FX Daily: Sterling faces dual risks on Budget day

The UK Budget announcement (12.30 GMT) will see markets weigh both fiscal and inflationary implications. Sterling faces moderate downside risks in a non-inflationary, fiscally tight scenario, and severe risks if fiscal sustainability is called into doubt. Elsewhere, the dollar has more potential to depreciate despite yesterday's correction

British Chancellor of the Exchequer Rachel Reeves

USD: Focus remains on geopolitics

The dollar has declined since Monday, in line with our call. While there are some signs that Ukraine peace deal optimism is supporting European currencies, short-term misvaluation justifies a dollar correction. Despite that, the dollar remains expensive relative to short-term market drivers and with markets reinforcing bets on a December Fed cut, risks remain on the downside for USD into Thanksgiving.

Some headlines that Ukraine had accepted the terms of the peace deal proved misleading yesterday. The tone is generally constructive, but there are sticky points that both Ukraine and

Russia are still negotiating with the US. What is clear is that the US is making its strongest attempt to date to broker a truce, and that Ukraine has opened up to some degree of compromise. The US is sending its peace envoy, Steve Witkoff, to speak with President Putin today. Any signs of a breakthrough should weigh on energy prices and the dollar, while favouring high-beta European currencies.

Domestically, one interesting development at the Fed: Kevin Hassett is reportedly the frontrunner to replace Powell as Chair, and the announcement may come before Christmas. Hassett is one of the most dovish candidates, and his nomination could prompt markets to revise the terminal rate lower (now just below 3.0%) and weigh on the dollar.

On the data side, yesterday's sub-consensus core PPI (0.1% MoM) and retail sales (0.2%) are endorsing the recent dovish repricing. But today's Fed Beige Book may be an even more important release. It provides anecdotal indications about the state of the economy – effectively replacing the delayed third-quarter GDP report. Any mentions of growing job market concerns should smooth the dollar's convergence to lower short-term rates.

Finally, we have published our preview of the Treasury's FX Report, which is due in the coming weeks after a shutdown delay. Based on our estimates, no country met the three criteria, and no FX manipulator tags should be announced in this report. However, Thailand should join the Monitoring List.

Francesco Pesole

EUR: Waiting for a breakthrough on peace talks

With a short-term fair value of just above 1.170, EUR/USD continues to trade in undervaluation territory despite a much-welcome rebound. This signals upside risks persist, but we must also note that the average misvaluation of the past three months has been -1% in the pair – signalling a clear tendency to trade on the cheap side.

Today, expect the euro to be moved by external events, above all geopolitical news and to a lesser extent any spillover from the UK Budget (see GBP section below). While the rally in EUR/USD yesterday should not be seen as a direct impact of Ukraine peace deal hopes (but more technical, due to rate differentials), some optimism on a truce is probably smoothing the recovery for the common currency. A breakthrough in the coming days could support the pair to 1.170, in our view.

Francesco Pesole

GBP: Our baseline is moderately negative for GBP

It's a big day for the UK and the pound. Chancellor Rachel Reeves is expected to deliver her budget address at 12.30 GMT. Here's our UK economist James Smith's latest thoughts ahead of the big announcement:

The latest reports appear to confirm that the UK's fiscal hole – which we put at £30bn/year after planned giveaways – will be filled through a combination of extending the planned freeze on tax thresholds and a raft of hikes to minor taxes. The outlines of the Budget look well-priced, but what's less clear from the press is how much of the pain will be frontloaded in 2026.

The more the Chancellor chooses to push back tough tax and spending decisions until later this *decade, the less scope the Bank of England will have to cut rates in the near-term, and the more sceptical investors are likely to be about the UK's commitment to debt sustainability.*

On balance, we think a budget that confirms £10-15bn of upfront tax hikes, which the OBR judges to push down on inflation next year, would be worth a modest dovish BoE repricing and renewed fall in gilt yields. Remember, pretty much whatever happens, the UK's deficit and gilt issuance will fall in 2026, owing to the freeze in tax brackets. But politics remains a major risk. Any sign that political pressure is building on Chancellor Reeves could prompt a renewed sell-off in gilts, if investors begin to price in the possibility of a more pro-borrowing successor.

From a currency perspective, sterling currently shows no signs of a material fiscal risk premium (calculated via EUR/GBP), and faces two different downside scenarios today:

1. Our baseline – disinflationary fiscal tightening forces some premium to leave the gilt market, with yields declining, but the dovish repricing in rate expectations causes some moderate GBP depreciation. EUR/GBP rises to 0.880-0.8830
2. A much worse scenario for GBP where budget announcements don't convince markets that the fiscal path is sustainable. That could shape into an uncontrolled selloff in gilts and sterling.

We think the room for sterling to appreciate today is narrower, although a scenario where markets price out fiscal risk but aren't convinced the BoE will be able to cut rates should send EUR/GBP moderately lower. All our scenarios with FX and rate implications are discussed here.

One final but important note. Last year's announcement saw yields actually fall when the Chancellor was speaking, before ultimately rising once the OBR's forecasts were released and the pro-inflation picture became clearer. This may well be the case again today.

EUR/GBP overnight volatility is at 13.5: high, but below some 2023 peaks and nowhere close to 2022 Mini-Budget 27 levels. The difference between 1-week implied and realised volatility has moderated from just above 3.0 yesterday to 2.2 this morning, therefore below multiple peaks of the past two years.

Francesco Pesole

NZD: Hawkish cut supportive for the currency

The Reserve Bank of New Zealand (RBNZ) matched our expectations for a hawkish cut overnight, prompting a rally in NZD. The 25bp reduction was accompanied by updated rate projections that showed no more rate cuts, and one member voted for a hold.

The forward guidance has, as a central scenario, unchanged rates for the whole of 2026, although unsurprisingly the Committee is retaining some dovish conditionality ("If the OCR was to change over the next three to six months, it might be more likely to go down than up.").

The NZD OIS curve has priced out additional easing, with only 5bp left in the curve by March. The notion that the RBNZ has maxed out its easing potential should support a recovery in NZD/USD, also in line with our bearish USD view. We continue to target a move above 0.570 in the near term.

Francesco Pesole

PLN: Zloty remains supported despite stronger rate cut bets

Data from Poland over the last two days has shown a mixed picture. Although the numbers from industry and retail sales surprised to the upside, the market is focused mainly on weaker wages. Our takeaway is that October's set of data suggests that GDP growth in the fourth quarter is likely to beat the 3.7% year-on-year rate posted in the third. At the same time, inflation is declining, which paves the way for another rate cut in December.

However, the market is heading dovish, reinforced by stop-losses, which have led to a significant narrowing of the rate differential against the euro, pointing to a significantly different path than the rest of the region. For the PLN, this is not a big threat for now. The weaker US dollar and the discussion of a ceasefire between Ukraine and Russia keep the PLN supported and the rest of the CEE region on the stronger side.

Although it appears that the deal will still have a bumpy road, the market reaction we look forward to remains asymmetric, in our opinion, in favour of stronger CEE currencies. In our opinion, the market remains pessimistic about the deal and any progress would therefore provide a bigger boost than a collapse of negotiations and weakening FX. In our view, EUR/PLN remains range-bound at 4.230-270 for some time and this story may be the key to breaking the lower bound.

Frantisek Taborsky

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com