FX Daily: Investors fall out of love with Latam

A less dovish than usual press conference from Fed Chair Jerome Powell has seen the dollar retrace about half of yesterday's drop on the back of the soft US May CPI figure. Today the focus will be on US May PPI and its readover to the core PCE release on 28 June. Elsewhere, politicians in Mexico and Brazil are prioritising domestic agendas over market stability

USD: Taking cues from today's PPI figure

The DXY dollar index has retraced about half the losses it suffered on the back of yesterday's softer-than-expected May CPI print. Driving that recovery was yesterday's FOMC meeting and press conference, where it seemed that the main message from Chair Powell was that inflation forecasts were being revised higher and the Federal Reserve easing cycle could be delayed - according to the median Fed expectation. In this space, we noted previously that Powell had proven dovish over the previous four press conferences. Perhaps he felt he did not have the room for dovishness given the new inflation forecast and the dot plot adjustment. Please find our full analysis of yesterday's Fed meeting here.

Yet the dollar is net lower after the May CPI release, and attention turns today to the US May PPI release. Here, the market looks at the breakdown of some of the key inputs such as medical costs and auto insurance and, given the two series use the same methodology, reads over the implications from the PPI data to the Fed's core PCE data. The latter is released on 28 June. A soft PPI reading today will raise expectations of another 'on-target' 0.2% month-on-month core PCE reading and give both the Fed and the market a little more confidence that the central bank may be able to cut rates in September after all. This is why we have a down arrow on the dollar today.

By closing under 104.95 yesterday, DXY has undone Monday's bullish break-out and probably means we are in a 104.00-105.50 trading range until further notice. As we highlighted in our Fed review piece, if the dollar is to weaken on softer price data, it should again be the high beta G10 commodity currencies that outperform. The Australian dollar and Norwegian krone are in focus here.

Chris Turner

EUR: French bonds receive a reprieve from US CPI

French political risk took a back seat yesterday as the softer US May CPI lifted bond markets around the world and allowed a recovery in French bond markets. Remember this asset class is the embodiment of French political risk. Still EUR/USD did well to spike to 1.0850 yesterday and probably argues that we are in some kind of broad 1.0720-1.0900 trading range for the near term. Here, the two opposing forces will be softer US price and activity data potentially dragging the dollar complex lower set against French political risk, where a further risk premium could still be built into the euro.

We think the euro will continue to underperform on the crosses - as it should anyway if the US yield curve bull steepens. Lower EUR/AUD and EUR/NOK should now be in focus.

The eurozone calendar is light today. We just have April eurozone industrial production hoping to string together the first set of three consecutive increases for the first time since January 2023.

Chris Turner

GBP: Soft CPI heading to the UK soon

Yesterday's softer-than-expected US May core CPI reminds us that we may see the same trends coming to UK shores soon. UK May CPI is released next Wednesday and the sticky core services component (5.9% year-on-year in April) may well come down.

Our UK economist, James Smith, had a good call on the sticky April CPI data (annual index adjustments) and believes the May data will be a lot calmer. That is why we are reluctant to chase the current rally in sterling and can probably see the top of this year's range holding for GBP/USD at 1.2850/2900. And despite French political risk, we see EUR/GBP trading back up to 0.8490/8500 next week as UK rates are repriced lower.

Chris Turner

Latam: The 'pink tide' finally hits Latam's shores

Back in November 2021, we were writing about the 'Pink tide' - the shift to the left in Latam politics and what it would mean for local currencies. At the time, we were previewing 2022 elections in Brazil and Colombia. In the subsequent years and up until recently, Brazilian and Mexican assets had been performing quite - or very - well. In Brazil, the Lula administration's commitment to a new fiscal rule last year gave investors a lot of confidence that President Lula's social welfare programmes would not derail the budget. And in Mexico, President AMLO's conservative handling of government debt through the pandemic and macro-political benefits (nearshoring etc) helped Mexico perform well.

Yet asset markets in both Brazil and Mexico have now come under a lot of pressure - largely as both governments are returning to their roots. In Mexico, the issue is one of a new super-majority for the Morena party allowing President AMLO and his successor, Claudia Sheinbaum, to shift to a more socialist agenda and also attempt to remake Mexico's judicial and electoral institutions. This worries international investors. Fortunately, Mexico's independent central bank is trying to provide some stability in financial markets and is today organising a switch operation in the government bond market. However, the Mexican administration sounds like it wants to push ahead with its reform agenda - which will hang over markets for the next several months. Given that long peso positions were several years in the making, we are now concerned that USD/MXN is a 20/21 story this summer.

In Brazil, we are starting to hear some worrying rhetoric from President Lula. His finance minister's efforts at fiscal consolidation were shot down in the Senate on Tuesday. Worryingly, President Lula said yesterday that public investment should not be compromised and that rising revenue and falling interest rates would allow Brazil to hit its fiscal targets. Lower interest rates? Brazil's local currency government 10-year bond yields are currently pushing to the highs of the year at 12.25%. And references to lower rates will unnerve investors that political pressure will grow on the Central Bank of Brazil (BACEN) to cut rates. Recall the real was hit last month when all four of the political appointees on the board voted for a 50bp rate cut compared to the 25bp vote from the other five members. There is another BACEN meeting next week. Again the voting patterns will be scrutinised. USD/BRL looks a 5.50 story - possibly higher.

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