FX Daily: Upbeat China PMIs lift the mood

Financial markets are caught between the two narratives of a softer landing (helped by China's reopening) and sticky inflation keeping policy rates higher for longer. That will probably keep bond markets on the back foot and FX markets volatile in ranges. Today's highlights will be PMI releases around the world and presumably high German inflation

USD: Foreign Direct Investment trends of interest

The dollar has softened marginally in Europe and emerging market currencies are generally bid after China released an encouraging set of February PMIs. There were strong rebounds for both the manufacturing and service sectors which are feeding the narrative that a 2023 China recovery is the real deal. The PMIs come ahead of this weekend's 'Two Sessions' political gathering where we expect a growth target of 5.5-6.0% to be outlined. So far, so good and the China PMI data trumped some local news where AUD/USD has ended up higher on the session despite some softer-than-expected GDP and CPI data.

Catching our eye this morning has been a survey by the US Chamber of Commerce (AmCham) that only 45% of American companies see China as their top three investment destination, compared to 60% a year ago. Clearly, geopolitics is driving this. Of the 24% of companies which said they might relocate out of China, one-third said they would relocate to the US. This topic of re-shoring/friendshoring will be an important multi-year factor driving Foreign Direct Investment (FDI) trends and could provide some resistance to those looking for the secular decline of the dollar. On that subject, we also note that Tesla will be building its next plant in Mexico. That only adds to the attraction of the Mexican peso, which remains our high yield/EM currency of choice.

Back to today. The US releases ISM manufacturing data which should remain soft at 48. More interest will be had in Friday's services ISM. We suspect the China PMI story might dominate FX trading today and maintain a slightly offered tone for the dollar. Yet DXY will probably trade well within Monday's range of 104.55-105.35.

Chris Turner

EUR: Inflation, inflation, inflation

EUR/USD got a lift yesterday from data showing Spanish February core inflation pushing to a new cycle high. The fact that Spanish core inflation includes food may not mean such a large read-through to tomorrow's eurozone core CPI data which is expected at 5.3% year-on-year. Yet our team thinks that this figure could now push up to a new cycle high of 5.4/5.5%. The worrying trend in prices continues to feed into European Central Bank expectations where the market looks to be pricing an extended tightening cycle into 2024, with the deposit rate (now 2.50%) possibly being raised as high as 4.00%.

Feeding into that story today will be German CPI, which is released around 14CET. The continued re-pricing of the ECB curve is providing EUR/USD with some support against higher US rates and suggesting 1.05 will be the bottom of the EUR/USD's first quarter range after all. Certainly, the disinflation story is taking a back seat this month.

Today, we have a few ECB speakers and we should expect a relatively quiet 1.0565-1.0645 range for EUR/USD. The more aggressive ECB pricing is also providing some support to EUR/CHF, which looks like it might end March near our 1.00 target.

Chris Turner

GBP: More focus on the Northern Ireland deal

Yesterday, we wrote a piece on what the new Northern Ireland deal - or 'Windsor Framework' - meant for sterling. While welcome news, we doubted that it would prove a game changer for sterling. Some other FX strategists felt that the news could be a lot more positive for sterling - even triggering a 2/3% rally in the pound were the DUP to come on board, support the deal and return to government in Northern Ireland.

We think the small rally in the pound that was seen (and has since partially reversed) is probably sufficient in that it reflects a warmer political relationship between the UK and the EU. We doubt any approval by the DUP makes much difference to the pound. As we discussed in the article, weak UK growth and an increasingly hawkish ECB will probably keep EUR/GBP supported for most of the year.

We do note, however, that some of last year's policy uncertainty is still being taken out of sterling via the FX options market. For example, the one-year EUR/GBP risk reversal - the price for a EUR call option over an equivalent EUR put option - has fallen to 0.95% from 2.5% last September. And one-year EUR/GBP traded volatility has fallen to 7% from 11%. But those moves may well have come far enough for the time being.

Our baseline sees EUR/GBP staying supported under 0.88. Look out for a speech by Bank of England Governor Andrew Bailey at 11CET today. Money markets price the Bank Rate at 4.75% into September. Our team thinks that BoE rates will not need to be hiked that far, yet with inflation staying high for the time being, Governor Bailey may find it too early to disabuse the markets of that pricing. GBP/USD could drift back to 1.2100 on the slightly softer dollar today.

Chris Turner

CEE: Gas prices support the region again

The National Bank of Hungary (NBH) left rates unchanged yesterday. Even though at face value it looks like nothing has changed, our impression is that the central bank still means business when it comes to fighting inflation and was able to sound a bit more hawkish. The central bank will not be distracted by promises and outliers. The NBH wants to see a permanent improvement in every aspect and will not rush policy easing. However, looking at the market reaction, it is clear that the market already understood the NBH's message in January and the February meeting did not bring much fresh news. As we mentioned in our NBH preview, we expect the forint to take a break in March and the central bank meeting is the last chance for gains below 380 EUR/HUF for now. We remain positive on the forint, but the current drivers have run out of steam. Plus we could see some negative news in the EU story in the coming days and a downgrade in the outlook from Moody's this Friday.

Today, we will see the PMIs across the region for February. We expect a slight improvement in sentiment in Poland and the Czech Republic and a deterioration in Hungary. In Hungary, the PPI for January will be published. The Czech Republic's state budget numbers for February will also be revealed, which could shed more light on the financing and issuance of CZGBs.

In the FX market, we have seen new gains for CEE again in recent days. The Czech koruna, in particular, has attracted attention, breaking below 23.50 EUR/CZK for the first time since 2008. The main reason, in our view, is the renewed decline in gas prices and the testing of new lows. However, the rest of the market does not indicate favourable conditions for the koruna and the region. With core rates rising further, interest rate differentials have compressed across the board and the US dollar is once again on the stronger side. Thus, we are hard-pressed to find reasons to see the current gains as sustainable.

Frantisek Taborsky

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com