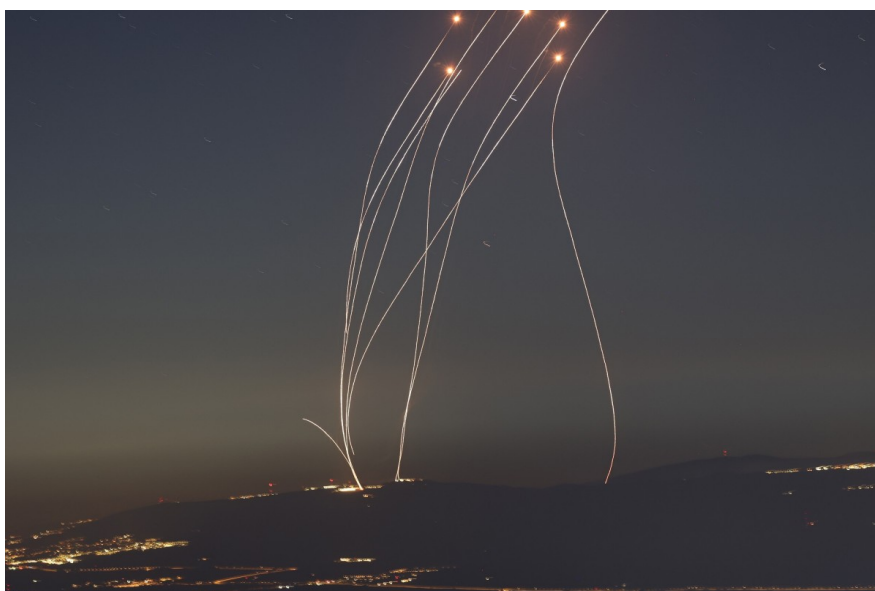


FX Daily: Middle East turmoil takes over

The rapid escalation in Middle East tensions sent oil higher and high-beta currencies lower against USD and CAD. The magnitude of Israel's retaliation against Iran will determine the inclination of markets to price in more geopolitical risk. This can out-shadow the US macro story before US payrolls on Friday



The Israeli Iron Dome air defence system intercepting missiles

➔ USD: Geopolitical risk helps the dollar

Escalation in the Middle East has led markets pricing in a greater risk of a fully-fledged conflict in the region, which could potentially involve the US. Iran fired missiles at Israel yesterday evening, and while most were intercepted (the US called the attack “ineffective”), some targets have been reportedly hit. Israel has pledged to retaliate against Iran as it continues its ground offensive in parts of Lebanon.

Oil rallied on the news that Iran was preparing a missile attack yesterday, and stalled overnight around 74-75 USD/bbl while awaiting the magnitude of Israel's retaliation. The situation remains highly volatile, but if Israel's response is not too aggressive (perhaps refraining from targeting Iran's nuclear infrastructure), markets may take the view that both countries are for the second time this year preferring to de-escalate after a brief hostile exchange.

The dollar strengthened on the back of rising geopolitical tensions, with the Canadian dollar also

rallying thanks to the oil price jump and a rotation away from more geographically exposed or simply higher-beta currencies like SEK and NZD.

Domestic US developments have been overshadowed by geopolitics, but it has been an intense week already both on the macro and political side.

The vice-presidential candidate debate for the US election didn't attract much attention. The media appears to slightly favour the Republican candidate as the debate winner, but this event doesn't seem to significantly impact the overall election outcome. This is reflected in the subdued market reaction, especially when compared to the main candidates' debate three weeks ago. Meanwhile, data is broadly endorsing Fed Chair Jerome Powell's recent pushback against a 50bp cut. While the ISM manufacturing was a bit softer than expected and prices paid dropped below 50.0, the Fed is laser-focused on the jobs market, and the surprise rebound in job openings for August is contributing to a bullish short-term case for the dollar.

Ultimately, Friday's payrolls will be the usual binary event for FX, although Powell's hawkish comments and the market's dovish pricing (still 70bp of cuts priced in by year-end) mean the bar for a USD-negative jobs report is higher. Today, we'll see the ADP jobs figures, which can move the market but rarely have any predictive power for payrolls. Geopolitical events should remain the main driver.

Francesco Pesole

➔ EUR: Negatives piling up

In yesterday's FX Daily, we pointed out how EUR/USD looked expensive in light of wider rate differentials (in favour of USD) and rising risks from the Middle East and French politics. Ultimately, it was the Israel-Lebanon-Iran tensions that triggered a move below 1.110, but the other two factors also remain negative for the pair.

French Prime Minister Michel Barnier faced a rough first speech in the Parliament, drawing criticism from both left- and right-wing factions as he laid out his policy plans. Despite a central pledge for fiscal consolidation, he delayed the plan to bring back the deficit within the 3% EU limit by two years, to 2029. That kept OATs offered, and the 10-year spread with bunds close to 80bp. Our rates team is doubtful there is much respite in sight for French bonds.

On the rates side, short-term differentials look unlikely to retighten sharply in the near term in favour of EUR, as markets are already pricing in 70bp by year-end from the Fed and yesterday's decline in eurozone's inflation below the 2% target means significant pressure on the ECB to continue cutting at the October meeting.

We retain our call for EUR/USD re-testing 1.1000 in the short term.

Francesco Pesole

⬇️ CEE: Full risk-off mode activated

The FX market has fully switched into risk-off mode and the whole emerging market space took a hit yesterday. The CEE region led the losses days before, so it was left behind yesterday. However, the situation in the Middle East does not seem close to calming down and while we are getting more dovish news from the developed market world, CEE currencies are likely to remain under

pressure for some time but fundamentals for a fading move later remain strong in our view. EUR/USD rapidly sliding lower will continue to keep CEE currencies under pressure. On the other hand, rates are resisting pressure from core markets and rate differentials are hitting record highs across the board.

Although we can assume that local rates will not hold current levels for long if core rates continue yesterday's trend, in Poland and the Czech Republic more than enough rate cuts have already been priced in and downward space is limited. Additionally, we might receive some hawkish news from Poland's central bank this week and from the Czech Republic with the release of September's inflation data next week. So across CEE, we see a growing FX and rates market divergence that will have to be closed at some point in the future, opening the door for fading the current FX weakness. The Polish zloty seems most appealing with the central bank meeting this week, while the Czech koruna may be attractive later. The Hungarian forint, on the other hand, will have the hardest path to finding stable ground within the CEE peers, in our view.

Frantisek Taborsky

➔ **PLN: Central bank to discuss timing of rate cuts**

Today we will have the National Bank of Poland's decision on rates. It is hard to expect anything other than no change at 5.75%. So today we will rather watch the central bank's statement but more importantly the Governor's press conference tomorrow. Clearly, the market will be looking for some hints on the timing of rate cuts next year. Already at the last press conference we saw the communication move from hawkish in July to dovish in September and we could hear something similar this time. Still, in his last press conference the governor left open a wide range of possibilities from the first to third quarter of 2025 depending on inflation. On the other hand, his colleagues are focusing on the first or second quarter. Our economists prefer the second quarter as the start of rate cuts and see 100bp overall next year.

The zloty, like the rest of the CEE region and the EM world, came under pressure as part of the risk-off mood in the markets. However, this does give us interesting levels at 4.290 EUR/PLN, the highest since the first half of September, ahead of the central bank meeting and press conference. The dovish shift has already passed, but the market is overshooting rate cut expectations in our view, which could lead to some hawkish repricing. The first rate cut is set for around January and 180bp for the whole of next year. Although in the current global conditions it may be difficult for rates to find a way up, still in relative terms the differential should improve, while attention could turn to the local story at least for a while. While we don't see the possibility of a fade moment right now, PLN may be the first currency in the CEE region to try to reverse some losses among its peers.

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