

FX Daily: Renminbi re-appraisal keeps emerging market FX on back foot

The dollar starts the week at marginal new highs, driven by the three key themes: i) Fed tightening ii) the war in Ukraine, and iii) the China slowdown. All three themes are showing no signs of reversing, although we should see slightly softer US inflation this week. For the near term, however, expect the dollar to continue higher and EM FX to stay pressured



📈 USD: Dollar may receive most support from external events this week

We can probably all agree that there are three key themes driving the dollar at the moment. The first is the Fed's aggressive tightening prospects as it responds to core inflation above 6%. Importantly, expectations of the Fed cycle remain resolute, with a terminal rate priced near 3.25% next year. The second is the tragedy of the war in Ukraine, which has delivered a stagflationary shock most keenly felt in Europe. And the third is China's keen pursuit of its zero Covid strategy, which is now triggering a fresh round of growth downgrades and disruptions to global supply chains.

What's the path for these themes this week? Let us start with Ukraine. The G7 has committed to a Russian energy embargo as soon as possible and the fact that the US is now sanctioning executives at Gazprombank - the key transit for European energy payments to Russia - looks like a sign that a full energy embargo is close at hand. This has implications for European growth. The market will also be on the lookout for any fresh messages today from the Kremlin on Russia's victory day commemoration. Any benign communication here looks unlikely.

Regarding China, investors continue to re-appraise the prospects for China's economy and asset markets. The onshore renminbi has today broken through the important 6.70/USD level. As we have noted recently, USD/CNY losing its anchor has added to global FX volatility and weighed on China-correlated currencies, such as the South African rand and the Brazilian real. An extra layer here could be the reluctance of investors to hold BRICS currencies as 'sphere of influence' geographic preferences start to emerge. With industrial metals taking another leg lower, it still seems too early to call the low in the renminbi.

Perhaps the best chance of dollar stability this week comes from the US April CPI data released on Wednesday. [Lower gasoline and used car prices](#) should knock headline and core CPI off its highs. Any larger than expected falls can perhaps suggest that the Fed need not be as aggressive in its hiking plans. And there are plenty of Fed speakers this week too. But some softening of the Fed tightening profile looks wishful thinking at this stage and it looks dangerous to position against further dollar strength.

DXY is now trading at the highest levels since 2002. Barring a much weaker than expected US inflation figure on Wednesday, we should expect it to grind higher still. At the same time, US 10 year real yields pushing further into restrictive territory make for a challenging time for equity and credit markets - favouring risk-averse positioning.

📉 EUR: ECB concern against the weak euro offers little help

EUR/USD remains very soft and has derived little or no support from European Central Bank comments in effect that any further euro weakness is undesirable. Looking at a variety of ECB estimates on the relationship between euro FX changes and eurozone CPI, the largest estimate is somewhere in the region of a 1% fall in the trade-weighted euro adding 0.1% to headline CPI. Currently, the trade-weighted euro is down 6% year-on-year - potentially adding 0.6% to headline CPI. That would normally be large, but in today's world of supply shocks and war in Europe, is being rather dwarfed. And equally, ECB remarks that it could hike three times this year has had little effect on EUR/USD - faced with a 300bp tightening cycle from the Fed.

Expect EUR/USD volatility to stay high and a break below 1.0500 could easily be seen this week towards the next major support at 1.0350. Asian FX intervention to support local currencies may also be depressing EUR/USD - as reserve managers reduce euro holdings in reserves to rebalance portfolios after dollar intervention in Asia.

📉 GBP: Plenty of challenges this week

Having suffered heavily last week, this week looks to be an equally formidable one for sterling. 1Q22 GDP is released on Thursday which may start to show the slowdown emerging in March, ahead of what could be a negative quarterly reading in 2Q22. The market still prices the Bank Rate at 2.15% by the end of the year - pricing which looks vulnerable. However, we do have a hawkish MPC member, Michael Saunders, speaking at 14CET today.

Tomorrow sees the Queen's speech at the opening of parliament. Political commentators have been discussing the risk that, after a poor showing in local elections, the UK government will look to push ahead with a legislative agenda that could be more combative on Northern Ireland trade. The current UK trade deal is not that much better than a no deal - yet UK government threats to tear up the N. Ireland protocol will likely weigh on a vulnerable pound. Cable looks headed to 1.20 and EUR/GBP to 0.86.

📌 CZK: Personnel changes un-nerve the koruna

EUR/CZK spiked on Friday afternoon after Czech media reported that the Czech National Bank (CNB) dove, Ales Michl, would likely be the successor to outgoing governor Jiri Rusnok whose term ends in June. Given that the CNB has been one of the most hawkish central banks in the world over the last few years, this has naturally raised much uncertainty.

Volatility looks assured over the next two months as the existing hawks have one last chance to express themselves at the 22 June meeting. Yet, the Czech koruna may remain fragile on a potentially big shift in direction in the second half of this year. And it may be hard to rule out EUR/CZK heading back to the 25.80/26.00 area, where the CNB will likely threaten to intervene again to support the CZK.

Author

Chris Turner

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

chris.turner@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

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