FX Daily: Modest dollar rebound is possible

There is probably some room for a small rebound in the dollar as the effect of Powell's Jackson Hole speech wears off and risk sentiment softens. EUR/USD could re-test 1.1100 in the coming days, although the conditions for a major unwinding of the recent rally are not there. Some tentatively encouraging news on Australian inflation shouldn't bother AUD

USD: Reaction to Powell looked a bit overdone from the start

A round of risk aversion is hitting the FX market this morning as the Chinese earnings season has failed to offer any real support to Asian equities and the impact of Federal Reserve Chair Jay Powell's speech on Friday wears off. The DXY dollar index has modestly rebounded since the start of the week, largely driven by the weaker EUR/USD, and one can probably argue another small leg higher in the greenback against pro-cyclical peers is warranted now.

After all, the OIS pricing for 100bp of easing by year-end means markets are positioned for a soft landing paired with no more inflation bumps. And while Powell's explicit rate cut guidance has some significance, investors had fully priced in easing well before Jackson Hole and the negative

USD reaction to the speech looked a bit overdone from the onset.

To be clear, we are not calling for a big dollar rally at this stage. Falling USD rates have made the greenback significantly cheaper to short and generalised dollar weakness is entirely consistent with Fed easing prospects being passed through to asset markets. However, the risks from a technical (including positioning) perspective and rate differentials are undoubtedly more balanced, and in the very near term slightly upside-tilted for the dollar.

We discussed yesterday how another major USD leg lower may require markets to fully embrace the possibility of a US recession, so perhaps the lack of tier-one US data this week is good news for the dollar. The only event of the day is a speech by the Fed's Raphael Bostic, who is generally considered hawkish-leaning and may not push the easing narrative much further. DXY can break and find some support above 101.0 in the next couple of days.

Francesco Pesole

EUR: ECB decoupling to be tested

The EUR/USD drop this morning appears largely USD-driven, although admittedly the euro does look on less stable ground when considering the room for European Central Bank dovish repricing compared to the Fed's. The two-year OIS USD:EUR spread tightened again below 100bp after Powell's speech (now at 96bp). That could argue for EUR/USD above 1.12 but the softer risk environment is favouring some profit-taking, and there may be some speculation that some rewidening in that rate differential is due.

Indeed, markets are pricing in one 50bp move by the Fed by year-end (100bp in total), but only 64bp by the ECB over the last three meetings of 2024. The investor community may not be consistently at ease with this decoupling of Fed-ECB rate expectations, and the risks are probably that some easing is priced back into the ECB curve (even without strong data catalysts) to realign it with the Fed. Germany's return to recession in the second quarter is a narrative that can contribute to that realignment.

EUR/USD may struggle to trade back closer to 1.120 in the next few days as the lack of key US data probably favours the dollar on the margin, and a retest of the 1.110 support is possible. But we don't see the conditions for the recent EUR/USD rally to be substantially unwound. From tomorrow, eurozone CPI figures will start pouring in, which will be a key test for that ECB-Fed decoupling story.

Francesco Pesole

AUD: Cautious optimism on disinflation

For the second consecutive month, there is some tentatively encouraging news on inflation for the Reserve Bank of Australia. Monthly headline CPI eased from 3.8% to 3.5% year-on-year in July. That was above the 3.4% consensus, but the slowdown in the trimmed mean (i.e. core) from 4.1% to 3.8% made up for that.

The Aussie dollar followed Australian bond yields higher right after the release, but is now trading back below 0.680. As discussed here, there are reasons to be cautiously optimistic on Australian disinflation at this point, but we still see market pricing for one RBA cut in December as too dovish and think easing will only start in 1Q25. Remember that RBA rates are at 4.35%, which is still below the rates expected of the Fed and the RBNZ (both 4.50%) by year-end.

Some short-term USD rebound can put some pressure on AUD, but it seems too early to rule out that the 0.6850 December-2023 highs will be tested.

Francesco Pesole

MXN: Judicial reforms take their toll

The peso closed at its lowest levels of the year against the dollar yesterday as investors continue to take a dim view of the ruling Morena's party constitutional reforms. Very much in focus currently are the judicial reforms centred on judges – including Supreme Court judges – being elected by popular vote. Outgoing President AMLO says his reforms seek to reduce corruption in the judiciary. Many others say the reforms represent an alarming concentration of power.

Worrying for investors is that these judicial reforms passed the committee stage on Monday without being watered down at all. And we should expect more peso volatility over coming weeks as the reforms are debated in Congress as the government seeks to secure a two-thirds majority in both the lower house and the Senate. And unlike in Brazil where the central bank could well be hiking rates on 18 September (on a day when the Fed will be cutting), the peso looks unlikely to receive any support from the central bank. Here Banxico is trying to steer a clear course to lower rates. Let's see whether Banxico's inflation report released today adds weight to Banxico's optimism on the path to lower core inflation – probably a peso negative if it does.

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