FX Daily: Quiet G10 markets despite Chinese turmoil

Beijing continues to fight the recent turmoil on multiple fronts: real estate, financial, and the FX market. Overnight, the PBoC set the CNY fixing with the largest gap to estimates in order to curb bearish speculation. Despite all the turmoil in China, G10 volatility has remained capped, and this is probably why authorities are not intervening

USD: Chinese authorities go all in to defend the yuan

Developments in the distressed Chinese financial and property sector are emerging as the most prominent driver for market sentiment, especially after the Fed minutes proved to have limited implications for central bank expectations and developed market calendars are quite light. Overnight, Chinese authorities turned their focus on the FX market, deploying what is now regarded as the biggest defence of the yuan via fixing guidance on record. The People's Bank of China (PBoC) fixed USD/CNY at 7.2006, significantly below the average estimate of 7.305, which marks the largest gap compared to the estimate since the poll started in 2018.

Today's PBoC move follows yesterday's reports that state-owned banks were asked by Chinese authorities to step up yuan interventions to reduce FX volatility. We could also see a cut in FX reserve requirements, often considered as a tool to avert sharp CNY depreciation.

So far, the spillover into G10 currencies has been limited. The highly exposed AUD is down 1.4% this week, a relatively contained slump considering the amount of bad news that has piled up in the past few days. This is probably a signal of how AUD was already embedding a good deal of negatives related to China and how markets are expecting government intervention to avert black swan scenarios.

This morning, the emergency yuan fixing has left FX markets quite untouched, with the exception of USD/JPY trading on the soft side, likely due to Japan's service inflation hitting 2% for the first time in 30 years overnight. Incidentally, the pair is well into FX intervention territory but is probably missing enough volatility to worry Japanese officials. Still, the oversold conditions of JPY and the threat of interventions are likely going to exacerbate any USD/JPY downside corrections.

The US calendar is empty today and the focus will likely be on bond market dynamics after back-end yields touched fresh multi-year highs yesterday. The combined effect of high yields and growing risks in China suggests the balance of risks is moderately tilted to the upside for the dollar. A return to 104.00 in DXY remains a tangible possibility in the coming days.

Francesco Pesole

EUR: Surprisingly resilient

After a week that has brought to the table some serious concerns about China's near and medium-term outlook, it is quite a success for EUR/USD to be trading around 1.0900. The pair is not just exposed to Chinese sentiment via the risk-environment channel, but more directly given the eurozone's economic exposure to China. The question now remains: will the Chinese story catch up with the euro? For now, it really appears that markets are welcoming Beijing's forceful reaction, although much will probably depend on the developments in the distressed shadow bank Zhongzhi and the actual depth of the real estate slump.

All in all, it does look like there is a path for the euro and other pro-cyclical currencies to weather this Chinese turmoil without taking much damage, but that also means a delay in any substantial rally against the dollar.

Data-wise, we'll take a look at the final inflation figures in the eurozone today. Markets are currently pricing in a 50% implied probability of a European Central Bank (ECB) rate hike in September, and have marginally scaled back expectations along the curve in the past few days. A full rate hike is not priced before the end of the year, which probably leaves some upside room for short-term rates in the eurozone should ECB officials come back after the summer holidays with some hawkish comments.

EUR/USD may keep trading in narrow ranges for now, with a modestly bearish bias to the 1.0850 level.

Francesco Pesole

GBP: Retail sales disappoint

The UK released retail sales data for July this morning, and the numbers came in quite markedly below expectations. Retail sales including fuel dropped 1.2% month-on-month, and the ex-auto fuel gauge was down 1.4%.

The release is in contradiction with a slew of quite supportive data releases for the pound. However, the FX impact has been quite contained given the very little weight that retail sales are given in the Bank of England's monetary policy decision equation compared to wage and inflation figures, which instead surprised on the upside this week.

The Sonia curve is fully pricing in a 6.0% peak rate in the UK, while markets are not convinced the ECB will hike rates at all. Incidentally, the euro is more exposed to China than the UK. That would suggest the 0.8500 support in EUR/GBP is under threat, and we definitely don't exclude it will be tested or broken temporarily in the coming days. However, the short-term swap differential when the pair last traded at 0.8500 (mid-July) was around 20-25bp wider in favour of GBP, meaning that a further widening of the monetary policy divergence may well be needed to keep EUR/GBP sustainably depressed.

Francesco Pesole

CEE: Higher rates offset stronger US dollar

Today's calendar in the CEE region has little to offer. FX seems untouched after the FOMC minutes, although there are a few things we should highlight. On one hand, the US dollar and equity markets are still pointing to weaker CEE FX. On the other, rate differentials are climbing higher across the board, especially in the Czech Republic and Poland. In addition, the US rate spike just after the FOMC minutes has added impetus to this. Thus, in the Czech Republic, the 2y rate spread against the euro reached its highest level since the beginning of July. In Poland, the spread jumped to the highest levels in a week. This should at least offset the negative impact of a stronger US dollar. However, at least in the Czech Republic, the effect of higher rates could outweigh and EUR/CZK could finally get below 24.0 for the first time since early August.

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