

## FX Daily: Too early for a broad dollar downtrend

Markets have been offloading dollar positions after the weaker-than-expected US core inflation read yesterday, and as China further eased Covid-19 restrictions. Still, we think it's premature for a sustained dollar downtrend, as a Fed pivot is not a given yet and risk assets continue to face a variety of headwinds. We remain moderately bullish on USD



Decelerating core inflation in the US surely represents an opportunity for the Fed to deliver a more convincing dovish pivot

### ➔ USD: Weakness may not last long

Yesterday's [US CPI read](#) dealt a big blow to the dollar. Decelerating core inflation (0.3% month-on-month) surely represents an opportunity for the Federal Reserve to deliver a more convincing dovish pivot and soften its tone on the length/size of the tightening cycle. This is being reflected in the Fed Funds futures curve, which is now expecting only 50bp in December and a peak rate of 4.95% in 2023: a 30bp correction since last week.

We can now expect a period of elevated market sensitivity to Fed-speak, as investors will attempt to gauge which members have been convinced to press the breaks on tightening from the latest inflation figures.

In a market that was still quite extensively long, the dollar is seeing some sizeable position rebalancing. The oversold JPY and GBP were the best performers yesterday, while gains were more contained in EUR and CAD. Overnight, risk sentiment received an extra dose of support from the news that China is easing Covid-19 quarantine and flight restrictions. The renminbi is trading below 7.10 for the first time since September.

Still, we remain reluctant to jump in on the broader bearish dollar story just yet. First, because it simply appears too early to call victory in the inflation battle, and more evidence will need to come from the jobs markets – which has remained exceptionally tight. There may not be much interest from the Fed to switch to a more dovish stance without having gathered all possible data before the December meeting.

Second, there is still a lack of alternatives to the dollar at the moment. European currencies are benefitting from lower gas prices, but that has been due to mild weather, and concerns about the energy crisis for this and next winter are unlikely to abate over the next few months. In China, markets are welcoming looser Covid rules, but infection numbers are elevated and vaccination rates are low, which means that the path to complete removal of restrictions still looks long. Grim export numbers also pointed out how China's strains are not only a domestic but also a global demand-related story. A heavy return to other EMFX currencies also appears premature given the worsening financial conditions and slowing global demand.

Third, risk assets are facing downside risks that go beyond the Fed story: from likely contracting corporate profits to housing market woes and, recently, the turmoil in the crypto market.

If nothing else, retaining defensive long dollar positions on the back of the incoming global recession and potentially more instability in risk sentiment would still look quite reasonable at this stage. In other words, the dollar peak might be past us, but a dollar downtrend may not be there yet. We remain moderately bullish on the dollar into year-end.

Today, the US bond market is closed for Veterans Day, while the stock market will operate as normal. Still, there could be some reduced trading volumes also in FX. The calendar includes the University of Michigan surveys (focus on the inflation expectation indices) and a speech by the Fed's John Williams.

*Francesco Pesole*

## ➔ EUR: Only a dollar story

EUR/USD is a straightforward dollar and risk sentiment story at the moment. As discussed in the section above, we struggle to see recent moves as the inception of a broad and sustained dollar downtrend, and we therefore think EUR/USD may be close to its short-term peak.

There were already very few indications that the euro was particularly oversold before the recent upward correction: now, we are likely looking at an even more balanced positioning. We see room for a return to EUR/USD parity in the near term.

The eurozone calendar is very light today, and focus will be on the long list of ECB speakers, which includes Philip Lane, Pablo Hernandez De Cos and Mario Centeno, as well as the arch-hawks Joachim Nagel and Robert Holzmann. Markets are currently pricing in 59bp of tightening in December. We currently forecast a 50bp hike.

Francesco Pesole

## ➔ GBP: Economic slump not as bad as feared, for now

The pound has been benefitting from its high sensitivity to global risk sentiment and the unwinding of a large short position. Domestically, second-quarter GDP numbers released this morning showed a smaller-than-expected contraction (-0.2% quarter-on-quarter), although that was mainly due to the upward revision in August's figures. Incidentally, September figures have been heavily affected by the Queen's funeral bank holiday.

Still, our UK economist expects a contraction in every quarter until 2Q23, and a lot of focus will obviously be on the measures announced next week by the Treasury. The domestic picture for sterling remains uncertain at best, and we think this puts GBP/USD at risk of rather fast corrections should the support of a weaker USD evaporate.

Francesco Pesole

## ➔ CEE: Rest after a tough week

After a tough week, Friday should finally bring some calm to CEE. Poland is also celebrating Independence Day, so trading will be limited. The calendar offers October inflation in Romania, the last figure in the region, and Czech National Bank (CNB) minutes from the November [meeting](#). In Romania, we expect inflation to fall from 15.9% to 15.2% year-on-year, slightly below market estimates. This should confirm the peak in inflation and the start of the YoY decline. However, the National Bank of Romania (NBR) earlier this week provided a new forecast showing higher inflation than the previous forecast, which would imply only a very slow decline in inflation in the coming months. Therefore, another rate hike in January cannot be ruled out. The CNB minutes should show more detail about the board's discussion of the potential risks of the new forecast and the conditions for additional interest rate hikes. However, in our view, yesterday's surprisingly low inflation completed the last piece of the puzzle and confirmed the end of the hiking cycle, although the decline in inflation is mainly due to government measures against high energy prices.

In the FX market, we saw a dramatic story yesterday with several intraday reversals. A massive miss on inflation in the Czech Republic pulled rates down across the region and in Poland offset the [NBP's dovish tone](#) during the press conference. In addition, higher EUR/USD after the US inflation print helped the entire region to stronger levels. Today's activity is likely to be limited due to the holidays, so we expect some calm after a busy week.

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