FX Daily: New quarter, same old dollar strength

The second half of the year started with markets re-entering defensive FX positions after the impact of quarter-end flows faded. This time, USD strength is emerging against commodity currencies in particular. Today, all eyes will be on the US manufacturing ISM and the eurozone-wide CPI figures, and there are some key releases to watch in the CEE space too

USD: Still in demand

The first six months of 2022 have been marked by the dominance of the dollar, with all G10 currencies scoring losses ranging from 2% (the Canadian dollar is the second best-performing currency) to 15% (Japanese yen). As we enter the second half of the year, we must ask ourselves in which way the drivers behind the dollar rally in 2022 – primarily the aggressive Fed tightening and an adverse risk environment – will play out in the remainder of the year. Our view remains that the dollar should continue to count on a rather solid floor in the third quarter thanks to the Fed's front-loaded rate hikes and a still challenging environment for global risk assets due to tighter liquidity and fears of a global slowdown. Some moderate dollar weakness may start to emerge in the fourth quarter when US rates peak. We discuss all this in our recent EUR/USD scenario analysis.

Turning back to this week's price action, quarter-end flows seemed to generate some dollar selling yesterday despite the widespread underperformance in global equities. Once the impact of end-of-period flows faded, markets rapidly re-entered defensive FX trades, with commodity currencies (Australian and New Zealand dollars in particular) coming under material pressure during the Asian session. While recession concerns remain the primary driver of weakness in the high-beta commodity-FX segment, the recent correction in commodity prices has left the segment even more vulnerable.

Today, the US calendar includes the ISM manufacturing index, which is expected to have dropped further. Late last week, we saw how bad data could help risk sentiment in certain circumstances as it supports a less aggressive Fed stance on tightening. Let's see if we witness a similar reaction to a potentially larger-than-expected drop in the ISM today, a scenario that could see the dollar lose some ground today, even though we continue to see any dollar correction as short-lived at this stage.

EUR: Limited impact from CPI?

EUR/USD continues to trade very close to the 1.0500 gravity line, as a week of central bank speeches in Sintra has not materially impacted global rate expectations, including from the European Central Bank, where the swap market continues to see 140bp of tightening by year-end.

Today, all eyes will be on the eurozone-wide CPI figures for June, after the surprise drop in German inflation and above-consensus readings in France and Spain. The euro appeared to have a reduced sensitivity to the inflation prints this week, and this may well be the case today as markets seem to have cemented their ECB tightening expectations. EUR/USD should remain mostly a function of global risk sentiment and USD dynamics, and may end the week in the 1.0430-1.0500 range.

Elsewhere in Europe, the Riksbank hiked by 50bp yesterday, and signalled two more half-point moves in September and November are likely. We discuss here why the krona's reaction has been muted, and why we think EUR/SEK will remain generally supported in the near term before trending lower in the latter part of the year.

GBP: Downside risks persist

The UK data calendar doesn't include market moving releases today. Brexit-related headlines should continue to come in over the coming days, but the pound may remain little touched by them for now. In our view, a re-pricing of aggressive Bank of England expectations is the biggest risk for the pound, which also remains exposed to further risk sentiment instability.

Should we see a break below 1.2100 in cable, the 1.1950 low could be re-tested soon. When it comes to EUR/GBP, an almost equally unattractive euro should keep the pair around 0.8600.

CEE: Heavy calendar kicks off the second half of the year in the region

Inflation for June will be published in Poland today. Our team in Warsaw expects a further acceleration from 13.9% to 15.4% year-on-year, and we do not expect an upside market surprise this time. As usual, this will be the final piece to the puzzle ahead of next week's central bank meeting. It is also the first June inflation number in the region, which will pave the way for other countries.

Next, PMIs for June will be released across the region. May's numbers showed a surprisingly strong deterioration in sentiment. In Poland, we even got below the 50-point breakeven mark. Further declines can be expected for June in all countries, but the question is how much economic growth is at risk.

In the Czech Republic, the Czech National Bank minutes from the last meeting under the outgoing governor are due to be released. Coincidentally, the term of the new CNB governor starts today.

From an FX perspective, we think the zloty has the most potential in the region for new gains at the moment and especially in the context of the decline in market rates in recent days. We think the CPI print will be a welcome boost for the hawks and a reminder that the central bank has not yet had its final word. In our view, this could bring the zloty back to 4.650 EUR/PLN. The forint confirms our view that 395 per euro is an undefeatable threshold in current conditions and the koruna remains under the CNB's rule around 24.75 EUR/CZK.

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