

FX Daily: Three takeaways after the euro's crazy Thursday

The ECB's 50bp hike and announcement of the anti-fragmentation tool failed to lift the euro yesterday. We are not surprised and see this as another testament to how the common currency is being moved primarily by non-monetary factors. The end of forward guidance should make the euro more responsive to data and ECB speakers. Today, keep an eye on PMIs



President of the European Central Bank, Christine Lagarde

USD: Climbing back

A very eventful day in the eurozone resulted in high volatility but no real change in the overall G10 FX picture. The dollar is climbing across the board again this morning, and we are not surprised to see that.

We had previously highlighted how the narrative of other central banks closing the gap with the Federal Reserve did not seem to be a realistic driver of sustained dollar depreciation, and yesterday's post-ECB moves were likely a case in point as they showed how: a) the diverging growth outlook and exposure to geopolitical risks remain a primary driver of FX; b) the pricing for some G10 central banks – but not for the Fed – is already very hawkish, limiting the scope for

hawkish surprises to be passed through the domestic currency.

There's normally some calm after the storm after such a big event, but the current market environment suggests volatility looks likely to remain the name of the game in FX, at least for the summer months. Today, PMIs will be published globally, and while those are not as highly regarded as the ISM in the US, it will be interesting to see the numbers. The consensus seems to be looking at some stabilisation in the gauges, with a contraction in gasoline prices possibly having offered some support.

We see the dollar potentially gaining a bit more ground today, as markets start to position for a hawkish Fed statement next week, and the global macro picture continues to weigh on sentiment. A consolidation above 107.00 in DXY is our base case for the day.

↓ EUR: Volatile times ahead

The ECB delivered a surprise 50bp rate hike yesterday and announced the deployment of an antifragmentation tool dubbed the Transmission Protection Instrument. Here's our [economist's take on yesterday's announcements](#).

The euro went on a roller coaster ride around the release of the statement and the press conference. Here are our three takeaways:

- First, this is another testament to how ECB hawkishness is proving insufficient to sustainably lift the euro. This is due to the fact that the deteriorating eurozone outlook and unstable risk sentiment continue to play a bigger role for the common currency. It also shows how markets had gone too far with their hawkish pricing before the meeting.
- Second, the sovereign spread factor is now officially the central theme in the eurozone. That is because announcing an anti-fragmentation tool and already laying out some relatively strict conditionality (the fiscal rule may be the main cause of concern) means that markets may stop focusing on the conditionality itself and instead look at the efficacy of the tool. This is especially true in the context of a collapsing ruling majority in Italy and a rise in the 10Y BTP-Bund spread caused by domestic political woes. The Lagarde-era ECB communication troubles may continue to be a source of downside risk to the euro, which will now trade more in line with sovereign spreads.
- Third, the end of forward guidance means that the market pricing on ECB tightening has lost an anchor and may make it (and by extension, the euro): a) volatile; b) more reactive to data; c) more reactive to ECB speakers. In other words, EUR volatility looks unlikely to fade this summer.

We'll take a first look at the euro's new reaction function to data releases today, as markets will focus on eurozone PMIs. Consensus expectations are for another drop, although quite contained in size (52.0 to 51.0 in the composite gauge, according to a Bloomberg survey). Anyway, some recovery in the dollar may keep EUR/USD below 1.0200 today.

An update about Italy: the President of the Republic will formalise the procedure for early elections over the coming days. The date for a vote has been decided: 25 September. Expect this to be mirrored in the EUR-crosses volatility curve. Opinion polls suggest the new prime minister could be Giorgia Meloni, leader of right-wing populist party Fratelli d'Italia, but she would need the support of another right-wing party (La Lega) and former PM Silvio Berlusconi's party Forza Italia.

GBP: Eyes on PMIs

Markets will focus on PMIs in the UK today after retail sales for the month of June plunged 5.8% year-on-year, more than expected. However, we doubt these figures will change the market's assessment around the August Bank of England meeting, with the swap market now fully pricing in a 50bp move.

Expect cable to be mostly driven by the dollar leg and global risk dynamics for now. The risk of a move to yesterday's lows (1.1890) is high in our view.

CEE: The region remains on edge

The ECB's decision did not turn out as badly for the region as we feared though the situation remains precarious. We think that EUR/USD downside risks persist despite the larger-than-expected hike by the ECB. The most vulnerable at the moment, in our view, is the Polish zloty, which has lost 55-65bp at the short end of the IRS curve over the last few days, taking the interest rate differential back to mid-April levels. We believe that sooner or later, the zloty will have to reflect such a shift in its value and return at least back to 4.80 EUR/PLN and, moreover, the market still has room to reduce its bets on further NBP monetary tightening.

Second in line in our view is the Hungarian forint, which, although firmly supported by the highest interest rate differential in the region, faces an uncertain geopolitical situation. Although the latest news from the Hungarian government on negotiations with the EU looks optimistic, we think it is too early to find an agreement. At the same time, Hungary is the most vulnerable country to a potential stoppage of gas supplies from Russia, which the Hungarian government is addressing in Moscow, and will certainly not help in negotiations with Brussels. On top of that, the Fitch rating review will be published today, and we believe there is a strong chance of an outlook downgrade. Overall, we thus believe that the forint is enjoying its moment of glory, but could go back above 400 EUR/HUF very quickly.

The Czech koruna tested the 24.60 EUR/CZK level for the first time in 10 days, which may have triggered the central bank intervention and is likely to be repeated in the coming days. Expectations for further CNB rate hikes are fading and negative comments by some board members regarding FX tools may attract more short positions with a view to ending intervention soon. However, we believe that for the time being, the Czech National Bank has little reason to change its current approach and this issue will be back on the table after the August meeting.

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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