

## FX Daily: UK inflation helps sterling ahead of Bank of England

UK inflation came in as expected but the detail is a little worrying. Elsewhere, US markets are closed for a national holiday and FX volumes should be thinner. In the EU, seven countries – including France – should be included in the deficit procedure today, which may contribute to keeping a lid on EUR/USD



### ➔ USD: US markets closed today

US data and communication from the Federal Reserve appear to be in a 'tug-of-war'. If the Fed stayed relatively dovish in the first quarter despite the slow disinflation, last week's FOMC and communication afterwards were relatively hawkish given the improvement in the US inflation picture and some softer activity data. On the activity side, retail sales for May were weaker than expected yesterday and a downward revision to the April print was also published. The reading is in line with our view that consumer spending has peaked in the US and should drive a broader softening in growth momentum into the second half of the year. On the flipside, May's industrial production rebounded more than expected.

Back to Fed communication, the general message being sent to markets is one of caution on disinflation. New York Fed President John Williams summarised the current narrative yesterday by

refusing to comment on the timing of the first rate cut and while he admitted some encouraging signs on inflation, he also stressed that more data is needed to start easing policy. It appears that there is simply not enough confidence in the data to trigger a dovish turn in communication, but markets' forward-looking nature means that data remains more important than Fed speakers, and the 50bp of cuts priced in by year-end reflects the cautious optimism on disinflation.

US markets are closed for a federal holiday today, so expect thinner volumes also in FX. Even on Thursday and Friday, the data calendar in the US is not very heavy: central bank developments and political risk swings in Europe will be more central. We remain of the view that the dollar should keep finding some support against European pro-cyclical currencies ahead of the French vote later this month.

*Francesco Pesole*

## ➔ EUR: Seven countries to face deficit procedure

EUR/USD has continued to stabilise but still seems to be lacking enough steam to meaningfully rebound given lingering political risk and fiscal concerns weighing on the common currency. What shouldn't help the mood in European markets today is the EU Commission's announcement of which countries will face the excessive deficit procedure. Italy and Poland already said they will be included in the list, and media reports suggest five more countries will face the infringement procedure – including France.

Our rates team believes there are lingering risks that EU bond spreads re-widen into the 30 June French vote after a couple of calm sessions this week. The 10-year OAT-Bund rate gap was 77bp at yesterday's close, 5bp below Monday's peak.

The eurozone calendar only includes a speech by the European Central Bank's Mario Centeno today, and we still think the unstable risk environment and downside risks for peripheral bonds will keep EUR/USD capped in the near term.

*Francesco Pesole*

## ➔ GBP: UK inflation in line with expectations but services still too hot

The [latest UK services inflation numbers](#) are a bit disappointing for the Bank of England, and the latest figure is 0.4ppt above what it had forecast back in the May monetary policy report. Things like rental growth are still pretty strong, though in line with prior months. The data all but confirms the Bank won't be cutting rates when it meets tomorrow. But we still have another report in July, and unless that's a material surprise, we suspect it will still leave the BoE on track for a cut in August.

In the FX market, EUR/GBP is trading at 0.843, just slightly lower after the release, and markets are pricing in a 43% chance of a first cut in August with a total of 46bp by year-end.

Although today's inflation data is a bit of a mixed bag we still see higher EUR/GBP in the medium term. While political risk in the EU may slow EUR gains in the near term, we believe the policy narrative will ultimately drive a substantial move higher in EUR/GBP, and we expect a move to 0.87 by late summer.

Francesco Pesole

## CEE: Good potential for the further rally

The National Bank of Hungary cut its key interest rate by 25bp to 7.00% yesterday, in line with expectations. [The focus](#) of the communication is the new forward guidance. While the previous one highlighted the possibility of “further reduction in the base rate in a cautious and data-driven manner”, the new one clearly states that the Monetary Council “will take decisions on the level of the base rate in a cautious and data-driven manner”. In practice, the NBH now focuses on the level rather than the delta. However, our forecast remains unchanged – no rate cuts in the second half of the year.

The forint responded by strengthening but we have seen this elsewhere in the region and throughout the EM universe. Given the rally in core rates, even HUF rates were heading lower and the hawkish NBH report did not make much of a splash here. However, we think the hawkish NBH may unlock a short-term rally in the forint along with the return of risk-on sentiment even though we are still rather negative on HUF in the medium term. Today's market open will be key, but for now, it looks like we could go back to 392 EUR/HUF.

In the CEE region, today's calendar is empty. However, the markets have plenty of reasons for action. The last two days have confirmed the turn in global sentiment in favour of EM currencies and CEE is benefiting significantly. As we expected, Poland's zloty has rallied the most among its peers so far and we think this will be the story for the days ahead. Positioning is much more balanced after erasing all of this year's gains while rates point to levels around 4.300-310. On the other hand, the Czech koruna is being pulled down by new bets for more than a 25bp rate cut next week. EUR/CZK moved above 24.800 yesterday and further comments from CNB could push FX towards 24.900 in our view. We think PLN/CZK thus has good potential to return to 5.800.

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