

FX Daily: Reports of sterling's demise are exaggerated

European FX markets have to contend with two big central bank meetings today. In the UK, we expect the Bank of England to deliver a 50bp rate hike and there may be less incentive for the BoE to protest against tightening expectations. This could help the pound. For the Czech National Bank, a new dovish board may cause some problems for the koruna



➔ USD: Wide spreads keep the dollar supported

Short-term dollar yields have found more support this week as the Fed has pushed back against the idea of a 2023 easing cycle. Even the historically dovish Fed member, Neel Kashkari, has discounted any prospect of easing next year. This is understandable in that the Fed is battling its toughest inflation challenge in 40 years and it will not help to keep inflation expectations contained if it starts outlining that this year's rate increases will be reversed next year. Arguably this could be the Fed's position until year-end when the Fed funds rate could be in the 3.25/3.50% region. Overnight USD rates at that level will be very high for the world's reserve currency and the risks are certainly of the dollar staying stronger for longer.

Expect a quiet day in FX today ahead of tomorrow's July US jobs data. And in terms of speakers, we have the Fed's Loretta Mester at 18CET today - who can be expected to add her remarks to this week's hawkish Fed pushback. Expect the dollar to remain reasonably bid against the low yielders (EUR and JPY) and DXY could nudge back towards the 107 area.

↓ EUR: Two big drivers weighing on the euro

If we were to pick out two big drivers keeping EUR/USD depressed right now we would say: i) 2 year EUR:USD swap spreads at their widest of the year and ii) the eurozone's terms of trade near its lows for the year as natural gas prices continue to tick higher.

On the former, there seems no compelling reason to expect swap spreads to narrow in favour of EUR/USD anytime soon. The bigger risk looks to be the market pricing more into the Fed cycle, where the policy rate is only priced now at 3.38% for the December meeting. This can easily move higher. Regarding gas prices, Gazprom seems intransigent in its view that a key turbine cannot be put back into use to improve gas supplies to Europe - which really should not be a surprise given events in Ukraine.

EUR/USD looks soft towards the lower end of a 1.0100-1.0300 range and could easily sink back to parity at any time.

↑ GBP: A hawkish 50bp from the BoE should help

Please see our full [scenario analysis of today's Bank of England meeting here](#). There will be many facets to today's meeting (rate decision, minutes, new inflation forecasts out at 13CET) to keep us all busy. Our default view is that an 8-1 vote can keep EUR/GBP steady near the 0.8350 area.

When releasing its last set of inflation forecasts in May, sterling sold off on the view that UK CPI would be below the BoE's 2% target in three years' time assuming market tightening expectations were delivered. This gentle push-back against market tightening expectations clearly has not prevented the BoE from returning to where we are today - i.e. on the verge of a 50bp rate hike. Given high gas prices and a strong dollar - plus BoE remarks that sterling plays a role in monetary conditions - the BoE may be reluctant to push back against tightening expectations today and will probably welcome the 3% bounce in trade-weighted sterling over the last month.

The euro has by far the largest weight in sterling's trade-weighted basket and euro weakness is making sterling look good. Yet the BoE will be aware that monetary policy decisions are having a major bearing on FX pricing. Retaining language that it will still be prepared to act forcefully - even after the presumed 50bp rate hike today - could be enough to send EUR/GBP down to the 0.8275/8300 area.

↓ CZK: The market will test CNB's dedication

Today, the Czech National Bank (CNB) will meet for the first time under the leadership of the new governor and the new board. [We expect the central bank to deliver](#) what the governor promised; stable rates, for the first time since May last year when the current hiking cycle began. Surveys and market expectations are still undecided between no change and a 25bp hike. However, we think more interesting will be the press conference, which will be led for the first time by the new governor, who will present the new CNB forecast. As the governor and new board members have not been seen much in the media since their appointment, we don't know much

about their views and so there will be no shortage of surprises. However, overall, we believe today's meeting should confirm the CNB's dovish change.

The Czech koruna has been gradually pushing higher in recent days and has been in the CNB's favoured band 24.60-24.70 EUR/CZK since the start of this week, which is likely to force the central bank to be more active in the market. However, we expect the koruna to come under real pressure after today's meeting and the CNB will have to significantly increase its efforts to keep FX under control. For now, this should not be a problem for the central bank, but the increase in the cost of intervention could tell us more about the possible end of this regime.

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