FX Daily: Taiwan's currency rally raises broader questions for the US dollar

The massive rally in the Taiwanese dollar over the past two sessions is raising concerns of USD-rich Asian countries being the catalyst for the next broader USD decline. That may be premature, and recent recovery in USD-denominated assets still argues for some more risk premium to be pulled off the greenback. Tomorrow's FOMC may have limited FX impact

The Taiwan dollar has jumped over the past two days over trade deal fears

USD: What the TWD is telling us

The most notable development in FX over the past few days has been the exceptional rally in the Taiwanese dollar, and to a lesser extent in other Asian currencies (MYR, THB, KRW). The trigger has apparently been a widespread concern among Taiwan's USD-rich corporates and investors (life insurance, above all) that a trade deal with the US would include the request for a weaker USD/TWD. That has so far been ruled out by Taiwanese authorities. Thinner-than-usual liquidity may have contributed to the exacerbation of the move in the usually tightly managed TWD, which is now trading 7% above its end-of-April close.

Speculation over a Taiwan-US FX deal may not be enough to justify the whole move, though. The recent decline in the USD means countries, like Taiwan, that have historically very high exposure to USD-denominated assets have taken an FX-led hit, and local players are now seeking greater USD hedging as well as starting to diversify away from US investments. This fits into a more worrying bearish narrative for the dollar, and opens up a risk that a period of supposedly USD-positive trade deals with Asian countries may turn into an opportunity for USD-rich Asian countries to reduce USD exposure. We'll be closely watching whether improved liquidity from today and indications from the CNY fixing suggest an acceleration, and whether the Treasury will be fine with any more broad-based USD declines before the inflationary hit from tariffs has been absorbed.

In the US, this week is quieter in data terms, with tomorrow's FOMC rate announcement being the key highlight. As discussed in our Fed preview, we expect Chair Jerome Powell to keep resisting the pressure from the Trump administration to cut rates. Market pricing and consensus agree. Powell recently emphasised that the US cannot maintain a strong labour market without price stability, and our view is still that the first rate cut may only come in September, while markets currently price in 23bp for July.

We don't expect this Fed meeting to have major implications for the dollar as markets appear aligned with Powell's recent rhetoric. A lot of the dollar recovery and stabilisation has been due to rebounding US equities, which have reduced demand for a USD premium. That premium hasn't disappeared though, as the dollar remains generally cheap relative to short-term rate differentials against major currencies. The new USD downside risks stemming from Asia shouldn't be downplayed, but might not all play out in the near term. Given residual short-term valuation and more room for speculative shorts to be unwound (especially against JPY and EUR), the dollar can keep regaining some ground as long as Trump continues to feed markets some positive headlines on trade.

Francesco Pesole

EUR: Overvaluation can't be unseen

There are no major data releases in the eurozone calendar this week, with the focus on some ECB speakers instead. Today, arch-dove Panetta speaks at an event in Asia. However, the ECB out-of-meeting commentary hasn't added too much colour of late, as a generally dovish narrative continues to persist, and there has been little pushback against market speculation for rates to fall close to 1.50% from the current 2.25%.

The majority of EUR/USD moves still depend on market sentiment on USD-denominated assets. Should a broader unwinding of USD positions or a sharper increase in USD hedging demand in USD-rich Asian countries materialise in the coming days, the euro and the yen probably stand to receive another round of reserve-related inflows.

A stronger euro due to factors unrelated to short-term rates will likely argue for even more cuts by the ECB, whose estimates in March included a material negative impact of an appreciation in EUR/USD on the eurozone's output. The dislocation between FX and short-term rate differentials however doesn't tend to last too long, and in this case would need to be fuelled by further unwinding of USD reserve positions. If that doesn't happen, the overbought and overvalued EUR remains at risk of more downside pressure. The 1.130 level remains the anchor in EUR/USD – a decisive break lower can see the 1.120 support being cleared soon.

Francesco Pesole

GBP: Widely expect BoE cut this week

EUR/GBP seems to be attracting buyers around the 0.850 level and is awaiting another clear-cut GBP bullish catalyst for a break lower. We recently discussed how the plans to improve the UK-EU trade relationship have unlocked some upside for GBP, although markets may now be awaiting some more tangible developments before building more sterling longs.

In domestic UK events, Thursday should see the Bank of England cutting rates by 25bp. This is widely expected by consensus and fully priced into the Sonia curve. As discussed in our economist's preview, we expect an 8-1 vote split (one vote for a 50bp cut) and no changes in forward guidance (future cuts to be "gradual and careful").

We think EUR/GBP may stabilise around 0.850 for now as a well-telegraphed BoE cut should not trigger major moves. Ultimately, the euro's greater exposure to potential positioning adjustments means the risks remain skewed to the downside for EUR/GBP.

Francesco Pesole

CEE: Central banks respond to dovish call

This week's focus is on central bank meetings and inflation prints in the CEE region. After yesterday's inflation numbers in Turkey, the Czech Republic follows today. We expect a drop from 2.7% to 2.2%, one-tenth above market expectations. This print will get extra market attention as the Czech National Bank will decide tomorrow. We expect a 25bp rate cut to 3.50% but believe a pause is also on the table, and any upside surprise in inflation would tip the board's decision-making in favour of another pause. In either case, though, we will also be watching the new forecast and forward guidance given the strong dovish market expectations.

Wednesday will also see a decision from the National Bank of Poland, which is likely to resume its cutting cycle after a year and a half. We expect 50bp in line with market expectations. Thursday, as usual, will be followed by the NBP governor's press conference, which should set the central bank's future direction. On Friday, Hungary will release its April inflation reading, which is likely to fall below 4% YoY, this year's low.

Politically, in Romania, during the first round of the presidential election, a pro-government candidate did not make it to the second round, which led to the resignation of the prime minister yesterday. The second round will take place in two weeks, however markets reacted yesterday with a strong sell-off in Romanian government bonds, and we are likely to see the full effect of the election today given the closed London market yesterday.

Although the global story sees rapid swings, the CEE FX picture and our views remain relatively stable. We have been building a case for lower PLN/CZK for the last month. Although the pair has moved significantly in recent weeks, this week should be an additional catalyst. We expect CNB to be hawkish versus market pricing in both scenarios, which should support further CZK gains below 24.900. On the other side, the NBP opening of the cutting cycle should pressure a weaker PLN, underperforming CEE peers. We expect EUR/PLN to range 4.280-300 this week with the upper range testing if NBP confirms its dovish stance.

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