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FX Daily: French and US political drama may lift volatility

Having enjoyed a brief session on Friday of unalloyed joy as Fed Chair Jerome Powell hinted at a September rate cut, financial markets may now face some uncertainty on political developments in France and the US. We re still happy with a bearish story for the dollar, but it might have to be the more defensive Japanese yen or Swiss franc which takes the lead now

Federal Reserve Governor Lisa Cook (L) and French Prime Minister François Bayrou (R). We think that the current political uncertainty in France and surrounding the Fed could lift volatility

USD: Focus on Cook's removal

The dollar briefly sold off 0.6% (and then rebounded) in Asia after news broke that US President Donald Trump was dismissing Lisa Cook, a member of the Federal Reserve's governing board. This follows allegations of mortgage application irregularity. The move by the Department of Justice yesterday to open an investigation into the issue was seen by the President as providing sufficient 'cause' for him to make the move. Cook rejects his authority for the removal, and the case will likely end up in court, leaving the question of whether she retains her post during the appeal or whether the Fed Governing Board and the rate-setting FOMC will be one member down until the court case is resolved.

After the resignation of Adriana Kugler and the appointment of Stephen Miran, the influential governing board is starting to lean towards Trump's way. Investors will naturally start to increasingly question the independence of the Fed, which would result in a steeper yield curve and a weaker dollar. The US 2-30 year yield curve broke to a new cyclical high overnight at 122bp and is back to levels seen before the Russian invasion of Ukraine in 2022. The question will be whether this pressure on the Fed triggers an outright sell-off in the long-end of the bond market. On that subject, this week sees the US Treasury auction $144bn of two, five and seven-year Treasury notes, where presumably Thursday's seven-year issue will be the most challenging.

Overnight developments stand in contrast to the benign bullish steepening of the yield curve triggered by Powell's dovish speech at Jackson Hole on Friday. Equity investors will no doubt keep track of the long end of the Treasury market this week, where a sell-off could pressure global equities after a good run in August. Pressure on the Fed is a dollar negative, but if Treasuries and equities start to come off, it will be the likes of the Japanese yen and Swiss franc which outperform, not the euro. And the euro has some new baggage – see below.

Away from politics, the US data calendar this week sees US consumer confidence today, a revision to second-quarter GDP on Thursday and core PCE inflation on Friday. We'll also hear an important speech on monetary policy from the Fed's Christopher Waller on Thursday. He voted for a rate cut in July and is seen as one of the front-runners to replace Powell as Fed Chair next May. Let's see if he's turned even more dovish, given recent US employment data.

It looks like it could be a choppy week in FX. The softer euro is making the DXY look bid. We suspect DXY can continue to bounce around in a 97.50-98.50 range for a while. USD/JPY looks toppy in the 148.00/148.50 area, and we retain a forecast of 145 for the end of September.

Chris Turner

EUR: French government looks likely to fall in September

Hitting EUR/USD late on Monday was the surprise announcement from French Prime Minister François Bayrou that he was calling a vote of confidence in his government's fiscal austerity plans on 8 September. The numbers don't look good in that his centrist party has 210 seats in parliament, while the far left and the far right have a combined 330 seats and have already said they will vote no.

French government bonds had already been underperforming in an otherwise benign environment for European government debt this summer. And we'll all be waiting for headlines today to see whether French 10-year yields start trading through Italy. The broader question for the euro is whether recent French news destabilises appetite for the euro more broadly, or whether this is an isolated French issue. Given the 'push' factors away from the dollar at the moment (pressure on the Fed and the macro justification to cut rates), we're not ready to go all out bearish on EUR/USD over this. But cross rates like EUR/JPY and EUR/CHF can start to come under some pressure as the FX regime shifts away from the lowvolatility, benign conditions seen through August.

Perhaps the largest threat to the euro at present is positioning. Futures data shows both the asset management and leveraged fund communities running large net long positions. Expect a pick up in protective EUR/USD downside positions in the FX options market. And depending on how hard French bonds get hit today, a break of support at 1.1580/90 could see follow-through to the 1.1500/1520 area – especially since investors probably added to EUR/USD longs on Friday's dovish tilt from Powell.

Chris Turner

GBP: Hawkish BoE and French politics to weigh on EUR/GBP

EUR/GBP looks to stay offered this week as French politics prompts some reassessment of long euro exposure. This comes at a time when a credibly hawkish Bank of England is already providing sterling with some support. Following this month's hawkish turn by the BoE, the market struggles to price one 25bp cut this year (just 12bp currently priced) and barely two cuts by next summer.

There doesn't look too much on the agenda to knock the BoE's hawkish agenda this week, which suggests EUR/GBP will be pressing support at 0.8600 shortly.

Chris Turner

CEE: Hungarian central bank confirms wait-and-see mode

Following yesterday's surprisingly strong retail data for July in Poland, we will see a decision of the National Bank of Hungary today, and we believe the central bank is very likely to leave rates unchanged at 6.50%. There is no discussion of rate cuts here at present, and the governor has repeatedly signalled the decision in recent days. However, the market will be watching for any changes in guidance, especially after yesterday's announcement by the government to extend price measures from August to November.

Tomorrow, wage figures will also be released in Hungary, and on Friday, we will see inflation in Poland for August and the second GDP estimate for the Czech Republic for the second quarter. August inflation should not differ much from July, when the headline rate fell to 3.1% year-on-year. For this month, we expect only a small tick down to 3.0%, one-tenth above market expectations. GDP data in the Czech Republic should confirm 2.4% YoY growth, but we see some potential for an upward revision here.

The CEE market continues to discount positive expectations regarding the conflict in Ukraine. Yesterday, the stronger US dollar also had a negative impact on the region. At the same time, we see that local rates are losing momentum with core markets, and spreads are tightening across the board. After yesterday's muted activity due to closed London markets, CEE rates will have a chance to catch up with the move in core markets, but the combination of all the factors mentioned seems unfavourable for CEE FX. In addition, we have seen strong long positioning, especially in the Hungarian forint and somewhat in the Polish zloty, which still has the potential for some unwind, leaving FX exposed here.

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