

FX Daily: Too early to jump on the bearish dollar ship

The dollar correction may extend a little further today as slowing US CPI could help risk sentiment further. However, Fed rate expectations should not be affected, and optimism about the Ukraine conflict and lower gas prices may be misplaced or too premature, so the dollar may stabilise or recover later in the week



⬇️ USD: Another leg lower with US CPI slowing?

An extension of supported risk assets kept the dollar under pressure at the start of this week. In particular, European sentiment appears to be rebounding quite sharply, largely on the back of falling gas prices and some market optimism around developments in the Russia-Ukraine conflict. All this has likely prompted some position-squaring effect on the overbought dollar which has widened the scope of the dollar drop.

The question is whether this correction is sustainable and the dollar did indeed peak last week. In our view, the narratives behind the recent FX moves are not solid enough for the strong bearish call on the dollar just yet. First, because the drop in gas prices may actually be related to mandated lower usage levels, which would actually be rather bad news for the eurozone's economy given the centrality of the manufacturing sector. Second, the market's optimism around

a ceasefire based on Ukraine's recent counteroffensive may be premature. Third, the dollar can still count on a strong domestic story, both on the growth side and on the monetary policy side, as markets have now cemented their expectations for a 75bp Fed hike in September and a 4.00% Fed Funds rate in early 2023.

Today's US CPI figures for August are, however, a risk event for the dollar. The consensus is centred around a deceleration in headline inflation from 8.5% to 8.1%, largely due to lower gasoline prices. Core inflation may instead accelerate above the 6.0% mark from 5.9% in July. All in all, and given the recent hawkish messages by Fed Chair Jerome Powell, it appears unlikely that – barring significantly below-consensus reads – expectations around Fed tightening will be heavily affected by today's CPI report. That said, there is surely a possibility that a risk-on environment may be bolstered further by evidence of US inflation having peaked, and another leg lower in the dollar may be triggered by another good session for global equities.

As discussed above, it is too early in our view to see a more structural dollar downtrend, and we see a higher probability of stabilisation or small recovery in the greenback in the second half of the week.

Francesco Pesole

EUR: Equity differential on the driver's seat

Last week, we highlighted the growing relevance of relative equity performance (as a gauge of diverging growth paths) in driving EUR/USD short-term fair value. Indeed, the market's growing optimism on Europe is fuelling a rebound in European equities, and the euro's parallel recovery is keeping that FX-stocks correlation very well alive.

We mentioned above how markets may have turned optimistic too early on the gas and Ukraine themes, but the euro may also have been helped by some hawkish comments from ECB officials. It's important to note that monetary policy is not playing a primary role in driving short-term EUR/USD moves, and that parallel hawkish repricing in Fed expectations means that the EUR-USD 2-year swap spread is close to its post-ECB meeting level.

The current swap rate differential does surely point at a stronger EUR/USD, but in order for the pair to reconnect with that differential under current market conditions, we'll likely need a period of stabilisation in European sentiment, something we are seeing now but may prove hardly sustainable in the coming weeks.

Today, some focus will be on the ZEW survey out of Germany, while there are no scheduled ECB speakers. Another potential good day for risk assets if US CPI moves lower may keep EUR/USD bid for now: a break above 1.0200 is possible at this stage, but a return to the 1.0000 level parity remains our base-case scenario into year-end for EUR/USD.

Elsewhere in Europe, Sweden's general election results haven't been called yet, and an official final count may only be announced tomorrow. However, it looks like a right-wing/far-right coalition is on track to secure a majority by a razor-thin margin. SEK is the best-performing currency since Friday, but that is in line with its high beta to European risk sentiment rather than a reaction to election results.

Francesco Pesole

📈 GBP: Jobs market remains tight

Jobs data released this morning were largely in line with consensus expectations and confirmed the UK jobs market has remained quite tight. Most crucially for the Bank of England, evidence that wage growth has continued to accelerate may suggest more aggressive tightening.

GBP is trading slightly higher after this morning's release but should have a larger reaction after tomorrow's CPI data. Today, Cable should still be moved by external drivers and may remain supported, while EUR/GBP may stay in the upper half of the 0.86-0.87 range.

Francesco Pesole

📈 CEE: FX switched the pipe from rates to gas

Current account data for Poland, the Czech Republic and Romania will be published today. We do not expect any changes in the current trend of negative balances across the region. But we don't think it will do anything to the stronger FX in CEE, which is already fully disconnected from the markets and follows only gas prices. Yesterday's rates sell-off sent interest rate differentials to new lows, in Poland since March this year, in the Czech Republic since December last year and in Hungary since mid-August. However, the market seems unconcerned by this move, and further declines in gas prices indicate further gains for CEE FX. We currently see the biggest gap in this relationship for the Czech koruna, which could continue its yesterday rally below 24.50 EUR/CZK and the Polish zloty closer to EUR/PLN 4.680. On the other hand, we see the Hungarian Forint fairly priced at the moment and awaiting [news](#) from the negotiations with the European Commission.

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