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FX Daily: Geopolitical risk storms back into the picture

The Israeli strike on Iran's nuclear facilities has sent oil prices spiking and has offered the oversold and undervalued dollar a catalyst for a rebound. The energy price shock is generally disliked by the euro and gives the Federal Reserve an argument to stay cautious. We see more short-term downside potential for EUR/USD

Israeli Prime Minister Benjamin Netanyahu delivered a video address as Defense Minister Israel Katz said Israel has launched a "preemptive strike" on Iran

USD: Geopolitical risk opens room for brief dollar rebound

The dollar is stronger across the board this morning after Israel attacked Iran's nuclear facilities. The main transmission channel from this specific geopolitical risk and FX is the price of oil, which has rallied around 8% since the Israeli strike. In other conditions, the DXY rally would likely be much larger than the roughly 0.75% rebound from the overnight lows we have seen so far, because the dollar would also benefit from the negative shock in equities and bonds. But USD's traditional correlations have disappeared of late, and it's likely that the 1.5% drop in S&P 500 futures is doing more to cap gains.

What matters most for FX at this stage is the depth and length of the Middle East escalation's impact on oil prices. We strongly recommend a read of our commodities team's analysis on this topic here. The key difference from previous Israel-Iran standoffs is that nuclear facilities have now been targeted, and while oil production does not seem to be affected just yet, markets have to add in a bigger risk premium given the crucial role of Iran in global oil supply. The next key risk is whether further escalations lead to disruptions in the Strait of Hormuz, which can seriously impact flows from the Persian Gulf, where most of OPEC's spare capacity incidentally sits.

While it's hard to speculate on the situation at the moment, Israel has announced more strikes will follow and Iran's retaliation has already started. The risks now point more definitively towards a prolonged period of tension, in contrast to recent episodes. And we think this could continue to take some pressure off the dollar. While the US may well intervene with oil reserves to curb excessive price spikes, the new risk premium added to crude means inflationary risks are rising at a time when the bulk of the price impact from tariffs in the US is set to materialise. We had felt the USD negative reaction to the soft CPI print was exaggerated, and new geopolitical tensions give the Fed another argument to stay cautious, arguing for that CPI move to be scaled back. Today, the US calendar includes the University of Michigan surveys, which have generally painted a grimmer picture of inflation and sentiment than other indicators.

Given the large impact on equities, the yen and Swiss franc are performing strongly alongside the dollar this morning. Unless this escalates into a commodity shock significant enough to trigger concerns over the economic strain on energy importers, we still see the yen as the most attractive hedge out there.

Francesco Pesole

EUR: Not liking the oil rally

The euro generally dislikes geopolitical shocks leading to higher energy prices, and has therefore detached from JPY and CHF in early price action after the Israeli strike on Iran. This is a trigger for an unwinding of stretched longs on EUR/USD, which, according to our model, briefly reached a 2-standard-deviation overvaluation relative to short-term drivers yesterday. That is just above the 5% misvaluation, which we have assessed as the peak, where further rallies would need to be justified either by a substantial shift in rate differentials (higher EUR short-term rates or lower USD short-term rates) or another material deterioration in the US debt market. That overvaluation sits at 4% after this morning's correction.

From a European Central Bank perspective, oil market volatility likely endorses its cautious tone on further easing, and potentially pushes the chances of the last 25bp cut of the cycle more to 4Q rather than 3Q – mirroring the current market preference.

Anyway, we'll likely need to wait for next week's ECB speakers to get a better sense of what this all means for monetary policy. And given the fast-moving geopolitical situation, it is definitely too early to draw conclusions just yet. EUR/USD will likely follow that situation closely and primarily via the oil price channel. But we think the starting point was already quite rich for the pair, and a return to the 1.14-1.15 seems entirely appropriate.

Francesco Pesole

GBP: A rough week gets rougher

The week has been a rather negative one for the pound's domestic drivers. April GDP surprised yesterday with a 0.3% month-on-month contraction, and our economist notes how growth may well get worse later in the year. Adding to that, payrolls dropped significantly in May, and a relatively uneventful spending review event did very little to suggest the government can dodge tax rises at the Autumn budget.

In line with our call, EUR/GBP has broken above 0.8500, and prolonged geopolitical turmoil in the

Middle East should drive further gains in the pair, where we retain a bullish bias.

Cable has potentially a wide room for downside correction given how expensive it looks relative to rate differentials. But we have seen how structurally bearish USD bets are preventing dollar gains from being sustainable. So we'd be more cautious on that side.

Francesco Pesole

CEE: Higher inflation supports higher rates for longer

This week's inflation data has shown that the problem of rising prices has not been resolved, while divergence within the CEE region continues.

- In the Czech Republic, Tuesday's number confirmed the headline rate at 2.4% year-on-year while core inflation moved above the central bank's forecast at 2.8%. The Czech National Bank thus has good reason to turn hawkish, and the August rate cut in our forecast is a question mark. There is a possibility that the CNB will end the cutting cycle for some time.
- Wednesday's numbers in Hungary also surprised to the upside with a rise to 4.4%. Although core inflation has slowed, the central bank remains hawkish, and our baseline remains no rate cut this year, though the situation may still change in the second half of the year.
- Yesterday's numbers in Romania also showed a slight upside surprise with a rise from 4.9% to 5.5%, slightly above market expectations. We have recently lifted our 2025 year-end inflation forecast to 6.0%, and we now see at most a single 25bp rate cut likely at the National Bank of Romania's final meeting of the year.
- The week ends today with final numbers in Poland, which should confirm the earlier flash estimate of 4.1%. The details will allow for a more precise calculation of core inflation, which excludes food and energy prices, and it probably moderated to 3.3% YoY in April. Inflation continues to surprise to the downside and is expected to fall to the central bank target in July, leaving substantial room for monetary easing from the National Bank of Poland.
- Current account numbers will be published in Poland and the Czech Republic.

In the FX market, a weaker US dollar further supports stronger CEE currencies. On the other hand, yesterday we saw a slight correction in rates after a sharp rise in previous days - a move that also pared back recent FX gains. However, the picture for CEE currencies still looks more bullish. The CZK in particular should continue its gradual gains, while PLN and HUF seem more of a mix to us.

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