FX Daily: Temporary and contrasting drivers

Short-term drivers of market sentiment are piling up ahead of tomorrow's US CPI. Some clarification from the Italian government on the bank windfall tax is paired with welcoming signs from yesterday's UST 3-year auction to help sentiment and offset deflationary news from China. Today, all eyes will be on the $38bn 10-year UST auction

US GDP surged in the third quarter

USD: Treasury auctions in focus

Headlines about the Chinese economy are centre stage amid the lack of market-moving US data releases before tomorrow's July inflation report. The plunge in Chinese exports reported yesterday was followed by a widely-anticipated fall into deflationary territory overnight: June CPI contracted by 0.3% (consensus was -0.4%), and PPI failed to ease back substantially (-4.4% from 5.4% in June). It is the first time since the pandemic peak that both CPI and PPI have contracted.

Evidence of combined consumer and producer price deflation undoubtedly endorse the notion of a broad-based economic slowdown in China, but a big chunk of the China growth re-rating appears to have already hit markets and we are actually observing little spill-over of today's numbers as investors tentatively re-enter high-beta positions after yesterday's risk-off unwinding.

The dollar had found substantial demand at the start of this week, but the prevalence of temporary drivers while Fed-related pricing has been put on hold ahead of key data releases continues to prevent a sustainable dislocation from recent ranges.

What may have helped to throw some cold water on the dollar rally yesterday was the result of the 3-year US Treasury note auction, which resulted in a slightly lower yield than pre-auction trading, a welcoming sign given recent concerns of dwindling demand for bonds. Today's $38bn auction of 10-year notes and tomorrow's $23bn of 30-year notes, which are both larger by $2-3bn than the previous corresponding offering, will be watched quite closely.

Today's 10Y UST auction is likely the only real highlight given a very light US calendar and no scheduled Fed speakers. Should we see more welcoming signs from today's Treasury debt sale, the dollar can keep paring recent gains into tomorrow's pivotal CPI read.

Francesco Pesole

EUR: Italian banks take a breather

The ECB consumer expectations survey showed another decline in inflation expectations, with those for three years ahead easing from 2.5% to 2.3%, and those for one year ahead from 3.9% to 3.4% in June. This is a welcome indication for the ECB that its rate-hike cycle is having its effect, however: a) long-term inflation expectations remain above the 2.0% target, and b) market-based long-term inflation expectation measures have recently jumped.

On this second point, we suspect ECB officials were looking with concern at the 5Y5Y EUR inflation swap forward rate touching 13-year highs on Monday at 2.67%. It has now eased by around 5bp, but remains worryingly high compared to the mid-July 2.50% level, and potentially inconsistent with the end of a tightening cycle.

The eurozone calendar is quite light this week, but the euro felt some pressure yesterday as the Italian government announced a surprise windfall tax on bank profits, which hit sentiment in the European equity market. Some of the initial hit on bank stocks yesterday was due to a lack of clarity on the details of the new tax: this morning, it was confirmed that the levy won't exceed 0.1% of each bank's asset, which has been received as positive news by Italian bank stocks and helped the euro recover some ground.

The decision by the Italian government follows unanswered calls by commercial banks to raise deposit rates. This follows a similar move by Spain last year, and discussions in other major European economies. This is one interesting thread to monitor, should the Italian government's decision fuel a bank profit windfall tax debate in other countries, and/or whether banks will pre-empt facing new taxation by raising deposit rates. The implications can be non-negligible from a monetary policy transmission perspective and for the euro. In the near term, the relevance of relative equity performance for EUR/USD should keep it quite sensitive to the matter.

A return to 1.10 is possible today as global risk conditions improve and bank stocks appear to find some breathing room.

Francesco Pesole

GBP: Unusually stable BoE rate expectations

The data and Bank of England event calendars are empty today and tomorrow in the UK, and will only pick up again on Friday with the release of GDP and industrial production. The lack of domestic events in the UK has helped an unusual period of very stable BoE rate expectations: markets appear rather anchored to the prospect of a peak rate around 5.70-5.75% for now.

EUR/GBP has faced some downward pressure, likely due to the negative impact of the Italian bank windfall tax announcement on the euro, but looks unlikely to break out of recent ranges. 0.8600 should continue to be the gravity level for now.

Francesco Pesole

AUD: Room for a big rebound

We have just published an update of our macro and market views on Australia. As highlighted in recent commentary, we are very reluctant to align with the view that the Reserve Bank of Australia is done with monetary tightening, and think that the market is underestimating the risks of another rate hike, which is our base case. That should be driven by a surprise in the monthly inflation data, potentially already in September.

This should pave the way for a recovery in the Aussie dollar, which currently is undervalued in the short and medium-term, having absorbed the negative implications of Chinese growth rerating and recent instability in global sentiment. We see substantial room for a recovery in AUD/USD before the end of the year, in line with our call for a USD decline, and target a return to the 0.69 July peak in the fourth quarter.

Francesco Pesole

Authors

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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

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