

FX Daily: Window of carry sees renewed interest in EMFX

Markets are enjoying some temporary calm and cross-market measures of volatility are sinking back to levels seen in early June. Barring an explosive US July CPI release tomorrow or some major escalation in the straits of Taiwan, these calmer conditions can see renewed interest in emerging markets (EM), including in EM local currency bonds



Hungarian inflation surprised on the downside in January

➔ USD: Dollar stability can allow some interest in high yield EMFX

A very quiet Monday and what looks the same again today has seen the dollar soften slightly across the board. The moves have not been particularly large, but we have seen steady out-performance in currencies like the Brazilian real (BRL), Mexican peso (MXN) and a few selected commodity-linked currencies in the G10 space. The moves are a reminder that FX markets never fully settle and that even in quiet periods, investors rotating into yield can generate some movement.

An FX trend that is probably worth watching is whether investors start returning to the battered EM local currency bond complex. On a global basis, aggregate EM local currency bond benchmarks are down around 8% year-to-date (better than equity benchmarks). Yet that 8% drop masks regional differences. EM Latam (dominated by Brazil and Mexico) is up 2% year-to-date, while EMEA and Asia are down 23% and 6% respectively.

Even though we think the dollar can stay quite well bid for the rest of the year as the Fed takes the funds rate to 3.25/3.50%, dollar stability at the highs could see renewed interest in this high-yield EM local currency bond space. Of these geographical blocs, we are already starting to see sizable bond market rallies in Latam, where the fall in US Treasury yields is being accompanied by views that some of the pre-emptive hikers – such as Brazil – have just about finished their tightening cycles. These views are being helped by the sizable turns in some of the big inputs in EM. For example, the UN's FAO world food price gauge dropped to a 13% year-on-year increase in July, from peaks of 40% YoY last summer and 35% YoY in March on the back of the Ukraine conflict. Energy price inflation is slowing too.

Quiet summer markets could therefore see investors starting to position at the long end of the EM local currency bond market for EM easing cycles coming through next year. Here many think Brazilian policy rates have peaked at 13.75%, while Mexican rates should peak alongside the Fed in December this year – probably in the 9.25/50% area. Given heavily inverted yield curves, bond investors will have to leave FX exposure open to these bond investments – meaning that a flow into this product could see some sizable FX rallies. Brazil has elections in October, adding to the complexity here, but a pick-up in flows to the EM local currency product could certainly help the MXN – where USD/MXN could trade back to 19.50 as could EUR/MXN.

Back to DXY, expect another range-bound day as the market awaits the US July CPI release tomorrow – a release expected to cement expectations that the Fed Funds rate will be taken to the 3.25/3.50% area by year-end.

Chris Turner

➔ EUR: On vacation

EUR/USD remains listless in the middle of a 1.0100-1.0300 range. The European data calendar is exceptionally light this week and this pair will instead be driven by geopolitical factors and US data/Fed speak. Our baseline for the remainder of this year is EUR/USD continuing to trade down near the 1.00/1.02 area. Italian politics will also prove a headwind into the September elections. Having said that, the Italian-German 10-year bond spread was quite contained yesterday, despite Friday's ratings outlook change for Italian sovereign debt by Moody's. Presumably, the ECB's flexible use of pandemic emergency purchase programme (PEPP) re-investments aims to limit the fall-out on Italian bonds for the time being.

Chris Turner

➔ GBP: Soft

EUR/GBP is pressing resistance at 0.8450 as we write this. We had felt that this might prove the top of a near-term trading range – despite [the Bank of England's bleak prognosis last week](#). In our mind, there still does not seem a compelling case for EUR/GBP to trade substantially higher, but we acknowledge that a break of 0.8450 can carry EUR/GBP to the 0.8485/8500 area.

Chris Turner

HUF: Inflation print as a spark of hope for the forint

We will receive the July inflation print in Hungary today. There is a high degree of uncertainty surrounding the forecast, but one thing is clear: inflation is expected to accelerate both in monthly and yearly terms. [Peter Virovacz in Budapest expects](#) close to 2% month-on-month inflation with the yearly index moving up from 11.7% to 13.3%, while year-on-year core inflation will jump through the 15% threshold. Based on industrial and agricultural producer prices, we expect further strengthening in food and durables inflation. On top of that, EUR/HUF moved to a record high during July, possibly adding further pressure to price increases.

Peter expects inflation to be above market expectations, however, we believe any number above 13% should revive the hawkish mood in the market again. Although the market is expecting another sharp National Bank of Hungary rate hike at the end of the month, slightly above our expectations, in the longer term – over the coming months – expectations are more tepid, lagging behind our forecast. Thus, we see room for a new flattening of the curve, and at the same time, the forint could see some support for the first time in a while. As we mentioned [yesterday](#), we see the forint as the most vulnerable currency in the CEE region at the moment. Today's inflation print is unlikely to change that, but it could at least underpin the current (in our view) unjustified gains, and soften any correction in the CEE region.

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

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