FX Daily: UK disinflation surprise paves the way for more sterling weakness

The dollar briefly reconnected with lower oil prices yesterday but has regained some support this morning. The balance of risks remains skewed to a stronger USD leading up to the US election. In the UK, downward surprises in services inflation have dealt a blow to GBP, and we think there is more downside room in the near term as markets increase dovish bets

USD: Solid momentum

The sharp drop in oil prices has been the biggest market story this week. Yesterday, the Israeli prime minister said the country is considering US concerns when planning a retaliatory attack on Iran. That broadly endorsed reports that Israel should target military infrastructures but not Iran's oil and nuclear facilities. The soft growth story and some disappointment about the recent stimulus announcement in China are contributing to oil's underperformance. There is probably a case for oil prices to stabilise now that most Middle-East-related gains have been trimmed, and considering some lingering uncertainty about Israel's retaliation. Another leg lower in the dollar would likely need to be triggered by some soft data, but the US calendar is currently quite light, and tomorrow's retail sales may print respectable numbers.

Instead, we continue to see a non-negligible risk that markets will place some "Trump hedges" by buying dollars ahead of a closely-contested US election, which could end up out-shadowing a potential downward correction in front-end USD rates. The timing of that is – however – quite uncertain. The predominance of the Fed story as a driver, mixed with earnings and the Middle East turmoil, means markets may keep trading outside of the US election sphere until only a few days before the vote, and then unwind the riskiest positions.

Yesterday, Donald Trump spoke at an event and discussed two important points for markets: tariffs and Fed independence. He sounded particularly hawkish on protectionism, particularly targeting US car imports from Europe and Mexico. On the Fed, he said that he would not temper with the Fed's independence, but equally claimed that the president should have a say on rates.

Elsewhere in G10, Canadian headline inflation slowed to 1.6% yesterday (consensus 1.8%), which prompted markets to price an even higher chance (77%) of a 50bp Bank of Canada cut next week. We remain in the 25bp camp though. The jobs market strengthened in September and the core measures did not decline further and remain above 2.0%. We expect CAD outperformance next week around the Bank of Canada rate announcement.

In New Zealand, third-quarter CPI came in line with consensus: 2.2% YoY for headline and 4.9% YoY for non-tradable inflation. That still added pressure to NZD overnight, as markets increased their dovish bets to -60bp for the 27 November Reserve Bank of New Zealand meeting. Admittedly, a 50bp cut is looking more likely with non-tradable CPI back below 5.0%, but 75bp would probably require a dovish repricing in the Fed expectations too.

Francesco Pesole

EUR: Bracing for tomorrow's ECB decision

The euro received some unusually positive news on the activity side yesterday, as the ZEW surveys came in slightly stronger than expected in Germany (13 vs 10) while rebounding quite markedly (from nine to 20) in the eurozone-wide index. Those are all soft indicators that the ECB itself has often disregarded, but might contribute to a sense that the negative growth narrative has bottomed out, ultimately curbing dovish expectations.

EUR/USD is predominantly driven by external factors. The substantial drop in oil prices has narrowed the scope for a further drop based on market factors, but we continue to suspect that pre-US election positioning should favour a weaker EUR/USD. Tomorrow's ECB meeting may prove to have only a marginal impact on markets: we explore a range of scenarios in the ECB Cheat Sheet. Our baseline is for stabilisation around 1.09 for now, but – as mentioned – the balance of risks is tilted to the downside heading into 5 November.

Francesco Pesole

GBP: Dovish pivot for sterling

Sterling is trading almost half a percent lower this morning after the September CPI report showed the closely-monitored services inflation falling more than expected from 5.6% to 4.9%. Consensus was 5.2% and the Bank of England's projection was a much higher 5.5%. The "core services" measure, which strips out more volatile items, has also fallen substantially from 4.9% to 4.6%. The less relevant headline and core CPI prints were also below consensus at 1.7% and 3.2%, respectively.

The data is unequivocally dovish for the Bank of England and paves the way for rate cuts at the two remaining meetings this year (November and December). We think that has incidentally opened the door for a period of underperformance by sterling. Market pricing for BoE easing is adjusting as we write but currently shows a 25bp priced in for November. Given the comments by Governor Andrew Bailey earlier this month suggesting the BoE could increase the pace of easing, markets may be tempted to price in some chance of a 50bp rate cut in November now that services inflation has fallen 5.0%.

Ultimately, the chances of the BoE delivering a 50bp cut are probably low, but the greater flexibility of pricing to the dovish end in the Sonia curve – paired with some positioning ahead of the UK Budget and the US election – can result in GBP/USD trading well below 1.30. The euro's softish momentum means EUR/GBP probably doesn’t look as appealing as Cable to play sterling’s weakened momentum, but a return above 0.840 now seems appropriate in the near term.

Francesco Pesole

CEE: Further signs of calming geopolitics means a boost for the region

Yesterday's final inflation numbers confirmed an increase in inflation in Poland from 4.3% to 4.9%. Official core inflation numbers for September will follow today. We also expect a rise here from 3.7% to 4.3% YoY. In the Czech Republic, PPI numbers will be released, one of the last key numbers before the November Czech National Bank meeting.

The markets saw another dose of reassurance yesterday, supporting the entire emerging market space in a recovery. CEE FX appreciated the calm, especially in the Czech Republic and Hungary, however rates markets rallied across the region. Signs of calm or at least avoidance of further escalation in the Middle East benefit the EM space and sets the stage for further gains within the region. Although the calendar doesn't have much to offer today, yesterday's turn in the global story should be supportive today as well. Like yesterday, the CZK is our currency of choice for current conditions.

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