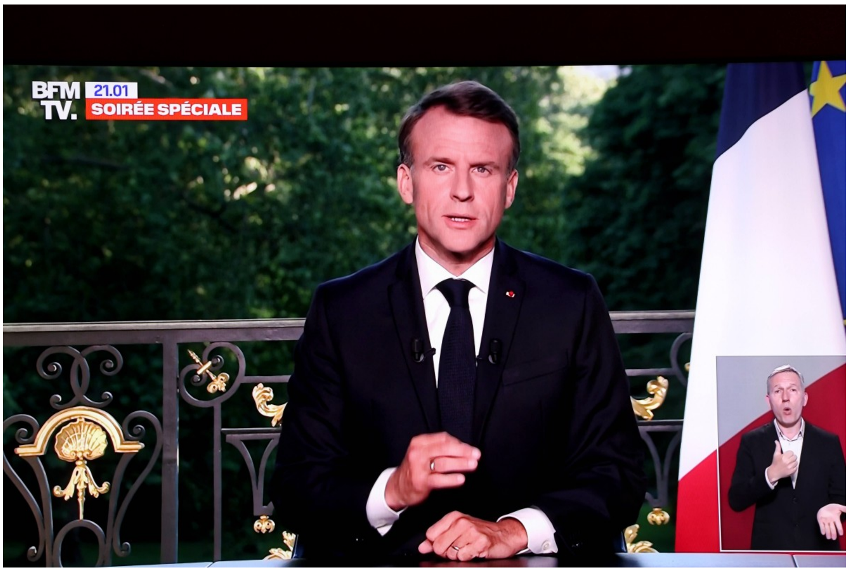
FX Daily: French political risk takes its toll on the euro

Despite another round of softer US price data, the mood in the FX market is one of a glass half empty. French political risk is really starting to weigh heavily on European FX and debt markets. And with the French election still a couple of weeks away, the risk premium in European assets could build further. EMFX has had a bad week, but the rand is bucking the trend



French President Emmanuel Macron's approval rating has dropped to the lowest level since 2018.

USD: Softer US price data being ignored in FX

Yesterday's release of softer US May PPI data should have sent the dollar lower across the board. After all, it pointed to the May core PCE price data - released on 28 June - coming in at 0.2% or even 0.1% month-on-month. That would be music to the ears of the Federal Reserve. What we saw, however, was the dollar reversing its PPI losses within a couple of hours as European asset markets reacted to an opinion poll showing French President Emmanuel Macron's approval rating dropping to the lowest level since 2018. In other words, it looks as though European politics is going to be the dominant driver of FX markets for this month. This suggests international investors will need a lot of convincing not to hold dollars.

The dollar is also deriving some strength this morning after the Bank of Japan left rates unchanged and also disappointed some in the market looking for an announcement on a reduction in BoJ JGB purchases. We do not think USD/JPY has to rally too far, however, since the JGB decision will be delivered at the 31 July BoJ meeting. Equally, the generalised rise in FX volatility and the drop in US rates are two strong factors for a lower USD/JPY. In fact, USD/JPY is just now coming lower after BoJ Governor Kazuo Ueda said the Bank's reduction in bond buying would be 'substantial'.

We think the performance of European asset markets will dominate FX markets today. But on the US data calendar, we have what should be a soft May import price release and the June consumer sentiment and inflation expectations data. Fed Chair Jerome Powell made a point of saying this week that the US consumer was solid. Consensus expects a firmer sentiment reading today and a firmer US May retail sales reading next week.

For the time being then, we think the dollar will shake off this week's drop in US rates and DXY will probably test 105.45/55 with risk to 105.90 should the euro come under more pressure later in the day as investors brace for more poor French opinion polls this weekend.

Chris Turner

EUR: French:German bond spreads above 70bp? That's bad

The French:German 10-year sovereign spread briefly pushed beyond 70bp yesterday. That is very wide and recalls pressure last seen in early 2017 when Marine Le Pen was running on a ticket of taking France out of the eurozone. We're not French political experts, but it looks like the euro is taking another leg lower in early Europe today on news that the French parties of the Left are getting their act together to form a coalition and only run one candidate per district between them. This rare cooperation of the Left stands to suck support from President Macron's party further.

In our markets piece looking at the French election, we felt that there was room for a risk premium to weigh on the euro further. We are now seeing a significant pick-up in FX traded volatility and strong demand for downside protection in the FX options market. The usual FX vehicle for hedging European political risk, EUR/CHF, is also responding. EUR/CHF actually sold off 0.7% on Macron's poll yesterday and there could be some decent downside to 0.9500 here if the Swiss National Bank next week were not to cut rates after all. Some think they can handle the FX side of things and will not want to deliver back-to-back cuts which would signal a misplaced confidence that the inflation battle has been won.

It is going to be a long month for the euro. And next week could see the European Commission place France in an excessive deficit procedure. Equally, if French debt gets hit any harder, speculation could grow that the European Central Bank would want to try out its new Transmission Protection Instrument (TPI). The only worrying thing here is that to benefit from the scheme, a country cannot be in an excessive deficit procedure!

With opinion polls taking such a toll on the euro and presumably more polls due this weekend, we expect investors will want to manage their euro exposure carefully. EUR/USD looks like it could press support at 1.0700/0720 today and could well make a run at 1.0600 next week.

Chris Turner

ZAR: Rand outperformance may well continue

Carry trade strategies have been suffering recently. This has not been because of a big rally in the chief funding currency the yen. Instead, it has been the target currencies themselves that have run into some political/fiscal challenges. We've been making the point this week about how popular target currencies in Latin America have suffered a lot.

In contrast, the South African rand had been performing well on the expectation that a new 'national unity' government would be announced today. This would include the more moderate Democratic Alliance and exclude the more left-wing, market-unfriendly political parties. Should that be confirmed today, the rand may adopt the mantel of a favourite carry trade target with its 8%+ interest rates and a more market-friendly and reform-minded new government.

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