

FX Daily: Preparing for deflation reality checks

Asset markets have now fully absorbed the re-tuning of communication by central banks over the last two weeks. Now, it's time for data to offer some direction, especially in the US. CPI data tomorrow may help build expectations around a May hike, and the dollar could find a bit more support. On Thursday we will see the ECJ's decision on Polish FX mortgages



USD: Data in the driver's seat

A key takeaway from the recent fluctuations in major G10 pairs is that, at this stage, data matters much more than central bank communication. The mass of hawkish comments - ranging from modest to aggressive - seems rather predictable in light of the markets' early-February dovish run and strong jobs data in the US. However, more than providing direction to the market in terms of the next central bank moves, recent communication merely offered some tools to assess central bankers' reaction function to data, and reinforced the notion that data-dependency is still the name of the game.

Arguably, February's price action so far has been mostly a reaction to strong nonfarm

payrolls data in the US rather than to Federal Reserve and European Central Bank meetings: as long as central banks remain data-dependent in the short term, it's really up to the data to drive trends in FX. At this stage, this should be especially true for the Fed and the dollar.

This week sees the release of US inflation, retail sales and industrial production figures. A note of warning: US data in January should be strong throughout, largely thanks to greatly improved weather conditions compared to December. The big jump in hiring seen in the latest jobs report also suggests increased demand.

Indeed, the most important piece of data will be inflation (tomorrow). Our in-house projections are in line with the market consensus for a month-on-month rise of 0.5% and 0.4% for headline and core rates, respectively. Auto sales and shelter should contribute to put a floor under core inflation for now, but we think these two components will start declining more sharply from mid-second quarter, which should fuel a more sustained downward trend in inflation.

In other words, we don't expect this setback in the deflationary path to suggest the trend is inverting. Still, this - with the aid of strong retail sales and industrial production figures - will likely be enough to allow markets and FOMC hawks to fully expect a 25bp rate hike in May after the one in March. Any upside surprise may push the peak rate pricing towards the 5.50% mark.

From an FX perspective, the dollar appears in a position to at least hang on to recent gains this week. We could see a return to 105.00 in DXY soon. Today's price action may follow a wait-and-see approach given there are no data releases, but we have observed a tendency of markets to move closer to defensive long-dollar positions into key risk events. The balance of risks appears skewed to the upside for the dollar today.

Francesco Pesole

EUR: Lacking the domestic push

In the midst of the dollar's upward correction, the euro has also lost its idiosyncratic bullish momentum. Hawkish comments by ECB members seem to have only offset the communication hiccups on the day of the ECB meeting but have failed to lift the euro as rate differentials swung back in favour of the dollar. The EUR-USD 2-year swap rate spread is back to 145-150bp in favour of USD, around the lowest this year after having shrunk to the 110bp area in the aftermath of the Fed meeting.

Our medium-term view is still one of EUR/USD appreciation over the course of 2023, but we don't see clear drivers for a EUR/USD rebound this week, especially from the eurozone side. It would probably require a rather low US CPI figure to send the pair sustainably back above 1.0800-1.0850. We see a greater chance of the pair coming under some additional pressure, and a strong US CPI read could mean the 1.0500 support (1.0490 is the 2023 low) is tested.

This week does not include key data releases in the eurozone, but just a few more ECB speakers. President Christine Lagarde will speak on Wednesday: expect another attempt to build market expectations around more tightening, although other ECB members have already gone a long way communication-wise and we don't see her speech as a big risk event for the euro.

Francesco Pesole

⬇️ GBP: Some key data for the BoE this week

The UK dodged a technical recession according to last week's fourth quarter figures, but that was hardly the key data point the Bank of England was focused on. This week sees the release of jobs, wages, CPI and retail sales. Among those, tomorrow's wages should be the most important release for the BoE's next policy moves.

Our UK economist discusses the relevance of this week's data releases in this [article](#). We think markets will be given reasons to consolidate their view around a 25bp hike in March, but expectations of further tightening may ultimately prove unfunded.

The EUR/GBP drop could extend to 0.8800 but we think markets are running out of reasons to stay bearish on the pair for longer. We continue to see euro outperformance from the second quarter and 0.9000 is our target level in EUR/GBP in the second half of 2023.

Francesco Pesole

➡️ CEE: Zloty is waiting for the ECJ decision

This [week](#), we start with the current account December figures from Poland and the Czech Republic.

On Tuesday, we will get the GDP numbers for the fourth quarter. For Poland, we expect 2.3% year-on-year in line with expectations, for Hungary 0.4% YoY, below market expectations, and for Romania 5.1% YoY, above market expectations. Also, on Tuesday we will see January inflation in Romania and we expect a slowdown from 16.4% to 15.4% YoY, implying Romania is the only country in CEE where inflation fell in YoY terms in January. January inflation in Poland will be released on Wednesday. We expect inflation to have jumped from 16.6% to 18.1% YoY, above market expectations. And Poland will also be in focus on Thursday when we should see the European Court of Justice's (ECJ) decision on the FX mortgage case, which will impact the local banking sector and Polish assets.

In the FX market, it will be challenging for the market to balance between the local and global calendar this week. A higher US dollar should be rather negative for the region. On the other hand, the heavy economic calendar in the region should push the focus onto local drivers. The Polish zloty will be the main focus this week. A jump in inflation should support market rates and interest rate differentials. On the other hand, Thursday's ECJ decision brings a lot of uncertainty and is probably one of the main reasons why the zloty has underperformed within the region this year. However, the outcome may not bring much clarity to the situation. Therefore, the zloty is likely to be very volatile this week, but we remain rather bearish. On the other hand, the Czech koruna and Hungarian forint should stabilise at current levels.

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