FX Daily: Taking the next step in the 'Pandexit'

In its annual report released yesterday, the BIS presented three scenarios for 'Pandexit' - the global economy's departure from the pandemic. Arguably they were akin to the Goldilocks analogy of conditions being too hot, too cold or just right. Today's ADP data will provide insights on the heat, while the cooling trend of new variants is much in focus too.

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USD: Feeling the heat from the ADP?

In its annual report released yesterday, the BIS presented a central scenario categorised as a surprisingly strong recovery, but uneven and incomplete. The two alternatives to the central scenario focused on: i) central banks having to respond to inflation with more aggressive tightening or ii) policymakers, particularly in EM, struggling for stimulus should new variants spread.

Insights into both these alternative scenarios could emerge this week as the market focuses on a potentially hot US labour report or the degree to which new variants cool recovery expectations.

On the former, today sees the release of the June ADP employment numbers, where a 600k increase is expected. Last month, a 978k increase did not prove a particularly accurate predictor for the NFP figure (+559k), but we suspect the market will be on edge over any strength in the US labour market which would encourage Fed hawkishness. After all, US money markets have barely given back any of the sharp adjustments made in the second half of June.

And as James Knightley writes, consumers seem pretty confident of a strong US labour market.

For the FX market, the greater sensitivity probably lies towards stronger US data and a stronger dollar against the low yielders. USD/CHF may be one of the key channels to express this view, where extreme SNB dovishness and Swiss inflation still well below target could see USD/CHF pushing above 0.9240 on a strong ADP number.

Also look out for portfolio adjustment flows around the 17CET WMR fix today. US equities have actually out-performed over the last one and three months, suggesting some dollar selling could come through - yet these flows are notoriously hard to predict. Elsewhere, Canada sees the release of April growth figures today. Poor numbers may be overlooked by investors as activity was heavily impacted by Covid-19 restrictions. The fast vaccination roll-out in Canada has, since April, helped the economic picture improve and suggests the data flow may provide more support to CAD in the summer months.

EUR: Going nowhere fast

Very strong Eurozone economic confidence readings have provided little support to EUR/USD so far. The missing link is a central bank ready to dial in dovishness - and there are no signs of that from the ECB so far. Yesterday's German inflation data and today's Eurozone June CPI data (expected to soften to 1.9% from 2.0%) are unlikely to change that position, though as Carsten Brzeski points out the situation could change in late summer as base effects drive headline CPI into the 3-4% YoY range. Indeed, we suspect investors may take advantage of any EUR/USD dip to the 1.1835/1850 area to position for a higher EUR/USD in late Summer.

Also today we will see June CPI for Poland. Base effects should see the headline YoY rate drop to 4.6% from 4.7%, but core inflation may stay sticky around 4.0%. This may ultimately see the Polish MPC become less equivocal on the need to tighten policy. But until they firmly make that move we could see some further PLN under-performance in the CE3 space. For example, PLN/HUF could drift back to the recent lows at 77.00.

GBP: Waiting to hear more on Northern Ireland

EUR/GBP is going through one of its low volatility periods. 1 month realized volatility is close to 5.00%. We should not, therefore, expect big moves, but the market will take notice of any progress on trade tension with the EU. Here a 3-month extension of the waiver on UK exports of chilled meat to Northern Ireland would be welcome.

As an aside, the sharp growth in UK house prices, now up 13% YoY seem to be supporting the very bullish pricing of the BoE cycle. The first 10bp hike is now priced for May 2022. Those expectations may be supported today in a speech at 13CET from outgoing hawk Andy Haldane. While the speech will focus on BoE communication over the last 30 years, he may also want to repeat his call that the BoE's QE programme be curtailed in August. This would leave the Asset Purchase Facility at £825 versus a current year-end target of £875bn.

Let's see whether EUR/GBP can hold below resistance at 0.8610 and drop back to the 0.8550 area.

CNY: Slowing PMIs should not be a problem

As Iris Pang today points out, the softening in Chinese June PMIs are not a harbinger of a more dramatic slow-down in Chinese demand. And while the Asian FX story is most certainly mixed at best at present - Covid-19 outbreaks don't help - we think the CNY should still see good demand on dips. Here the implied yield through the 3 month CNH forwards is still a handsome 2.6% p.a. and long positions in the CNY could be protected by a central bank reluctant to see large drawdowns in its currency.

It may take a while for investors to fully jump back on the bandwagon of long positioning in north Asia FX (ex JPY), but a Korean tightening cycle later this year could very much support this story too.

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