FX Daily: Higher bar for a weaker dollar

Markets are awaiting Israel's retaliation against Iran, which should determine whether oil goes higher. The dollar is in a solid position, and unless US data disappoints materially, the direction of travel could be a hawkish repricing in the USD curve to re-align with the Fed's 25bp-per-meeting guidance. The yen sell-off may have further to run

Brent crude prices are stabilising while awaiting Israel's retaliation against Iran

USD: On solid ground

Investors remain on high alert about the volatile Middle East situation. Brent crude prices are stabilising around $75/bbl while awaiting Israel's retaliation against Iran. It has been reported that the US is attempting to deter strikes on Iranian nuclear plants, which could be seen as a further escalation by Israel.

The most noticeable effect for FX has been a stronger dollar, although yesterday's price action seemed to default back to trading the US macro story. The stronger-than-expected ADP employment figures sent the USD 2-year swap rate back to 3.40%, some 13bp above last week's levels. The pricing for year-end Fed funds continues to largely embed a 50bp cut in either November or December, meaning room for further re-alignment with the Fed's less dovish rhetoric and consequently upside risks for the dollar. We sense that the bar for a dollar-negative reaction to US data today and tomorrow is probably higher after Fed Chair Jerome Powell's recent pushback against 50bp reductions.

Looking at today's data, ISM services may need to head back below 51.0 (consensus for a slight increase to 51.7) and jobless claims rebound to 230k to prompt a material USD correction. Unless market nerves on Middle East tensions ease, and oil corrects lower, the dollar may retain decent momentum into tomorrow's payrolls. The other release of the day is durable goods orders, and the Fedspeak calendar includes Jeff Schmid and Neel Kashakari, both hawkish-leaning FOMC members.

Francesco Pesole

EUR: Can break below 1.10 soon

Consensus is building rapidly around an October ECB rate cut. Yesterday, Isabel Schnabel – who at some points was considered the hawks' "spokeswoman" – admitted that the ECB "cannot ignore the headwinds to growth", especially given the progress on disinflation. This could be a sign that the hawks are throwing the towel on the October debate, and will accept another cut after the lower-than-expected CPI figures earlier this week.

The 2-year EUR swap rates are down 40bp since the start of September, and some 10bp over the past week, as 50bp of easing is priced in by year-end, with an October cut now fully expected. The euro can no longer count on a supportive short-term rate differential, and a EUR:USD 2-year swap rate gap at -110bp is consistent with EUR/USD back at 1.100, or slightly below that.

There is no key data or ECB speakers today. Barring soft US data or an oil correction, EUR/USD can test 1.1000 before the US payrolls.

Elsewhere in Europe, the pound is sharply underperforming following a surprisingly dovish tone by Bank of England Governor Andrew Bailey in a newspaper interview overnight. He suggested that the BoE could turn a "bit more aggressive on easing" if inflation continues to improve. The pound correction may extend to the 1.300 mark in the near term, as a probably long-due dovish repricing in the Sonia curve is paired with gradually higher USD swap rates.

Francesco Pesole

JPY: Ishiba hits the yen

The yen has been under severe pressure after the new Prime Minister Shigeru Ishiba said Japan is not ready for a new rate hike. This prompted a complete unwinding of bets that Ishiba would have focused on fighting inflation, which had led to some JPY appreciation and a Nikkei sell-off earlier this week.

With Bank of Japan (BoJ) Governor Kazuo Ueda echoing Ishiba's relatively dovish tone yesterday, the prospect of another hike by year-end is indeed starting to fade. There is still a CPI print to look at before the October BoJ meeting, but it seems unlikely the bank will hike on 31 October given yesterday's communication. It might be too early to completely rule out a December move, but it is now clear that would require a substantial inflation surprise.

The latest yen moves are probably part of a positioning adjustment after the recent build-up in JPY speculative longs. Now that the positioning is more balanced and markets have priced out BoJ tightening this year, another large move higher in USD/JPY would probably need to follow a hawkish repricing in the USD curve. As discussed in the dollar section above, Powell's latest comments may be helping such repricing in the coming weeks, meaning the JPY correction can extend to 150. We believe there can be good resistance forming around the 150-152 region, where 100- and 200-day moving averages converge.

Francesco Pesole

CEE: One step closer to first rate cut in Turkey but still behind the market

Yesterday's widely expected National Bank of Poland decision to leave rates unchanged at 5.75% will be followed by a more important governor's press conference today. However, before that we will see September inflation numbers in Turkey, closely watched by the markets. Our economists expect a further decline from 52.0% to 48.3% year-on-year and 2.2% month-on-month, in line with market expectations, mainly due to a supportive base effect, despite administrative price adjustments and no respite from services. The lagged effects of monetary tightening on credit and domestic demand, combined with the continued real appreciation of the lira, will likely keep the underlying inflation trend on a downward path for the remainder of this year.

Of course, the market is keeping a sharp eye on the rate of disinflation and the downside surprise in previous months has led to significant dovish repricing betting on an upcoming rate cut by the Central Bank of Turkey. We expect a first cut in November or December in the baseline scenario but no cut this year can also not be ruled out. USD/TRY has stabilised after the August move up and September seems more steady again, which is an opportunity for the market to collect some carry in the lira once again, especially in the current global volatility from which the TRY market seems disconnected.

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