see it staying supported. Even though short-dated US yields fell 2bp on last night's release of the January FOMC minutes, the release did not look particularly dovish. The clear message was that the Fed needed to see additional evidence or progress before cutting rates again. At the same time, the Fed released a very interesting speech from Vice Chair Philip Jefferson. He noted that those from the entire income spectrum had been enjoying the benefits of wealth effects and seemed to suggest that US household balance sheets were in relatively healthy shape.

For today, FX markets will also be digesting some overnight comments from President Trump that the US could sign a new trade deal with China. That saw USD/CNH come off a little in Asia, but we doubt it is enough to prompt a big re-rating of the Rest of the World currencies just yet. Assuming that there is no big spike in the US weekly jobless claims data today, we think DXY can find support under 107

*Chris Turner*

## EUR: New theme alert – fiscal risk premium

The euro is looking soft on the crosses and a new theme may be coming into play on the back of geopolitical developments. US isolationism means that Europe is going to have to ramp up defence spending sharply. Please see our team's views on the subject here. The question is: who's going to pay for it? Will spending be undertaken at the European supranational level? Or will a failure to reach any collective agreement put pressure back on local and national budgets? Italy could be in focus here with perhaps one of the greatest needs to increase defence spending but a debt-to-GDP ratio already close to 140%. Our rates strategy team feels that the recent narrowing in Italian-German sovereign bond spreads could well reverse as it dawns on investors that national governments will be paying the defence bill.

Some of these trends started to show through in financial markets yesterday, where European debt really started to underperform. We are seeing a bearish steepening of European bond curves, where the German 2-10-year Bund curve, now at 38bp, has steepened to the highest levels since October 2022. We are wary that the theme of increased government bond supply can pressure peripheral spreads and demand a new fiscal risk premium of the euro.

This comes at a time when there is not much trade risk premium priced into EUR/USD either. As above, there do not seem any immediate signs that the US consumer is about to crumble or that the Fed is about to pull the trigger on another rate cut. Overall we have a slight preference that EUR/USD stalls in the 1.0450/70 area and could drop to 1.0350 should we start to see Italian longer-dated government bonds coming under pressure.

The eurozone data calendar today sees February consumer confidence at 16CET. No fireworks are expected here. And despite low unemployment and high real wage growth in Europe, it looks as though the twin threats of trade and European security will keep European savings rates high and demand subdued.

*Chris Turner*

## GBP: The European bond market sell-off is unwelcome

If European bond markets are going to sell off further, life may become even harder for UK Chancellor Rachel Reeves. Remember she is going to provide a spending update on 26 March and needs to credibly argue how the government will hit its fiscal rule of a balanced budget in FY29/30.

Higher gilt yields mean a higher bar for a credible spending plan and questions whether she can present a plan that defers spending cuts to the later years. If gilt yields are pressing their January highs at the time of the March review, this means either: a) the Chancellor will need to deliver deeper spending cuts or b) UK asset markets get hit should her plans not look credible. Neither scenario is a good look for sterling and that is why we doubt GBP/USD holds any near-term gains over the 1.26 area.

*Chris Turner*

## CEE: Markets have priced most of the positives

After a rather quiet first half of the week, we will see a busier calendar today. The main focus should be on Poland, where labour market data including wage growth, industrial production, and PPI will be released. Although recent PMI readings give some ground for optimism, industrial activity remains subdued and the ongoing recession in Germany is weighing on Polish manufacturing. Industrial output remains stagnant with annual changes swinging from positive to negative, depending on the calendar effect. We forecast a slightly negative reading for January. At the same time, PPI deflation is moderating, and we should see growth in producers' prices in the coming months. Wage growth fell below 10%YoY in December and we expect pay in the enterprise sector to continue rising at a single-digit pace in 2025 after three consecutive years of double-digit growth.

Yesterday, the market saw the first correction after several weeks of rally in CEE FX under the positive sentiment coming from the Ukraine negotiations. As discussed here earlier, we believe the main driver of the rally was and still is sentiment only, while the fundamentals of the economy remain almost unchanged for now. At the same time, we have seen some rally in CEE rates while EUR rates are flat or higher. This leaves the market with a narrower interest rate differential across the board which we believe will start to weigh on strong CEE FX once positive sentiment starts to fade. Yesterday could thus be the first day of this correction and PLN and HUF in particular may be vulnerable given the heavy positioning built up in recent weeks. Although we are not calling for a significant correction, we believe that for now the rally is done and the market is pricing in most of the positives. Any surprise will come rather on the negative side from these levels.

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