

## FX Daily: Looking beyond the squeeze

The dollar long-squeeze continues to support G10 FX, but a more balanced positioning picture may soon allow the supportive monetary and growth considerations for USD to re-emerge. This week, PMIs in the eurozone and the UK will be watched closely to gauge the risk of stagflation. Elsewhere, Australia's election result should be no game-changer for AUD



New US dollar loans are choosing between term SOFR and SOFR in arrears

### ⬇️ USD: Still feeling the long squeeze

European stocks are higher and US equity futures are pointing to a positive start to the week, as global risk sentiment continues to drive the majority of FX moves amid strong volatility. This morning, the Australian and New Zealand dollars are leading the rally against the dollar on the back of risk-on sentiment and yet another strong day for the Chinese yuan. Reports that President Biden is considering lifting some of the tariffs on China are also helping. We doubt the Australian election had much of an impact – as discussed in the AUD section below.

At the moment, it still appears the market is in the process of rebalancing a positioning picture that was heavily skewed towards a long dollar. Given the large and widespread unwinding of dollar longs in the past 10 days, we suspect such a position-squaring effect may start to run out of steam soon, and markets will be left once again with the prospect of aggressive monetary tightening by the Fed (three back-to-back 50bp hikes are on their way, in our view) and a widening growth differential between the US and other parts of the world – in particular, Europe.

The positive outlook for the US economy, despite recession fears, should be confirmed by the flow

of US data this week, with the focus mostly on the April personal income and spending report, which will also include the Fed's favoured measure of inflation – the core personal consumer expenditure deflator. This should show decent real spending growth with households prepared to run down some of the savings accumulated through the pandemic, and inflation topping out, which could help to ease growing recession concerns.

The FOMC minutes from the May meeting should see a confirmation that 50bp rate increases in June and July are backed by the vast majority of members. We'll also hear comments from Fed Chair Jay Powell later this week. Today, the data and Fedspeak calendar are quite quiet.

All in all, we think that the USD long-squeeze may add some extra pressure to the greenback in the coming days, but we see a higher probability this week that the dollar will find some stability or show signs of rebounding given the still supportive monetary and growth outlook for the US. The 101.00-101.50 area could represent the bottom of the dollar correction.

## **EUR: Rally may soon run out of steam**

EUR/USD is pressing the 1.0600 resistance at the time of writing, still benefiting from a soft dollar environment, but still not showing clear signs of building idiosyncratic EUR strength. This week, markets will keep a close eye on PMI data in the eurozone. An intensifying debate around the stagflation risk elevates the importance of high-frequency data, although PMIs, which have had a tendency to surprise to the upside, have also had a quite negligible impact on the euro in recent months.

Indeed, there appears to be quite limited room now for a further re-pricing higher of ECB rate expectations, considering that around 90bp of tightening are already fully priced in, and recent comments by ECB members have mostly fallen on the hawkish side of the spectrum.

Today, another high-frequency release will be watched, the Ifo business survey out of Germany, along with some ECB speakers (Holtzmann, Nagel, Villeroy and de Cos). The IMF World Economic Forum in Davos has started, and we'll see ECB President Christine Lagarde deliver remarks along with other governing council members later this week.

We think the upside room for EUR/USD is shrinking and with the dollar potentially stabilising or mildly rebounding, the rally may start to look quite tired as it approaches the 1.0700 mark. Beyond the very short-term, a return to 1.0500 appears likely in our view.

## **GBP: Shrugging off the downside risks (for now)**

Economic surveys will be very much in focus in the UK as well, especially given how central the growth outlook has become for the Bank of England's tightening plans. The pound has enjoyed a solid rebound, both against the dollar (back above 1.2500) and the euro (EUR/GBP having moved in the lower-half of 0.8400-0.8500 this morning). Still, downside risks remain material for the pound, both due to a potential forced dovish re-pricing of BoE rate expectations (currently at 2.20% for year-end) and a resurgence of Brexit-related concerns.

Those risks may take time to materialise though and the pound may retain some good momentum this week, especially against the euro, and EUR/GBP may break below 0.8400.

## AUD: Not many implications from change in government

As briefly discussed in the USD section above, this morning's strength in the Australian dollar appears once again fully motivated by external factors. The result of the election in Australia does not appear to be a straightforward positive or negative for the AUD, also considering it was in line with projections. The Labor Party leader, Anthony Albanese, was sworn in as Prime Minister this morning, and appears on track to secure a fully-fledged majority in the parliament.

Labor's manifesto leads with improvements to medicare, investing in vocational training, and cheaper childcare. Although it is possible that Labor will represent a slightly more fiscally supportive government than its predecessors, we don't see many implications for financial markets from this election result.

AUD remains strictly tied to China-related sentiment (which has improved lately) and global risk dynamics. For now, AUD/USD should be able to hold above 0.7100, although some material downside risks persist.

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