

## FX: Where is the love?

A look at how major currency pairs could perform this Wednesday.



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### USD: Balance sheet talk to inject a steepening bias in the US yield curve

The view that the Fed will begin its balance sheet normalisation policy in Sept will likely be supported by the July statement noting that the process could start “relatively soon”. This has been the message from Fed officials, with even the more conservative members such as Lael Brainard championing this idea. While the Fed will refrain from actually committing to a start date, we do see plenty of reasons to start the balance sheet run-off process sooner rather than later, not least because financial conditions are evidently becoming unresponsive to adjustments in the short-term policy rate.

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*For global markets, we are shifting to the idea that a rise in long-term yields driven by a pickup in the term premium may be the lesser of two evils.*

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Risky assets stand a better chance of withstanding such a bond market adjustment, rather than

one due to a sharp repricing of policy rate expectations. While the dollar may use the Fed meeting to recoup some of its losses, a 'Goldilocks' global market backdrop looks set in stone over the summer.

## EUR: Tempting to revise our EUR/USD forecasts higher, but...

It's evident that markets are at the most bullish they've been on EUR/USD for some time: the pair yesterday saw the 1.17 handle for the first time since in two years, while net long speculative positions are close to their 5-year highs and 3M 25d risk reversals are now at their highest since 2009. Admittedly, there is a bit of temptation to get caught up in the current wave of EUR optimism by revising our baseline forecasts higher. But doing so would be throwing out the logic that underpinned our call for EUR/USD to reach 1.15 this summer. And with the sun still shining, we prefer to view the 1.16-1.17 range as a near-term overshoot. From the ECB's perspective, a strong EUR itself doesn't come without costs; in addition to having a dampening effect on exports, persistent FX strength adds a disinflationary impulse and for us to be confident that a higher EUR can be sustained, we need to see more broad-based signs of domestic inflation. This makes the July eurozone CPI release on Monday an important event.

## Weak UK growth tempers any BoE rate hike expectations

Second quarter UK GDP data today confirms what we already know in that activity remains feeble. Growth rose by 0.3% in the second quarter. This all but dents any lingering hopes of a rate hike at the August MPC meeting next week, while any negative surprise could weigh on the 36% probability of a November hike, currently priced in. This would be slightly GBP negative, with risks that GBP/USD moves back below 1.30.

## AUD: Inflation and Governor Lowe push AUD away from the 0.80s

A sub-consensus headline second quarter CPI figure of 0.2% QoQ vs. 0.4% expected supports the Reserve Bank of Australia's view that domestic inflationary pressures are lacklustre, but officials may take some comfort in the slightly firmer core readings. This sentiment was echoed in Governor Lowe's speech shortly after the data release; the RBA chief made clear there is no need for domestic policy rates to move up in line with other central banks that are tightening. There was some tentative attempt to talk down the currency, with the Governor stating that it "would be better if the AUD was a bit lower". A "bit lower" is in line with our view that AUD/USD should be trading closer to 0.75, with the current overshoot due an excessively weak US dollar.