

FX Daily: This could be another good week for the dollar

The debt-ceiling roller coaster continues, but markets remain cautiously confident Biden and McCarthy will reach a deal by the end of this week. This, combined with hawkish hints by Fed officials and minutes could prompt another repricing higher in US rate expectations, and keep the dollar supported a bit longer. Elsewhere, UK CPI will be key for sterling



USD: Dollar can find more support

The most bullish expectations were probably for a debt ceiling deal to be on the table by today. This hasn't been the case following a partial breakdown in negotiations on Friday, but a reconciliation and new staff-level talks over the weekend are keeping hopes alive that President Joe Biden and Speaker Kevin McCarthy will reach an agreement by the end of this week.

We discussed late last week how the dollar was enjoying a rather ideal mix of factors. Progress on debt ceiling talks was prompting some re-rating of US growth expectations, and paired with hawkish comments by some Fed officials, markets were shifting towards a more hawkish set of expectations for the near- and medium-term.

However, the volatility in the debt-limit sentiment also means volatility in rate expectations and the dollar. On Friday, the temporary setback in debt-ceiling negotiations saw markets fully unwind 10bp of tightening that had been priced in for June. This morning, the Fed funds future curve still embeds around 50bp of easing by year-end, considerably less than the 75bp from around 10 days ago. All this signals that markets remain cautiously optimistic about a deal, but Friday's setback is probably preventing the Fed hawks' rhetoric from being passed through to the June pricing just yet.

With Biden and McCarthy expected to meet in person again today, headlines on the debt limit will likely drive most FX moves today. The US calendar is empty today, and may not offer major drivers for the market until Friday, when April PCE deflator (the Fed's favourite inflation measure) numbers are released. Activity on the Fed side will be more interesting to monitor. The minutes (out on Wednesday) will be scanned closely for hints about a pause, while hawkish hints from the document could help rebuild some tightening expectations for June (should debt ceiling talks progress) and keep supporting the dollar. There are also some Fed speakers to watch this week, starting today, with James Bullard, Raphael Bostic and Mary Daly.

All in all, given the recent positive short-term reaction of the dollar to progress on debt-ceiling news and assuming the stalemate will finally be resolved some time this week, we could see the greenback staying supported, especially given that the lack of key data releases should not particularly challenge another hawkish repricing of Fed expectations. A key risk would only come in the form of particularly dovish FOMC minutes, although recent comments by FOMC members are pointing in the opposite direction. We still think that the Fed has already hit the peak, and our US economist expects as much as 100bp of cuts in late 2023 as the economic outlook deteriorates. With this in mind, we expect any dollar resilience to prove unsustainable beyond the short term.

Francesco Pesole

EUR: Watch eurozone surveys this week

EUR/USD has been moved almost entirely by the dollar in the past week or so, as debt-ceiling news dominated. While this will remain the primary driver this week, some domestic news is likely to come into the mix on the euro side as well. On the data side, we'll take a look at two important surveys, which are largely expected to show a slowdown in growth sentiment in the eurozone. PMIs will be released tomorrow, and the Ifo on Wednesday. German's growth prospects recently displayed some slightly worrying signs, as discussed by our economics team [here](#), after ZEW numbers were released.

On the European Central Bank side, we heard some rather hawkish comments by President Christine Lagarde, who reinforced her pushback against the notion of a pause: she will speak again on Wednesday, and on the same day, the ECB will hold a non-policy meeting (no statement, no press conference). Today, Philip Lane, Luis de Guindos, François Villeroy and Pablo Hernandez De Cos are scheduled to speak, and many other members are scheduled to deliver remarks throughout the week.

Still, with markets fully pricing in two more 25bp rate hikes by September, it now seems unlikely that ECB speakers can push short-term EUR rates much higher. The partial re-widening in the EUR-USD 2-year swap rate gap from the -62bp level in early May to the current -87bp is entirely a Fed hawkish repricing story. The stretched long EUR/USD positioning coming into the debt-ceiling negotiation period meant the pair was vulnerable to corrections, but we still expect a rebuild of

long-term bullish positions in the second half of the year as markets rotate back away from the dollar and into European currencies.

For this week, the balance of risks appears tilted to the downside for EUR/USD as the dollar may find a bit more support from a debt-ceiling deal and hawkish Fed rate expectations. We can't exclude the drop extending to sub-1.0700 levels at this stage, although opportunistic buying would probably start to emerge more prominently around such levels.

Francesco Pesole

⬇️ GBP: All about inflation

Wednesday's inflation data in the UK will be a make-or-break event for the pound. Markets are pricing in 19bp of tightening, and if our expectations are correct and CPI data indicates enough of a cool-down in prices to convince the Bank of England to pause tightening in June, the downside risks for sterling are quite sizeable.

We keep pointing to EUR/GBP as the best pair to play GBP weakness. Should the dollar find more support this week, we could see a decisive acceleration in cable's correction on diverging Fed-BoE diverging narratives and the 1.2250-1.2300 region being explored, while we see upside risks for EUR/GBP into the 0.8750-0.8800 area in the near term.

Francesco Pesole

➡️ CEE: US dollar to remain main driver

Today, we will see industry and labour market numbers in Poland. We **expect** industrial production to fall by 2.5% year-on-year in April, less than market expectations. Industry remained in the red and the only bright spot so far is the automotive industry, but it is expected to start shining less brightly when the backlog of work is filled and previous orders executed. On the other hand, we expect the unemployment rate to have fallen from 5.4% to 5.3% in April. Tomorrow, Polish retail sales will follow, which we estimate fell 8.6% in April, a bit more than the market expects. Also scheduled for tomorrow is a meeting of the Hungarian National Bank. We **expect** central bankers to deliver the first effective rate cut of 100bp to 17%, starting a gradual normalisation of monetary policy. On Wednesday, consumer confidence will be released in the Czech Republic and on Friday we will see labour market data in Hungary. On the sovereign rating side, on Friday, Moody's rating review of the Czech Republic will be published. The agency cut the outlook to negative (Aa3) last August and we expect it to remain unchanged this time.

On the FX side, the US dollar, which moved the entire region significantly weaker last week, will remain the main driver this week as well. In this environment, the Czech koruna is showing the highest beta and we think it has even slightly overshot its reaction. Unless we see another significant EUR/USD move downwards, EUR/CZK should not exceed 23.80 and, conversely, stabilisation in global markets should take the koruna back below 23.70. The Hungarian forint will also be in focus this week. Although market expectations have shifted towards our expectations in recent weeks we can still expect a rather weaker forint after the NBH meeting tomorrow. Nevertheless, given the sell-off last week, positioning can be assumed to be light and the 378 EUR/HUF level should be the cap at the moment. Moreover, we believe that any further weakness in the forint will be used by the market to re-enter long positions to benefit from the significant carry that will be with us for some time despite the start of rate cuts.

Frantisek Taborsky

Author

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

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