FX Daily: How much more fuel in the disinflation tank?

Last week's US disinflation shock altered the FX landscape, but a few days without key data releases will tell us whether that impulse can keep the dollar on the back foot as the FOMC risk event draws nearer. EUR/USD appears a bit overstretched in the short term and could face a correction this week

USD: Some caveats to the bearish narrative

On Friday, we published FX Talking: The dollar's break point, where we discuss our updated views on G10 and EM currencies and present our latest forecasts. The radical shift in the FX positioning picture since the US CPI and PPI releases last week now forces a reassessment of the dollar outlook. The Commodity Futures Trading Commission (CFTC) data on speculative positioning offers little help in understanding how much dollar positioning has changed since the latest reported positions were as of Tuesday, before the inflation report. Back then, the weighted aggregate positioning against reported G9 currencies (i.e., G10 excluding SEK and NOK) had already inched into net-short territory (-2% of open interest, in our calculations).

When making the parallel with the November-December 2022 dollar decline, positioning shows a key difference. At the end of October 2022, markets were still speculatively long on the dollar (around 10% of open interest against CFTC-reported G9). Another important factor – especially for EUR/USD – is the degree to which other central banks outside of the US can still surprise on the hawkish side, which is significantly lower than it was last autumn.

These caveats to the rather compelling bearish dollar story mean that it may not be one-way traffic from here in FX, even if we see the dollar weaken further into year-end. On the fundamental side, the disinflation story puts risk assets on a sweet spot, favours a re-steepening of the US yield curve and should make pro-cyclical currencies more attractive. However, the Federal Reserve may not turn into a USD-negative that swiftly. Our US economist still sees a 25bp hike next week as likely. It is fully priced in, but will the Fed be ready to throw the towel on more hikes just yet? Core inflation is declining, but the jobs market remains very tight and other economic indicators remain resilient. The dot plot is still showing another hike before a peak and Fed Chair Jerome Powell may prefer to err on the hawkish side, especially through a rate cut pushback (first cut priced in for the first quarter of 2024).

This week will be interesting to watch since the lack of tier-one data in the US will offer a clue on how FX markets will trade from now on; the question is whether investors now see enough reasons to add short positions on the dollar ahead of the FOMC or take a more cautious approach. The latter – which appears marginally more likely in our eyes – may see the dollar reclaim some portions of recent losses. DXY could find some support after climbing back above 100.00.

Francesco Pesole

EUR: Rally looks a bit stretched

EUR/USD is trading at the highest levels since early 2022, and CFTC data showed that pre-CPI positioning on EUR/USD was already quite stretched on the long side (+19% of open interest). We also estimate there is currently a 2% short-term risk premium built into EUR/USD, based on our financial fair value model which includes rates and equity factors. This short-term overvaluation gap of EUR/USD could be closed either by a correction or by some EUR/USD-positive factors rising without triggering a climb in the pair.

The week is rather quiet data-wise in the eurozone, but we'll hear from European Central Bank President Christine Lagarde and other ECB speakers today at a conference organised by the Bank. This is one of the last occasions that could influence market expectations ahead of next week's policy meeting, even though a July hike is likely a done deal and the debate appears already entered about September.

We see some moderate risks of a correction in EUR/USD this week, possibly to the 1.1100/1.1150 area. A continuation of last week's rally may start to face increasing resistance at the 1.1300/1.1350 area.

Francesco Pesole

GBP: CPI is a big risk event

Our team discussed here how the latest UK wage growth figures likely paved the way to a repeat 50bp hike by the Bank of England in August. The faster-than-expected inflation deceleration in the US hit the pound in some non-dollar crosses, largely because of the vulnerability of the ultra-hawkish BoE market rate expectations.

Such vulnerability of the pound remains very much present now as markets continue to factor in 130bp of tightening to a peak in the UK, leaving ample room for dovish repricings. This week's UK CPI print is thus a major risk event for sterling since signs of deceleration in price pressure would likely nudge the dial in favour of 25bp over a half-point hike in August. Markets currently price in 45bp for August, so the downside risks likely exceed the upside for the pound.

Francesco Pesole

CEE: Global conditions boost the region

This week in the region offers only secondary data and should bring some calm. Today we will see core inflation in Poland. We expect a drop from 11.5% to 11.1% year-on-year. Tomorrow in the Czech Republic, PPI numbers for June will be released. With the August CNB meeting also approaching, we can expect the first comments from board members trying to fight dovish market pricing. Thursday will see the release of wage and industrial production statistics in Poland. IP fell by 2.2% YoY according to our estimates, more than the market expects. Nominal wage growth has stabilised at low double-digits at 12.1% YoY. Poland's retail sales numbers will be released on Friday and we expect a 5.5% YoY decline, also slightly more than the market expects.

CEE FX showed a strong rally last week – especially the Hungarian forint due to global conditions. We expect the same story this week. The region should still benefit today from EUR/USD's move higher late last week. Sentiment remains open to risk and the renewed fall in gas prices to the lowest levels since early June is playing into the hands of the Hungarian forint in particular. The calendar in the region has little to offer and so the main focus will be on the global story. Overall, we expect further gains across the region albeit at a slower pace. The Hungarian forint remains our favourite in the CEE region. We expect the forint to strengthen further below 373 EUR/HUF. However, we also expect further gains from the Polish zloty and Czech koruna with moves below EUR/PLN 4.40 and EUR 23.70/CZK.

Frantisek Taborsky

Authors

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com