

FX Daily: Middle East turmoil strengthens dollar position

Israel's retaliatory strike on Iran overnight triggered an initially big reaction across asset classes, although markets appear moderately less concerned at the European market open. Safe-haven currencies are leading the pack, and there are now risks of a more structural bearish turn on EUR/USD



USD: FX to trade only on geopolitics today

It was reported overnight that Israel launched a retaliatory strike on the Iranian city of Isfahan. For now, it appears that Iranian media are downplaying the size of the attack, and reassured that nuclear facilities have not been affected. The news has had ramifications for different asset classes already, although the initial impact has partly been unwound in the early morning hours. After spiking above \$90/bbl, Brent is trading at \$89 at the time of writing, while the Nikkei dropped to as much as 3.5% but has now trimmed losses to 2.4%. Equity futures point to a -0.5/-1.0% open across US and European main stock indices while US 10-year treasury yields briefly traded at 4.50% before rising back to 4.55%.

The FX market has mirrored the initial large impact and subsequent partial reversal observed across other asset classes. Safe havens are in demand, led by CHF, then JPY and the dollar, while

antipodeans are the biggest underperformers. Markets will be monitoring today's headlines very closely, trying to gauge the risk of the Iran-Israel tensions spiralling into a fully-fledged conflict in the region.

If we see a further escalation, we think NZD, AUD, SEK and NOK could lead the losses in G10. The correlation of NOK and AUD with a potential spike in commodity prices is often overshadowed by the risk-sentiment factor. In the high-beta space, CAD should emerge as a relative outperformer, as it would benefit from the higher oil prices and its geographical distance, and also thanks to greater correlation with strong US data and USD. The yen can benefit from a combined effect of lower rates and risk correction, as well as potential acceleration in the Bank of Japan tightening cycle if energy prices raise inflation concerns. The Swiss franc is also in a very good position to extend its rebound, particularly given its previous role as a hedge during the 2022 European energy crisis.

JPY and CHF could gain more than the dollar in a geopolitically-driven risk-off scenario, but the dollar may be able to hold on to gains more easily once some geopolitical risk is priced out. That is because markets have received greater incentives to turn structurally more bullish on the dollar of late. A return to \$100+ in oil prices may convince the Fed to throw in the towel on hopes of monetary easing for now, and a potentially magnified impact across EM currencies of geopolitical risk would fuel a substantial rotation back to the dollar. Some of the EM strength had been triggered by popular carry trades, which aren't only being unwound due to Middle East turmoil, but fundamentally as the Fed is on a diverging path from other dovish central banks.

Today, expect geopolitical news to dominate. The US calendar is incidentally empty, and the shift in the Fed narrative to a more hawkish stance is hardly surprising at this point. It remains to be seen, however, how far FOMC members want to push the narrative of potential hikes at this point. The Philadelphia Fed Business Outlook survey – released yesterday – jumped to the highest in around two years, and while many other surveys are pointing to a less bright picture, the latest hard data has endorsed the few optimistic activity surveys, if anything. Risks remain skewed to a rally to 107.0 in DXY.

Francesco Pesole

📌 EUR: Middle East turmoil overshadows ECB factor

The euro isn't as exposed as higher-beta currencies to a potential escalation in the Middle East, although extending the dollar considerations above, substantially higher energy prices could lead to a more structural bearish stance on EUR/USD. While we have been highlighting how a much stronger terms of trade and economic-fundamental position of the euro compared to 2022 hardly points to EUR/USD parity at this stage, it is possible that markets price in a deterioration in economic conditions in the eurozone as a consequence of higher geopolitical risk.

When it comes to how the ECB decisions might feed into the FX impact, we can identify two main scenarios. If the Middle East situation spirals into a fully-fledged conflict, and there is a major correction in equities and big commodities rally, then a potential delay in ECB easing plans would hardly do much to support the euro. Remember how in 2022 the ECB was delivering large rate hikes, but the euro remained under pressure. In a second scenario, where geopolitical events fail to generate a major equity and commodity shock, then the ECB decision on whether to go ahead with rate cuts would have a much bigger say on EUR/USD direction.

While markets monitor closely how the situation evolves in the Middle East, the downside risks for EUR/USD have undoubtedly risen overnight, and the 1.0600 support may not hold for much longer.

Francesco Pesole

📉 GBP: Soft UK retail sales

UK March retail sales have come in slightly softer than expected this morning. That has clearly been overshadowed by news from Iran, but retail sales should not change the picture anyway for the Bank of England.

Anyway, data this week has pointed to a lower probability that the BoE will start cutting rates before August, which is the month when our economist expects the first move.

That has led us to believe that EUR/GBP will struggle to find much support in the short term, despite our medium-term call on the pair being moderately bullish. If we do see a geopolitical risk escalation, GBP should, however, be in a more vulnerable spot than the euro, given the pound's higher sensitivity to global risk sentiment and CFTC data showing that GBP has the largest net-long positioning in G10.

Francesco Pesole

➡ JPY: Lower than expected CPI in Japan

Overnight developments have been driving the yen higher, although domestic developments may have contributed to JPY lagging the Swiss franc in this risk-off environment.

Japan's national inflation figures came in below expectations this morning, with headline CPI slowing from 2.8% to 2.7%, and core CPI from 2.8% to 2.6%. Core inflation excluding fresh food and energy actually moved below 3.0% for the first time since 2022.

Our Japan economist discusses what the implication of the release could be for the Bank of Japan's tightening prospects [in this note](#). While a pause at the April meeting is largely expected, we still think risks are skewed to an earlier hike compared to what the market is currently pricing. Market expectations are currently for a move in October, while our economist is calling for a 15bp hike in July followed by a 25bp hike in October.

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