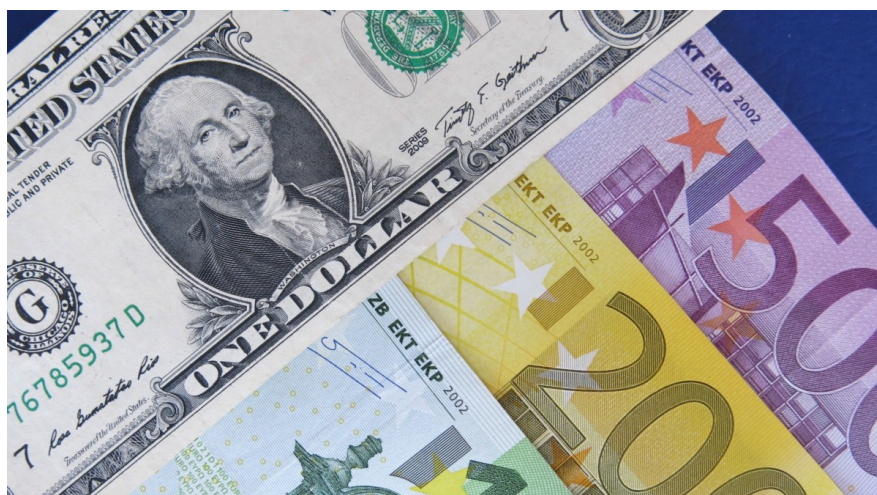


FX Daily: Heatwaves

Despite a very light US calendar and no Fed speakers, a heatwave will be felt in the FX market this week. Italy's political crisis seems to be leading to snap elections, and to a potential debate at the ECB if spreads widen. The ECB should hike by 25bp, but a 50bp is not out of the question, though EUR/USD downside risks persist. Keep an eye on a busy UK data calendar



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➔ USD: Consolidation time?

The week has started with a tentative upbeat mood in global risk assets, and the dollar is modestly weaker against all currencies in early trading. Another reason for the dollar losing some momentum is that markets have almost fully priced out the prospect of a 100bp Fed hike in July after two of the most hawkish FOMC members – James Bullard and Chris Waller – said that their base case was still a 75bp move.

We doubt that between now and the 27 July FOMC meeting, markets will seriously reconsider a 100bp increase; first, because the Committee has entered its blackout period, and there are therefore no speakers until next week and second, because the US data flow is set to be mostly second-tier this week. Some focus should be on housing data, which is expected to continue feeling the pressure from higher mortgage rates, while PMIs (not ISM) on Friday should not have much market impact.

At the same time, we see no reason for markets to doubt their 75bp conviction call for July, and that should continue to put a floor under the dollar in the near term. Expect the large majority of dollar moves this week to be linked to swings in global risk sentiment driven by non-US developments. Oil market swings will continue to be watched closely, as Brent will attempt to hold above \$100/bbl amid rising demand concerns. The 3 August OPEC+ meeting is expected to be a big one.

Another thread to keep track of is rising Covid cases worldwide as highly contagious variants seem to be spreading rapidly. China's situation seems to have stabilised over the weekend, and the government is deploying another round of mass testing in Shanghai. The risk of fresh lockdowns in China will remain a key driver of global recession fears. Adding to such fears may also be the upcoming heatwaves which are increasing the risk of extreme weather events and power shortages across the northern hemisphere. Finally, the precarious situation of Italy's government is only another element of risk for the euro and European assets, as concerns about a Russian gas supply remain elevated.

We could see some consolidation around current levels in the dollar this week, with DXY oscillating around the 107.00-109.00 region although the balance of risks remains tilted to the upside in our view given the numerous threats to the global outlook.

➔ EUR: Italian politics only one of many risks

Last week, we outlined [four scenarios for Italy's latest political crisis](#). Now, it appears that one of the last two scenarios – a new unity government without Mario Draghi as prime minister, or early elections – are becoming the most likely. After the 5-star Movement pulled its support for Draghi, two key right-wing parties have explicitly called for snap elections, with late September/early October looking like the most likely window for a national vote. Despite Draghi having pledged to resign at a parliament speech on Wednesday, he could still be given a new mandate and try to form a new government, although the chances of him leaving the political scene have significantly increased.

In our scenario analysis, we estimate that – without the ECB's support – the 10-year BTP-Bund spread may widen even beyond the 250bp mark. This would surely open up a debate within the governing council as the anti-fragmentation tool is set to be announced this week, and some members may well oppose further support to Italian bonds if the source of the sell-off is domestic policy – rather than monetary tightening.

All this is not good news for the euro. A blow-up in Italian bond spreads may well add pressure to the common currency this week (and especially to EUR/CHF), even though any developments on the EU-Russia spat on gas supply and swings in global risk sentiment may continue to drive the majority of EUR/USD moves.

The ECB meeting on Thursday ([here's our economist's preview](#)) is the other major event to keep an eye on. We expect a 25bp rate hike, although there are some risks of a larger, 50bp, move. From an FX perspective, don't expect fireworks from the euro, as previous hawkish surprises showed the ECB's inability to lift the currency in the currently challenging risk and economic backdrop.

The chances of parity being retested remain high, and we struggle to see a significant rebound in EUR/USD for the moment. Expect exacerbated volatility around the 1.0000 level.

➔ GBP: A very busy data calendar this week

Following a weekend of TV debates, another round of voting in the Tory leadership contest will cut another candidate from the list and tell us whether Rishi Sunak has managed to hold on to his position as front-runner. Markets will keep an eye on this, but for now, the implications for sterling are likely to remain quite contained.

Data will be much more in focus in the UK in the coming days, especially tomorrow's jobs data and Wednesday's inflation figures. Headline CPI is expected to have accelerated to 9.3% year-on-year in June, while the core rate may have inched lower. Later this week, retail sales and PMIs should also have some market impact.

All in all, we expect this week's data flow to help markets fully price in a 50bp rate hike by the Bank of England (currently, 42bp is priced in), which could offer some moderate support to sterling. Bank of England Governor Andrew Bailey will deliver a speech tomorrow.

Still, global risk sentiment is expected to play a bigger role in driving GBP/USD for now, and we suspect that a return above 1.2000 is not likely at this stage. EUR/GBP may keep oscillating around the 0.8500 gravity line this week.

➔ CEE: CNB likely to clash with the market again this week

In Poland, core inflation for June will be published today. We expect an increase from 8.5% to 9.3% YoY in line with market expectations. On Wednesday we will see data from the labour market and industrial production. We expect June output to show consistently strong year-on-year growth above 13%, however, quarter-on-quarter momentum has already declined in previous months. Retail services, which will be released on Thursday, should also show a strong reading. In the rest of the region, we have a rather lighter calendar this week. Czech PPI, the last of a set of monthly numbers, will be released on Wednesday, and we also have the last week and a half until the Czech National Bank's blackout period begins before the August meeting so we can expect more comments from the board in the coming days. Over the weekend, we saw an interview with CNB's Oldrich Dedek who confirmed his view not to raise interest rates further and instead is in favour of continued FX intervention.

Finally, on Friday, after the close of trading, Fitch is going to publish its rating review for Poland and Hungary. Back in May, the agency downgraded the outlook from stable to negative for the Czech Republic, and we think the same move is possible for Hungary.

On the FX side, the Polish zloty finally broke below our level of 4.80, however, we see no room to go lower for now. Rates have fallen again in response to Governor Adam Glapinski's latest statement, and we only see further room for appreciation if rates are able to return to their June levels. The Czech koruna peaked near 24.30, as we expected, and we anticipate the market to reach CNB levels in the 24.60-70 range this week, which should trigger more central bank activity in the market compared to the previous week. However, Hungary's forint was the main surprise last week, managing to get close to 400, the strongest level in two weeks. Indeed, market rates reached new records, but we still believe that the forint will soon correct and move back above 405.

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