FX Daily: Risk environment gets some Chinese support

Developments in China have not exactly been helping the global risk environment this year. Yet overnight there are reports that the Biden administration could seek to lift US tariffs on Chinese imports and that a June China PMI reading was a little stronger than expected. It is not a lot to cling to, but on a quiet day may be supportive of risk-sensitive FX

USD: Battered risk currencies could receive a reprieve

Liquidity is returning to FX markets after Monday's US public holiday. The US data calendar is pretty light today and the next big input will be tomorrow night's release of the June FOMC minutes, where we will hear more about the rationale behind the 75bp hike. That is probably a dollar-positive event risk.

Before then, FX markets have a little positive news to digest this morning. Reports out yesterday suggest that President Biden could be announcing the roll-back of some US tariffs on over $300bn of Chinese (largely) consumer goods. Clearly, high US inflation is driving this discussion and lowering inflation, rather than China-bashing, sounds more of a vote winner at the US November mid-term elections. Any progress here could provide a small lift to risk-sensitive, pro-growth currencies - having seen the damage done to these currencies during former President Trump's

2018-19 trade war.

The above sounds a slight dollar negative. But what does this mean to the central bank story? Equity futures have been marked a little higher on the news and we have seen US yields rise - presumably on the view that recession fears are marginally eased and that central banks can get on with the job of normalising policy. Certainly that was the case in Australia overnight, where the Reserve Bank of Australia (RBA) delivered what could be described as a hawkish 50bp hike. Here, the RBA cited low unemployment and high savings as keeping demand supported. And there was certainly no sign of the RBA blinking on what it said will be a further normalisation of policy in the 'months ahead'. Perhaps the Australian dollar could receive a brief reprieve today after a tough June. AUD/USD looks biased to 0.6950.

DXY looks mixed today. The China news is a slight DXY negative, but US yields are bouncing back today reminding us that if the RBA has cause to keep tightening, the tightening case is even more compelling for the Fed. On balance, DXY could probably drift back to 104.50 or a little lower, but should hold above 104.00 ahead of tomorrow's FOMC minutes. And for those looking for a little stability in summer markets, the near 9% implied yield on the Mexican peso three month forward looks attractive.

EUR: Asian FX intervention is not helping

While some potentially better news out of China should in theory be positive for the pro-growth euro, the currency also faces headwinds from Asia, too. Here, these come from Asian central bank reserve managers selling FX reserves to support their local currencies. Overnight, Korea announced that its FX reserves had declined $9.4bn in June. Not all of that will be FX intervention, but the issue here is that after Asian central banks intervene to sell USD/Asia, the next step is for their portfolio management team to sell EUR/USD in order to rebalance the euro weight in their FX reserves back to benchmark levels. This looks like a real headwind for EUR/USD this summer and may be one of the reasons why EUR/USD struggles to make it much above 1.05 now.

Elsewhere, the Hungarian forint remains under pressure despite the large rate hike last week. It looks like it will be a long summer for the National Bank of Hungary.

GBP: No news is good news

Sterling is consolidating not far off recent lows and with equity markets looking fractionally brighter today, the risk-sensitive sterling could find a small lift. The UK data calendar is light today, but at 1130CET the Bank of England (BoE) releases its Financial Stability Report. Presumably, this will address the risk of how banks and consumers cope with higher interest rates and also look at the risk of stranded assets for banks from climate transition risk.

Typically, these reports do not move FX and rate markets too much and later there will be focus on a speech by BoE dove, Silvia Tenreyro. Despite her dovish leaning we doubt she will push back too much against the pricing of the BoE tightening cycle - especially since nearly 40bp of expected tightening has been priced out of the curve over recent weeks. EUR/GBP to gravitate to the centre of a 0.8550-0.8650 range.

ILS: Bank Of Israel hikes 50bp

Following many central banks around the world in moving to 'more forceful' policy tightening, the

Bank of Israel (BoI) yesterday hiked rates a more aggressive 50bp. This takes the base rate to 1.25%. That is still pretty low compared to headline inflation running above 4% year-on-year and, like the Swiss National Bank (SNB), sees the BoI shifting its rhetoric to dealing with inflation. The BoI research department sees the policy rate being taken up to 2.75% in 1H23 - in line with market pricing.

Similar to the SNB, the BoI had been fighting local currency (shekel) strength for many years as it battled deflation. In doing so, the BoI's FX reserves grew to $200bn. Like the SNB, the BoI may not be too happy with recent weakness in its local currency and it will be interesting to see whether the BoI, like the SNB, now starts selling FX reserves to drive the currency stronger. The BoI releases FX reserves on a monthly basis and details FX intervention - so let's see whether BoI has been selling FX above the 3.50 level in USD/ILS.

Medium term, we like the shekel and feel that when the major dollar trend does turn - perhaps towards the end of the year when Fed easing is priced more clearly - USD/ILS should return to the 3.20/30 area and perhaps go even lower next year. This year's tech-wreck is not expected to hit the Israeli economy as hard as it did in 2000 - so thinks the BoI - and Israel's balance of payments position should improve later in the year.

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