

FX Daily: The only fireworks are in the US

An ISM services collapse sent the dollar weaker into today's Independence Day holiday, and there is growing speculation of VP Kamala Harris replacing Joe Biden as a Democratic candidate. Friday's payrolls may also be soft. On the other side of the Atlantic, EU peripheral spreads are tightening and the UK election may have a very contained market impact



➔ USD: ISM hits the dollar into Independence Day

A collapse in the ISM services index yesterday triggered a large shift in USD positioning, with the greenback losing across the board. The currency we regard as [better positioned to rally this summer](#) – the Norwegian krone – rose more than any of its G10 peers. The rally in equities and risk-on environment for FX left the yen weak at the end of yesterday's session despite the dollar decline.

A closer look at the ISM print paints a concerning picture for US activity. The index fell to the lowest in four years (48.8), new orders plunged to 47.3 from 54.1, business activity collapsed to 49.6 from 61.2, and employment fell to 46.1 from 47.1. Combining the manufacturing and services, ISM employment points to a 175k **drop** (!) in payrolls, as opposed to the expected 190k gain. The news on inflation was also dollar-negative as prices paid slowed to 56.3 from 58.1.

Market bets on Federal Reserve easing did not rise dramatically, though, which also explains the yen's underperformance. While expectations for a September cut increased to 20bp, total easing by year-end remains below 50bp. We suspect some of that reluctance to price in more easing is related to rising chances of Donald Trump winning the US presidency in November. The assumption here is that Trump's protectionist and tax-cut policies can slow Fed easing.

Today is a US national holiday. Financial markets are closed, volumes will be thinner and there are also no data releases or Fed speakers. Independence Day celebrations also means we may not get major updates on a possible Democratic candidate replacement. The latest media reports suggest that President Joe Biden is weighing dropping out given the growing pressure from within the Democratic party, although he received backing from key Democratic governors after a crisis meeting at the White House yesterday. Other reports suggest Vice President Kamala Harris is the most likely to take his place. The second option remains California Governor Gavin Newsom.

Recent polls show that Harris has more support than any other candidate from Democrat voters in swing States, and she has more support than Biden in a head-to-head against Trump. At the same time, there are probably lingering concerns in the party about the VP's low approval ratings, which were for a long time below those of President Biden. Should we see confirmation of Biden's withdrawal, the dollar could trade slightly weaker, as markets may conclude that Democrats would have not pushed for a change in candidate if it had not led to better chances ahead of November. Still, until a new round of polls for the presidency (Trump now leads Biden 49%-43%) with the new Democratic candidate is published, we doubt markets will wish to meaningfully unwind USD longs driven by bets on a Trump victory.

All in all, we had expected the dollar to weaken in the second half of the week on the back of US macro data, and after the ISM decline, we could see further USD softness tomorrow when the June jobs report is published. Rising bets on Trump and EU political risk can limit dollar downside beyond the very short term, but the immediate impact of US data should remain significant for now.

Francesco Pesole

➔ EUR: Beware of French bond optimism

The message that European Central Bank officials sent from Sintra was one of patience. There is clearly no pressure to move with back-to-back rate cuts given slower disinflation, and it seems that the preference is also for a wait-and-see approach over verbal intervention when it comes to the recent bond market turmoil.

At the same time, market expectations for ECB easing (40bp by year-end) were given an implicit nod by some speakers openly discussing the chances of further cuts. There is a good probability those expectations will remain quite stable throughout July, meaning that the policy factor should not really be a major driver for EUR/USD.

Developments in the US remain much more relevant for the pair. We had argued for a move to 1.0800 on the back of softer US data this week, but admit that the move came in before our expectations given the shockingly low ISM services. We remain somewhat doubtful that markets will be comfortable with EUR/USD trading close to 1.09 given lingering uncertainty about French politics and the rising risk of a Trump re-election.

In France, there has been a remarkable tightening in the OAT-Bund 10-year spread, which closed

at 66bp yesterday from a late-June peak of 82. The main trigger was the news that numerous centre and left-wing candidates have dropped out of three-way runoffs to curb the rise in Marine Le Pen's right-wing National Rally party. This raises the chances of a hung parliament, which appears a more desirable outcome for markets as it limits the chances of aggressive spending manoeuvres. Our rates team continues to call for a structurally wider French spreads and we expect that to weigh on the euro throughout the summer.

Francesco Pesole

➔ **GBP: Election impact should be limited**

Britain votes in its general election today. The latest polls confirmed the opposition Labour party has an approximate 20-point lead over the Conservatives and is projected to secure around 431 of the 650 parliament seats. Expect the first impact on markets at 10:00pm BST (11:00pm CET) when the exit polls are published by the country's three major broadcasters. It is generally believed that exit polls have a very good predictive power for the final outcome in the UK. In the past five elections, they predicted the House composition with an average error of only four seats. We will publish a reaction note after the exit polls tonight.

We have struggled to identify major risks for the pound heading into today's vote. Not only because opinion polls have firmly suggested Labour should secure a majority, but also because it seems unlikely that the change in government will influence the policy path for the Bank of England. Aside from the seemingly remote possibility of Labour not securing the 325-seat majority, there may be some risks associated with the populist/hard-Brexiteer Reform UK faring better than expected and taking more seats than the Conservatives. That would not have real policy implications for this government, given the projected solid majority for Labour, but could trigger some concerns for the longer term.

All in all, we do not expect to change our view on the pound on the back of the election result. We still expect larger BoE easing compared to market expectations and remain bullish on EUR/GBP on the back of that.

Francesco Pesole

⬆️ **PLN: NBP sees inflation up next year as well**

As expected, the National Bank of Poland left rates unchanged yesterday. The new forecast was published for the main figures. The baseline assumes inflation this year in the range of 2.8% and 4.3%, only slightly above the scenario maintaining the full inflation shield in the previous forecast. On the other hand, inflation for next year has been revised up significantly. However, the picture is still within what we heard from NBP Governor Adam Glapiński at the last press conference. Today's press conference is at 3:00pm local time. We expect that not much will change here and we will hear confirmation that rate cuts are unlikely this year.

Markets were not much impressed by the new forecast yesterday. However, the whole CEE rates market was dragged down by the rally in core markets and the PLN market showed more resilience, underperforming the CZK and core market. Still, the dovish bias is deepening ahead of today's press conference, which we see as a bad direction given our more hawkish NBP forecast. If the NBP delivers a traditional hawkish message, PLN should benefit the most. EUR/PLN already fell below 4.300 yesterday as we expected, and some paying flow in the rates market could support

EUR/PLN towards 4.280.

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