

FX Daily: Recessionary fears drive dollar to 20-year highs

Recessionary fears have pushed the dollar to the highest levels since 2002. Crucially, the pricing of the Fed tightening cycle is withstanding recession fears more robustly than those in the likes of Europe. For today, expect the dollar to consolidate near the highs in advance of tonight's release of FOMC minutes. And look out for a large hike in Romania



USD: Slowdown fears keep the dollar bid

Macro themes continue to drive financial markets. One does not have to look too far beyond the inverted US yield curve or the collapse in copper to understand that investors continue to re-price global growth prospects lower. Bank of England Governor Andrew Bailey yesterday said that the global growth outlook has 'deteriorated markedly'. The big question for financial markets is whether this deterioration in growth prospects is enough to curtail tightening cycles - especially that of the Fed. It was instructive in yesterday's risk asset sell-off that only 6bp was priced out of this year's Fed tightening cycle compared to 12bp taken out of both the ECB and BoE cycles. Driving that is probably: a) European activity is more exposed to the Russian energy supply shock and b) the US economy entered this global tightening cycle with more momentum and a positive output gap.

Inverted yield curves are typically bad news for pro-growth currencies (commodity exporters +

Europe & Asia ex-Japan) and typically good news for the dollar and the Japanese yen and Swiss franc. This environment looks set to continue over the summer months as the Fed continues to push ahead with tightening. On that subject, tonight sees the release of the June FOMC minutes where the Fed hiked 75bp. Expect these minutes to sound hawkish and to emphasise that the Fed is not for turning.

Continued Fed tightening amidst a global slowdown remains a very positive environment for the dollar. And after this Friday's June nonfarm payroll data, next week's release of June CPI (13th) looks like an enormous event risk for FX & Rates markets. DXY should stay bid and probably edge higher towards 109 through July - that puts EUR/USD at parity.

📌 EUR: Parity beckons

When it came, the break of EUR/USD to a new cycle low was unexpected. If anything, driving yesterday's market activity was the continued rise in European natural gas prices as Russian supplies ebb. Already running at only 40% of capacity, Russia's Nordstream 1 pipeline will be closed for maintenance 11-21 July (when will it reopen?) and exposes the friction of continuing European dependency on Russian gas at a time when it ideally would be shunning it completely. One year ahead Dutch natural gas prices have risen around 30% over the last week and back to the December spike highs. And the German government is now being dragged into state bailouts of major gas utility giants such as Uniper.

Recall that the German Bundesbank estimated that the [German economy could take a hit of 5% of GDP](#) in the case of gas being rationed. It feels like we are now not far away from such a scenario. The pressure on European growth now sees the Eurostoxx benchmark equity index down 22% year-to-date, versus -20% for the S&P 500. The question will be how much tightening the ECB can get done before the growth shutters come down.

As above, the strong dollar environment could see DXY trade some 2% higher, meaning that EUR/USD looks likely to drift towards parity this month. The trade-weighted euro is a whisker away from the lows of the year and an ECB response to threaten more aggressive rate hikes may prove counter-productive for a pro-cyclical currency such as the euro.

Elsewhere, the Russian rouble fell about 15% yesterday. It does not look like Russian authorities have started a new buying programme. Instead, it seems the slowdown in Russian gas exports leaves Gazprom with less FX to sell - bringing the onshore USD/RUB market into better balance.

📌 GBP: Big hitters quit the cabinet

Sterling has tended to ignore the indiscretions of Boris Johnson's government - largely because the Conservatives have a large majority. But the resignations of the big-hitters in charge of the Treasury and Health will leave the PM rocking and effectively sees sterling hit as hard as the euro. It is not clear whether the new chancellor, Nadim Zahawi, will represent a shift in economic policy, although he may be tempted to loosen up fiscal policy earlier than expected.

EUR/GBP can continue to trade near 0.8600, but a 2% dollar advance puts cable down near the 1.17 area. Additionally, we have been saying over recent months that sterling has been exhibiting more of the characteristics of a growth currency. A tough summer for equities suggests cable remains vulnerable to the 1.14/15 area.

➔ RON: National Bank Romania may surprise on the upside, but leu holds steady

We think the National Bank of Romania (NBR) [will raise its interest rate by 75bp to 4.50% today](#). However, recent meeting results in the Czech Republic and Hungary and inflationary developments increase the chances that we could see a bolder move. In addition, [the National Bank of Poland will be meeting tomorrow](#), so this may also weigh in favour of a bigger move by the NBR today to avoid looking like it is behind its peers. Indeed, Romania has the lowest interest rates in the region, while inflation reached 14.5% year-on-year in May and is very likely to exceed 15% in June, which should be the peak. However, we do not expect a rapid slowdown in inflation and we can't expect too much from FX either. The central bank is in full control of the RON and has demonstrated several times in recent months that there is little chance of breaking that stranglehold. And it has good reasons for doing so. In our view, the [FX pass-through in Romania](#) is the strongest in the region and the country cannot afford further inflationary pressures. Thus, we continue to assume that 4.95 EUR/RON is an untouchable threshold, which should last at least until the end of this year.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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