FX Daily: Tiptoeing back into the dollar

Long-waited evidence of UK disinflation, dovish Bank of Japan comments and reports of a potentially cautious tilt for the ECB next week all triggered tentative rotation back to the dollar yesterday, as the Fed peak story no longer looked like a standout in the developed central bank spectrum. We suspect markets may still cautiously favour the greenback

USD: Dollar takes a breather

The second disinflation surprise in a week, this time in the UK, initially seemed to have the potential for some global spillover yesterday – i.e. curve re-steepening and a risk-on narrative. As discussed in our daily notes over the past few days, the dollar's drop was starting to look overstretched, and as markets actually downscaled the UK CPI's global implications during yesterday's session, they also saw an opportunity to rotate back to the dollar.

Beyond technical short-term valuation considerations, the reasoning behind this dollar rebound appears quite straightforward in our eyes. Last week's (post-US CPI) narrative revolved around the Federal Reserve standing out as a dovish outlier compared to expectations and its own projections, but this week has offered evidence this may well be a more widespread dynamic among G3 central banks. If undershooting UK inflation now opens the door for a smaller 25bp Bank of

England hike in August, the Bank of Japan's latest comments leaned on the dovish side (CPI figures are released overnight in Japan) and there have also been reports of European Central Bank members potentially refraining from committing to a September hike when they announce policy next week.

We must note the inflation and central bank picture is not homogeneous. In the commodity space, Canada saw larger than expected headline inflation, but sticky core price pressures suggest it's too early to rule out further tightening by the Bank of Canada. In New Zealand, headline inflation beat consensus and the RBNZ-issued core measure was unchanged at 5.8% from the first to second quarter. In a day of dollar strength yesterday, CAD stayed bid (helped by its close correlation with USD) and NZD lost less than its closest peers like AUD.

In Australia, the release of June's employment figures overnight sent AUD rallying. Employment rose 32.6k versus 15k consensus, with 39.3k attributable to full-time hiring, and the unemployment rate moved from 3.6% to 3.5%. Jobs data remain secondary in importance for the Reserve Bank of Australia, which has proved to put greater weight on monthly CPI readings. We currently expect one last hike in September on the back of an inflation uptick.

Moving back to the US, the Philadelphia Fed index and existing home sales data will be watched along with jobless claims today. We are inclined to think the dollar can consolidate or even tick higher again today as markets start to eye next week's FOMC as a potential hawkish risk. DXY may test 101.00 by the end of the week.

Francesco Pesole

EUR: A bit more room for a correction

EUR/USD has slipped back to the 1.1200 level, but remains around 2.5% overvalued according to our short-term financial fair value model. A key input to the model, the two-year EUR-USD swap rate gap, has rewidened (in favour of the dollar) to pre-US CPI levels, now hovering around -115/-120bp. On Friday, it had shrunk to -100bp, the tightest since late May.

Today, the eurozone calendar includes consumer confidence figures for July, with consensus expecting a virtually unchanged read from last month. Yesterday, the eurozone final core inflation printed 5.5% versus the preliminary 5.4%. Still, media reports that Governing Council members are planning to soften their tone on forward guidance as they hike by 25bp next week suggests – as also hinted in recent remarks – that concerns on inflation may have eased slightly.

We think EUR/USD is more likely to ease back from these levels than jump back higher. A test of 1.1100 in the coming days would be in line with a re-connection with its short-term fair value.

Francesco Pesole

GBP: Life after the big repricing

In a matter of 10 days, markets moved from pricing in a peak rate close to 6.5% to only 5.75% in the UK. Some pre-CPI positioning on Tuesday had seen the pound soften and the Sonia curve shift lower. The FX impact yesterday was large but ultimately not extreme despite the big moves in rates.

The question of whether the Bank of England will hike by 25bp or 50bp remains open. We are in the 25bp camp, as discussed by our economics team here, while markets are pricing in 35bp, close to a 50/50 split. GBP/USD is (like EUR/USD) still overvalued by around 2.5% in the near term according to our calculations. This tells us that the positive risk-premium that had been built into Cable was only partially scaled back yesterday, and the move was actually very much in line with the drop in GBP short-term rates.

Volatility in the pound should remain elevated. We continue to favour a weaker GBP/USD into the 1.2800/1.2850 area in the coming days but are less convinced of EUR/GBP upside potential into the FOMC and ECB risk events next week.

Francesco Pesole

CEE: Global conditions call for a pause in the region's appreciation

Several data will be released today in Poland, including industrial production, producer prices and wage growth. We forecast that industrial production remained in the red in June at -2.2% year-on-year, falling for the fifth consecutive month in annual terms. Rapid disinflation in producer prices likely continued in June as well and annual growth is trending towards negative figures. Nominal wage growth stabilised at low double-digit levels at 12.1% YoY. We project wage pressure to continue over the medium term despite some deterioration in economic activity.

Later today, we will get the Central Bank of Turkey decision. The bank has acknowledged that inflation has been well above its target, which calls for more effective use of monetary policy. The June decision was considered to be "the first step of the monetary tightening process". Given this backdrop and rising pricing pressures amid i) FX pass-through from recent lira weakness, ii) strong mid-year wage adjustments and iii) inflationary effects from government measures to raise revenue, we expect a policy rate hike of 5 percentage points to 20%. However, risks point to a smaller move given the bank's signals of gradualism.

We saw some weakness across the board in the FX market in the region for the first time in a while. Similar to two weeks ago, we see the main reasons on the global story side, which stopped supplying impulses for stronger EM FX. The Dollar Index showed some gains for the first time in ten days, European equity markets are flat and gas prices have stabilised around 26 EUR/MWh. Rather than reasons to weaken, we see yesterday's move as profit-taking after a multi-day rally, which is especially the case for the Hungarian forint. The Czech koruna continues to adjust to the Czech National Bank comments, which we believe got lost in translation and misinterpreted. However, the main message here is that we see no reason to turn negative on CEE FX for now and continue to expect new gains despite yesterday's weakness.

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