FX Daily: The dollar should be stronger

The divergence of FX markets from rates and equities generally doesn't last long, and we expect a delayed USD strengthening after yesterday's upside surprise in 1Q US PCE data. We cannot rule out a consensus 0.3% MoM March core PCE print today, but 0.4% now looks much likelier. In Japan, FX intervention risk is even higher after a dovish hold by the BoJ

USD: Expecting a delayed strengthening

The dollar should be trading higher after yesterday's US GDP report. The very short-lived USD jump against major currencies denotes how the FX market still has some tendency to give greater weight to negative news on US data compared to USD-positive news. But a lagged re-linking with higher rates and lower equities looks likely.

As discussed by our US economist here, the slowdown in US 1Q growth was quite substantial: in one quarter, the annualised growth rate was more than halved from 3.4% to 1.6% (consensus was 2.5%). Interestingly, consumer spending was quite weak too: 2.5% annualised versus a consensus 3.0%. What matters more for the Federal Reserve, however, is that core PCE inflation came in much higher at 3.7% QoQ annualised, from 2.0% in 4Q and above the 3.4% consensus.

This has direct implications for expectations on March's PCE figures released today. Given that 1Q

PCE numbers are a quarter-on-quarter measure, any revision from October through February may have influenced yesterday's print. So, we could still get a 0.3% core PCE print today – consensus before the GDP report - although this is obviously less likely. Market expectations are probably close to 0.4% today.

The main drivers of FX all point to a stronger dollar: higher Treasury yields, widening swap differentials in favour of the dollar, and falling equities. There is a good chance that markets will scale back US rate cuts further if core PCE comes in at 0.4% month-on-month today. Pricing dynamics appear skewed to being trimmed to just one 25bp cut by year-end in the short-term (currently -40bp). Our rates team believes a move to 5.0% in UST 10Y is all but possible at this stage.

The FX market has moved autonomously since the GDP release yesterday, but it would not be the first time that the dollar reconnects with rates and equities with a small lag. We think this is likely to happen today or early next week unless PCE data surprisingly offer hopes on inflation today. We believe DXY probably belongs to levels above 106.0 based on current market conditions.

Francesco Pesole

EUR: Divergence rhetoric fading?

With a June cut looking likely, it is probably more interesting for investors to start looking at the policy path beyond June. Our call is that the European Central Bank will not cut rates at consecutive meetings and deliver only 75bp of total easing in 2024. Governing Council member Madis Muller seemed to stress exactly this point this week, ruling out back-to-back cuts at the beginning of the cutting cycle. He still believes risks to inflation are tilted to the upside.

It appears that the divergence narrative - triggered by US data and the ECB in-meeting communication – may start to fade slightly, with the improvement in the eurozone economic outlook probably playing a role in making the hawks reluctant to give in to a dovish policy path. We still expect a cut in June, but the accompanying message may fail to push rates much lower. That potentially limits how far EUR/USD can fall on higher USD rates, although we still think the strongest argument against EUR/USD close to parity is that the economic fundamentals of the euro (like the eurozone's terms of trade) are nowhere near as bad as they were in 2022 when the pair last broke below 1.00.

Today, the ECB publishes the CPI expectation surveys for March. In February, the 1-year gauge came in at 3.1% and the 3-year at 2.4%. Expectations are probably for a nudge lower in both surveys. Still, the dollar story should drive most EUR/USD moves today: we see risks skewed to a higher dollar and do not see the pair being able to trade sustainably at 1.0700+.

Francesco Pesole

GBP: Pound and euro still look too similar

The pound and the euro reacted perfectly in tandem to US GDP yesterday. We have been long discussing the potential for EUR/GBP to move higher later in the year as the policy divergence balance shifts against the pound. However, we cannot ignore that EUR and GBP have had similar reaction functions to US data since the start of the year.

So, with US data having a neutral impact on EUR/GBP, ECB pricing should not be very volatile, which suggests that only another round of repricing in BoE expectations can really stir the pair. The BoE policy meeting on 9 May is obviously the next big event for the pound, but data may still prove more important given a divided MPC.

Francesco Pesole

JPY: Cautious BoJ paves the way for intervention

One camp where the dollar's strength is untouched is USD/JPY, which is trading at 156 this morning. Overnight, the pair rallied after the Bank of Japan's widely expected rate hold was perceived as dovish. While revising the core inflation projections closer to its 2% target (1.9%) for the fiscal year 2025, markets had probably built expectations that the BoJ would add currency-specific comments and potentially start quantitative tightening.

Instead, there were few indications of concern about the yen's weakness among policymakers and it was reiterated that the Bank will "conduct the purchases in accordance with the decisions made at the March 2024 MPM". The only tweak consisted of erasing a line where it signalled the amount of JBGs it was planning to buy each month, a move that was partly anticipated by media reports yesterday.

Before the Bank of Japan decision, April Tokyo CPI figures were released and came in sharply lower than expected. The headline measure slowed from 2.6% to 1.8% and core from 2.4% to 1.6%, around 0.6% below expectations. The data was distorted by school subsidies, although even when excluding such distortion, the data is showing slower than expected price pressure.

A weaker yen makes intervention even more likely. As discussed in our note on this topic yesterday, the seemingly imminent FX intervention might only happen closer to the 160 level, as Japanese officials tend to focus more on the rate of change of the yen as opposed to specific USD/JPY levels, and volatility in both USD/JPY and the trade-weighted JPY is below the levels of 2022 (when Japan last intervened).

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