FX Daily: Stress-tested economic models see the dollar in ascendancy

The dollar continues to perform very well. It remains buoyed by a hawkish Fed and also by the travails of major trading partners which are suffering more from high energy prices and weaker export markets. This trend looks set to continue this week which will culminate with a speech on Friday by Fed Chair, Jay Powell on the economic outlook

USD: Travails overseas are keeping the dollar bid

Catching our eye this European morning is news of Chinese banks cutting their loan prime rates to support the mortgage sector and also some pretty terrible Korean trade data, where the first 20 days of August produced an unprecedented US$10bn deficit. The news serves as a reminder (as did the PBOC policy rate cut this time last week) that the Chinese economy is slowing (USD/CNH now trading above 6.84) and producing very difficult trading conditions for a country such as Korea, trapped between higher imported energy costs on the one hand and slowing export markets on the other.

Arguably a country like Germany faces similar challenges, where its economic model of importing cheap energy from Russia and exporting high-value goods around the world (especially to China) is facing challenges like never before. On higher energy prices, we note that natural gas costs continue to surge. And as drought conditions across Europe continue to disrupt coal shipments, similar problems in China's Sichuan province are impacting hydro-energy supplies and increasing demand for alternatives such as natural gas.

These challenges to ex-US growth models continue to leave the dollar in the ascendance; we saw DXY surprisingly push above 108 on a quiet Friday. This week's focus should be on some mildly positive US data and culminate in Fed's Powell speech on the US economic outlook on Friday. The Fed is probably quite comfortable with what the market prices for its policy rate this year (around 125bp of hikes to a 3.50-3.75% target range.) What could be vulnerable to re-pricing higher would be the subsequent 40bp of easing priced in for the second half of next year. As we have seen recently, the Fed is quite keen to counter notions of a 2023 pivot.

With European and Chinese data remaining soft this week - and no end in sight for the surge in gas prices - expect the dollar to hold its gains. The 109.30 July high in DXY looks like the direction of travel.

Elsewhere, a couple of weeks ago we had felt that there was a window for carry trades and had picked out the MXN/JPY cross rate. That has moved up to 6.80. However, rising levels of volatility again (both in EUR/$ and $/JPY) suggests positions in high yield FX may be hard to hold and we would prefer more defensive long dollar positions now.

Chris Turner

EUR: Will sub parity levels trigger an ECB response?

EUR/USD remains very heavy and could sink below parity at any time. Adding to the sell-off may well be the portfolio adjustments of Asian central banks. Asian FX remains under heavy pressure and will prompt intervention to sell dollars and support local currencies. Asian FX reserve managers will then need to sell EUR/USD to re-balance FX portfolios to benchmark weightings.

We also wonder whether we will see a more hawkish ECB this week. The market prices a 54bp rate hike for the September 8th meeting. Could the ECB start to discuss prospects of more aggressive rate increases if it wants to offer EUR/USD some support? Watch out for any speeches from the hawks in northern Europe this week.

A retest of July's 0.9950 low looks to be the bias for EUR/USD this week. Customers are also asking us whether now is the time to increase hedge ratios on dollar receivables. As we discuss in our EUR/USD forecast revision piece, we think the euro's fair value has been damaged by the energy shock - meaning that EUR/USD is not especially cheap even at these levels.

Chris Turner

GBP: Does 1.15 beckon for Cable?

The mighty dollar is causing problems for all and Cable could well retest July's 1.1760 low this week. Thereafter it is hard to rule out a move to 1.15 - a level seen in the March 2020 flash crash.

We still have a preference that EUR/GBP does not need to rally too hard - given challenges faced in the eurozone - but acknowledge that sterling does look vulnerable. The UK calendar is pretty quiet this week.

Chris Turner

CEE: The main stage of the sell-off is over, but risks remain

August is entering its final phase, which means only secondary data in the calendar for the CEE region. Today, we will see retail sales in Poland for July, which should show a further slowdown in YoY terms. On Wednesday, the Czech Republic will release confidence indicators, the first data for August. Consumer confidence is just a hair's breadth away from its all-time lows, and we cannot expect improvement this time either, thanks to the rising cost of living. In Hungary and Poland, labour market data will be published, in both cases confirming the severely tightened conditions. On Thursday, the NBH will again have a chance to intervene against the weakening forint by raising the 1-week deposit rate. For now, we do not expect a rate change this week either, but the level of the forint in the coming days will be crucial.

For CEE currencies, EUR/USD attacking parity remains the main theme. Thus, we do not expect a trend reversal this week either. In our view, the Polish zloty remains the most vulnerable currency in the region. After Friday's data, it weakened the most in CEE and we see room for further losses towards 4.770 EUR/PLN. On the other hand, we continue to believe that the Hungarian forint should move to stronger levels around EUR/HUF 403, but negative sentiment is likely to keep the forint at weaker levels for a while longer. The koruna, unsurprisingly, remains stable after returning to CNB intervention levels and we cannot expect much this week. But we are watching the central bank balance sheet data to track FX intervention activity after weeks of silence.

The Romanian leu continues to fluctuate around 4.88 EUR/RON and has maintained these levels despite a region-wide sell-off that has not escaped the ROMGB. Even though the CEE region should have seen the main part of the sell-off, EUR/USD near parity and rising gas prices remain the main risks. Of course, pressures from these directions would mean further losses for regional FX, so we remain bearish on CEE currencies this week.

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