FX Daily: What to expect from a manic week in markets

Geopolitical risks failed to update over the weekend and will remain central in FX price action. The dollar's rebound has been lacklustre, and while some support is warranted by the current market conditions, there'll still be a tendency to fade the rallies. A busy week for central banks should see cuts in Switzerland & Sweden, and holds in the UK & Norway

Geoopolitical developments have stormed into the picture, and the implications of the Middle East conflict for energy markets can easily spill over into central banks' inflation assessments

USD: Dollar rebound has been lacklustre

This was always meant to be a very busy week for markets, as a few key central bank meetings – including the Federal Reserve's – were set to refresh the market understanding of policymakers' stance on the inflation-growth balance in the second month of global US protectionism. But as we know, geopolitical developments have stormed into the picture, and the implications of the Middle East crisis for energy markets can easily spill over into central banks' inflation assessments.

We should therefore start with geopolitics. On Friday, we published a market guide on the Middle East conflict, where our commodities colleagues noted that the larger risk premium in oil prices is justified and disruptions could push Brent prices towards $80/bbl or even $120/bbl if shipping through the Strait of Hormuz is affected. It is now trading just below $75 and should keep showing elevated intraday volatility.

The higher oil prices mean central bankers are expected to be more cautious with easing or dovish guidance. The Fed, which is widely expected to keep rates on hold on Wednesday (full preview here), can now use energy market volatility as an argument to fend off US President Donald Trump's calls for rate cuts while it assesses the depth of the tariff impact on inflation. We see non-negligible risks that the 2025 dot plot projections will be revised from 50bp to 25bp, and we think the FOMC event this week mostly carries upside risks for the dollar.

But a more hawkish Fed is not enough to keep the dollar bid in the current environment. The USD bounce since the Israel-Iran strikes started has been relatively contained and is now being largely unwound. That is despite no signs of de-escalation in the region and oil prices staying supported. In our view, that is once again the symptom of the market's distrust in the dollar at the moment, so even a clear-cut dollar positive event like an oil price shock mixed with geopolitical tensions fails to discourage the methodical USD-short building we have observed in the past couple of months every time the dollar was attempting a recovery.

With Treasury yields deterring rather than encouraging a return to USD in the current environment (even if due to oil prices, not deficit concerns this time), we think further dollar rallies should continue to be faded. At the same time, though, the downside risks for USD are probably lower now that geopolitical risks have flared up, and considering how much risk premium is already in the dollar. Explorations below 98.0 in DXY may not last very long unless there are signs of de-escalation.

The G7 summit in Canada starts today; expect headlines on trade and geopolitics throughout the next couple of days.

Francesco Pesole

EUR: Peak central bank action in Europe

The eurozone's dependence on energy price exports should put a curb on EUR/USD upside in our view. We had already argued before the Israel-Iran conflict began that moves beyond 1.1600 started to look too stretched based on previous peaks of misvaluation. At the time of writing, the short-term fair value is just below 1.110 according to our model, and moves below 1.1640 would send the pair beyond the three-standard-deviation upper bound.

Anyway, price action in the coming days will be heavily dependent on oil market volatility and the USD moves. On the eurozone side, the main highlights are the ZEW survey results out tomorrow, and a few speeches by the European Central Bank's Governing Council members. Today, we'll hear from both sides of the spectrum: hawk Joachim Nagel and dove Piero Cipollone.

Expect a lot of action in other European central banks. The Riksbank (Wednesday) and the Swiss National Bank (Thursday) are both expected to cut rates by 25bp, although for the former, it is a closer call in light of the latest oil price shocks. Expect holds by the Bank of England (preview here) and Norges Bank (preview here) on Thursday.

Francesco Pesole

JPY: BoJ to hold, but hike chances underpriced

G10 central bank activity this week starts with the Bank of Japan, which is widely expected to keep rates at 0.5% overnight. But the primary focus, alongside any forward guidance, will be on the interim review of Japanese government bond purchase operations. Despite speculation that the BoJ might reduce its quarterly purchases from 400 billion yen to 200 billion yen, it is expected to maintain the current pace.

While the BoJ may not give much away in terms of rates guidance at tomorrow's meeting, we think the risks are definitely skewed to the hawkish side. In our view, markets continue to underestimate the risks of a rate hike as early as July or September, which are 10% and 25% priced in at the moment.

We think the yen remains a rather attractive hedge at the moment, especially if US equities face more hits from geopolitics. Excessive rallies in oil prices may dent the attractiveness of the yen as a safe-haven, but a hawkish repricing in BoJ expectations should make up for it in our view.

Francesco Pesole

CEE: Higher oil prices dampen hopes for rate cuts

The second half of the month is usually quieter in the CEE region. The calendar is light, with PPI in the Czech Republic and core inflation in Poland today. Friday's final numbers in Poland showed a downward revision to the headline number by a tenth to 4.0% in May. At the same time, the breakdown suggests core inflation around 3.2% from 3.4% in April.

Tomorrow in Hungary, wage numbers will be released, which are closely watched by the central bank, and we expect a further decline to 8% year-on-year in April.

On Thursday, the Central Bank of Turkey meets. We expect rates to remain unchanged at 46%, in line with market expectations. Given continued disinflation and an improving appetite for TRY assets, the CBT has started easing liquidity conditions to normalise the average funding cost around the one-week repo rate. With this easing, we assume that the central bank will want to wait for the July meeting to begin cutting rates.

In the Czech Republic, the Czech National Bank's blackout period will begin on Wednesday ahead of next week's June meeting. Last week, we heard from two board members, including the Governor, suggesting a pause in the rate cut cycle in June and an open discussion of a rate cut in August. However, the Governor's words suggest a longer pause given the surprisingly high inflation and outlook for the months ahead. We should hear from other board members today and tomorrow, and we expect a hawkish tone here as well. In Romania, we will follow the coalition negotiations on the formation of a new government and the fiscal package, both of which are expected to be presented this week.

On Friday morning, the markets switched into risk-off mode, and we saw losses across the region following the escalation in the Middle East. However, we later saw some correction after rates sold off. We believe higher energy and oil prices are a reason for CEE central banks to be more hawkish versus current market pricing, which should protect FX from more weakness. The current weaker levels therefore look attractive to us, especially in CZK and PLN.

Today's open may start in a risk-off mood again after this weekend's events, putting further pressure on CEE currencies, but we believe the medium-term picture is positive thanks to the hawkish bias of central banks for the region's currencies.

Frantisek Taborsky

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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