

FX Daily: Washington holds the key to the dollar's correction

The dollar rebounded yesterday, likely aided by some position-squaring, as US data disappointed and risk sentiment remained unstable. Markets are set to remain very sensitive to US debt ceiling news into the weekend, and the dollar's support may linger barring positive developments. The Czech National Bank will unveil its hawks



A key meeting between President Biden and Congress leaders has been put off until next week

➔ USD: All eyes on debt ceiling talks

The dollar bounce seen yesterday was the result of some position-squaring and below-consensus data, while the still unstable risk environment caused by recessionary fears and the US debt ceiling stalemate keeps creating a breeding ground for more defensive positions in FX. Unsurprisingly, high-beta currencies (Scandies and Antipodeans) took the biggest hit yesterday, while the yen showed resilience.

On the debt limit saga, there have been some tentatively encouraging comments by Republican negotiators, but a key meeting between President Biden and Congress leaders was put off until next week. We still think investors are worryingly eyeing a scenario where it would ultimately take an adverse market reaction to break the impasse, and lack of any progress towards a deal can definitely continue to offer some support to the dollar.

On the other hand, a benign scenario where a bipartisan deal has a positive impact on sentiment can leave the dollar quite vulnerable given the quite aggressive rate cuts being priced into the USD curve, which the dollar is not currently negatively discounting thanks to safe-haven demand.

On the data side, jobless claims surprised on the upside and PPI to the downside yesterday – both adding to rate cut bets – while today's focus will be on the import price index and the University of Michigan inflation and sentiment gauges. FOMC member Mary Daly is scheduled to speak this evening.

Francesco Pesole

➔ EUR: No domestic drivers

EUR/USD continues to follow primarily USD dynamics, and a quiet calendar in the eurozone (final CPI reads are not normally market-moving) means this should continue to be the case today. For now, the USD appreciation was not enough to trigger a break below 1.0900 in the pair, but the lack of some encouraging news on the US debt ceiling story means – in our view – that 1.0900 will hardly prove to be a sturdy support for much longer.

On the ECB side, we'll hear from Germany's Governing Council member Joachim Nagel. ECB speakers have had a limited impact on the euro after the latest ECB meeting and this should not change for now.

Francesco Pesole

➔ GBP: BoE offered few reasons to turn bearish on the pound

As we expected, the Bank of England's 25bp rate hike did not have any major implications for GBP. The drop in Cable yesterday was almost entirely due to the USD rally and was in line with the move in other dollar crosses.

As discussed by our economist in our [BoE review](#) note, the BoE retained its flexibility and kept the door open for more rate hikes if inflation proves persistent. While we don't exclude one final June hike, our base case is that we have reached the peak of the BoE tightening cycle as inflation will start to rapidly decelerate this year.

Still, the Sonia curve continues to price in around 38bp of tightening to the peak, which leaves the pound at risk of a rate-driven negative impact down the stretch. We feel this will materialise in EUR/GBP, which should climb back to 0.9000 in the second half of the year as EUR and GBP rates re-converge, in our projections. For now, however, there aren't many convincing reasons to call for GBP underperformance against its main peers in the near term.

Francesco Pesole

➔ CZK: The koruna less attractive than expected

Inflation in the Czech Republic [surprised](#) significantly to the downside yesterday with a drop from 15.0% to 12.7% year-on-year vs. 13.2% in the Czech National Bank forecast. In addition, the government unveiled a fiscal package aimed at reducing the state budget deficit in the coming years. Nothing has been approved yet, but the first proposals look ambitious. Thus, the government would like to bring the public deficit from this year's 3.5% of GDP to 1.8% next year

and 1.2% in 2025, resulting in by far the lowest public deficit in the CEE region. For Czech government bonds (CZGBs), this means that for next year supply could reach almost half of this year's levels.

Overall, this is clearly a positive direction, but the government now faces a complex legislative process, during which we may yet see some changes. From the CNB's perspective, the tax changes introduced are rather anti-inflationary, which should calm down the hawks on the board and prevent an interest rate hike at the June meeting. Speaking of the central bank, the CNB minutes will be released today, which should reveal the names of the board members who voted for rate hikes last week.

Overall, lower-than-expected inflation and the prospect of low CZGBs supply pushed market rates down and the interest rate differential thus returned almost to pre May-meeting levels. Moreover, the lower EUR/USD is pushing the entire CEE region to weaker levels. Thus, the Czech koruna erased almost all the gains it made after the CNB meeting last week. Thus, today's minutes could revive the CNB's hawkish tone and help the koruna return below 23.50 EUR/CZK. However, it seems that the koruna is no longer as attractive as we previously thought and we are hardly looking for a significant catalyst for a new rally until the June CNB meeting.

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