FX Daily: Geopolitics impact on FX remains contained

The dollar is trading higher this morning after the US strikes on Iran. But the moves still look quite small in FX, which suggests lingering reluctance to unwind strategic USD shorts, as well as market hopes for a potential de-escalation. Oil remains the key driver for FX, but data and Fed Chair Jay Powell's testimony are also in focus this week

Iranian Foreign Minister Abbas Araghchi held a press conference following US strikes on Iran and will travel to Moscow for talks with Putin.

USD: Eyes on Iran's response

Here are a few initial considerations on the FX reaction to this weekend's US strikes in Iran, with the caveat that this is a fast-developing situation. First, the dollar bounce looks small so far, especially considering its oversold and undervalued position. This follows the recent script: markets are quick to punish but slow to reward the dollar. For this to change, we think a prolonged period of elevated oil prices is necessary, as that would dent the appetite for oil-averse safe-haven alternatives like EUR and JPY, and in a way force-feed a return to the dollar to investors seeking defensive plays.

Markets seem to be pricing in a modest chance of this happening and treating the escalation in Iran with a good deal of caution. Brent prices jumped above $80/bbl in early trading but have now trimmed gains to just above $78. If indeed this geopolitical risk and oil spike proves to be only temporary, we think markets will rapidly default back to preferring strategic USD shorts on the back of US-generated bearish drivers.

The determining factor at this stage appears to be Iran's retaliation against the US strikes (here is our commodities team analysis). We have seen scattered reports about potential disruptions in the Strait of Hormuz, which has the potential to send oil prices considerably higher and trigger further unwinding of USD shorts before any de-escalation restores the conditions for rebuilding those positions.

Data will likely play a secondary role this week. The US calendar's highlight is Friday's core PCE figure, which is expected at 0.1% but may still fail to drive rate expectations given the Federal Reserve's stated cautiousness in signalling any dovish shift. We'll see how Powell defends those views (and the Fed's independence) in congressional testimonies tomorrow and Wednesday. Expect also some focus on today's S&P Global PMIs, which are expected to have slipped back lower in June, and on whether consumer confidence (tomorrow) has moved back above 100.0.

Francesco Pesole

EUR: Busy week for data

The yen and antipodeans are most under pressure at the time of writing, but it was EUR and SEK that initially took the biggest hits in G10 as markets reopened, which could signal they're the two G10 currencies most vulnerable to further meaningful geopolitical escalation. Both have been among the top G10 performers year-to-date alongside NOK, but unlike Norway's currency, EUR and SEK are negatively exposed to oil prices due to their countries' energy dependence.

For now, as discussed in the USD section above, the impact of geopolitics on FX remains small. On four occasions, EUR/USD tested the 1.1450 support level since the June 13 Israel strikes on Iran, yet markets lack conviction that this conflict will be prolonged or that the dollar has much to gain from that. Ultimately, it may still take some domestic macro event, especially in the US, to drive any substantial deviation from the 1.1450-1.1600 range.

The eurozone calendar is quite busy this week. Today's PMIs and tomorrow's Ifo surveys are expected to show some modest improvement on the back of abating global trade tensions. On Friday, we'll see the first June CPI flash estimates for France and Spain.

We have a slight preference for a return to 1.140 rather than another acceleration in the EUR/USD multi-month rally over the coming weeks. But we'll have to play it by ear given the highly volatile geopolitical situation.

Francesco Pesole

GBP: Higher scrutiny on activity data

The UK also releases PMIs for June this morning, and in line with the US and eurozone, expectations are for a modest increase in the composite figure, from 50.3 to 50.5. We see, however, a greater potential for reaction to data for the pound relative to USD and EUR. That's because the set of soft data in June and Bank of England, which at the margin struck a slightly dovish tone last week, may well have increased rate expectations' sensitivity to data releases.

Markets are pricing two cuts by year-end, and that is also our call, but another deterioration in activity figures might prompt some speculation on another cut, considering rates at 4.25% are among the highest in the G10.

We have seen the rally in EUR/GBP lose some steam around 0.8550, but we still think the momentum can remain generally bullish on the pair, and we expect a break above 0.860 in the near term. The intraday high to watch for the pair is April's 0.871. Above that, we'd be looking back at 4Q23 levels, which look too elevated unless the BoE delivers an aggressive easing cycle from here.

Francesco Pesole

CEE: Fade initial sell-off

This week, the focus shifts back to the region's central banks. Poland's wage and industry numbers will be released today. Last time wages surprised to the upside, and the central bank sees them as one of the hawkish risks. Tomorrow will also see the release of retail sales in Poland and consumer sentiment in the Czech Republic. However, the meeting of the National Bank of Hungary will be of interest. Although rates are expected to remain unchanged at 6.50% with no surprises, including hawkish guidance, the central bank will also release a new forecast. The Czech National Bank will also meet on Wednesday and is expected to leave rates unchanged at 3.50%. The key will be forward guidance and clarity on whether or not we can still expect any cuts in this cycle. We don't think so. On Friday, the Czech Republic will release the final GDP estimate for 1Q, which could bring some upward revision. And, of course, we continue to follow the negotiations on the government and fiscal package in Romania. Over the weekend, we saw confirmation of the PM and MinFin in the new government. Today, at the earliest, parliament is expected to hold a vote of confidence in the new government.

The FX market in CEE was rather muted last week, although we did see higher volatility in the rates market. Higher rates and wider rate differentials from last week would indicate stronger CEE FX this week. However, after the weekend's events, we can expect the market to be in a risk-off mood today, negative for the EM and CEE region. Still, we maintain the same view as in the initial escalation in the Middle East. After the risk-off mood dissipates, we will likely end up with higher energy prices and inflationary risk for central banks, which should ultimately be more hawkish than in the baseline scenario. Therefore, we continue to believe that fading spikes in both EUR and USD crosses is generally the right strategy going into the current environment.

Typically, the most vulnerable to spikes in energy prices and global risk-off sentiment is HUF, while CZK is the most resilient. Both currencies should get a hawkish boost from central banks later this week, reinforcing our bullish view after the initial sell-off. EUR/RON should continue to be capped at 5.02, while Friday suggested significant upside if fiscal consolidation talks collapse.

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