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Weekly Report

G10 Weekly FX Update

Written by:

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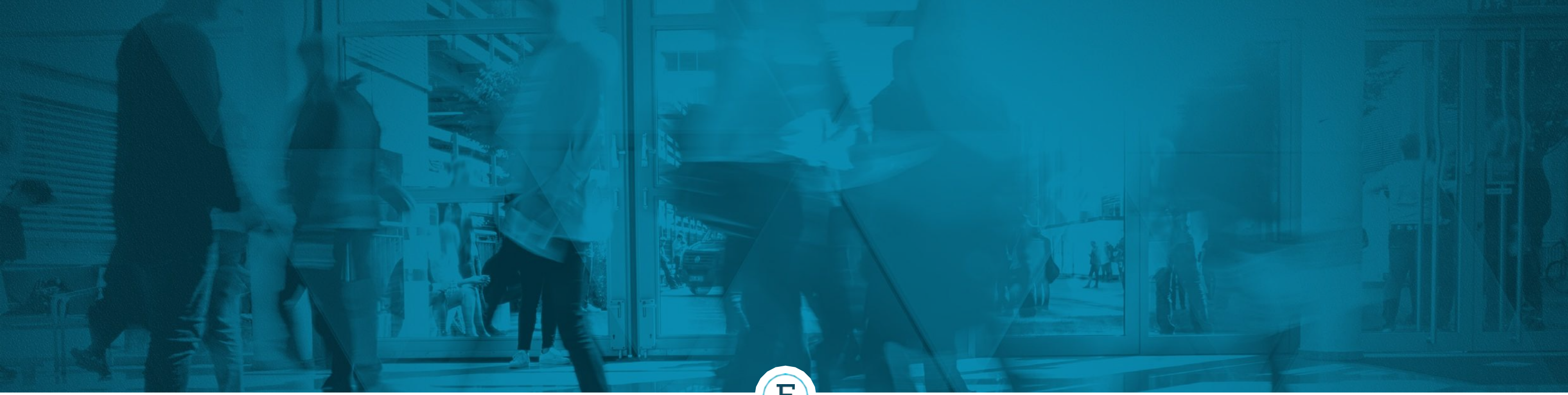
24th July 2023



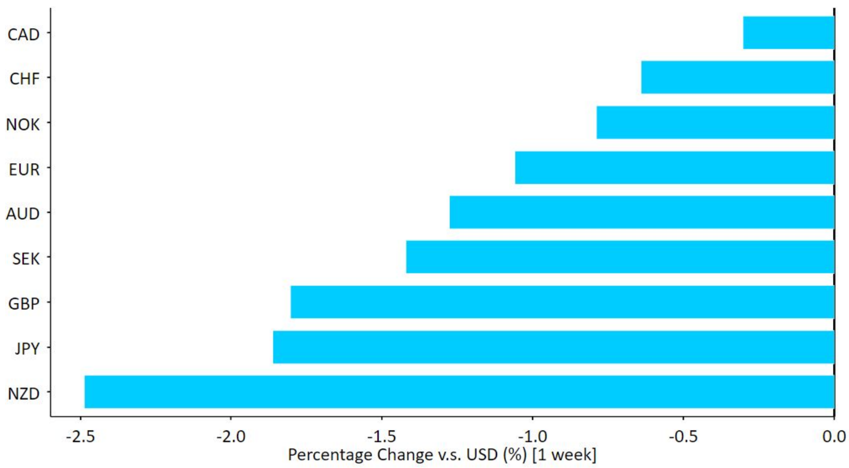
US dollar snaps back as bearish consensus gets squeezed

We said that the euro rally against the dollar was looking stretched, and last week's market action seemed to confirm our view.

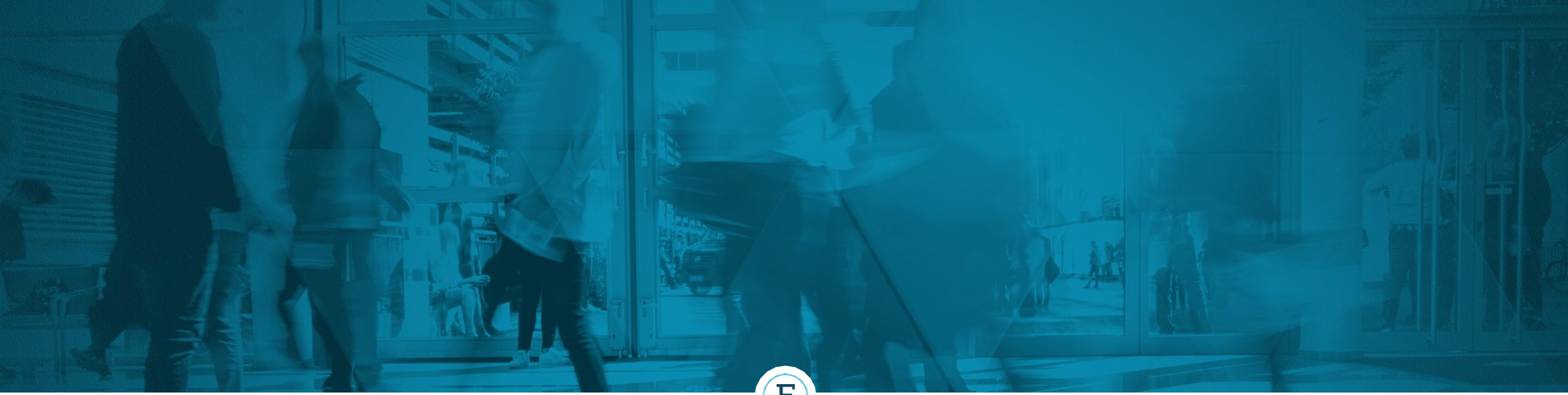
The dollar rallied across the board on no particular news, a sign of a trend driven by technical factors rather than fundamentals. The bearish consensus on the dollar, as disinflation takes hold in the US, ensures that stretched investor positioning is vulnerable to a snap back, and that seems to be what happened last week. The greenback rose against every major currency worldwide, and most emerging market ones as well. One of the clear exceptions was the Colombian peso, which continues to benefit from very high interest rates and is now the top performing currency worldwide so far this year.

This week will be packed with critical data releases and policy news. The Federal Reserve meeting on Wednesday is followed by the European Central Bank one on Thursday. Both are universally expected to hike rates by 25bps. The former, however, may communicate a pause, whereas the latter still has work to do. The G3 PMIs of business activity will also be in focus on Monday, as will the second quarter GDP report and PCE inflation report out of the US on Thursday and Friday respectively.

Figure 1: G10 FX Performance Tracker [base: USD] (1 week)



Source: Refinitiv Datastream Date: 24/07/2023



GBP

The general sell-off in European currencies against the US dollar hit sterling particularly hard last week. A surprisingly soft inflation report, notably the unexpected retreat in the core number from its three decade highs, contributed to this underperformance, as did rather high valuation - the pound remains the best performing G10 currency so far this year, alongside the Swiss franc. This is the first time in many months that the Bank of England will have seen good news on the inflation front, as both the headline and core numbers came in lower than consensus.

It is too early to assume that the disinflation trend visible in the US has also taken root in the UK, though it is certainly a hopeful sign. Markets are still pricing in a 50% chance of a jumbo 50bp hike in August, and UK rates are very likely to end up higher for longer than any other G10 country, which should continue to support the pound.

EUR

The European Central Bank continues to wrestle with its inflation problem. Going by the core index, the disinflationary trend evident in the US has yet to cross the Atlantic. Last week's slight upward revision to the June inflation number confirmed that the ECB still has work to do, so raising rates by another 25bps at its meeting this week is effectively a certainty.

Traders will be paying close attention to the communications from the meeting, which will be key to the euro reaction. Unlike at the June meeting, we think that Lagarde will refrain from offering any clear forward guidance on the next meeting, with the ECB likely to adopt an entirely data-dependent approach. In particular, the ECB's balancing act between weakening growth and stubbornly high inflation will be key for the common currency leading into the August holidays. Recent data on the former has been very disappointing, typified by this morning’s soft PMI numbers.

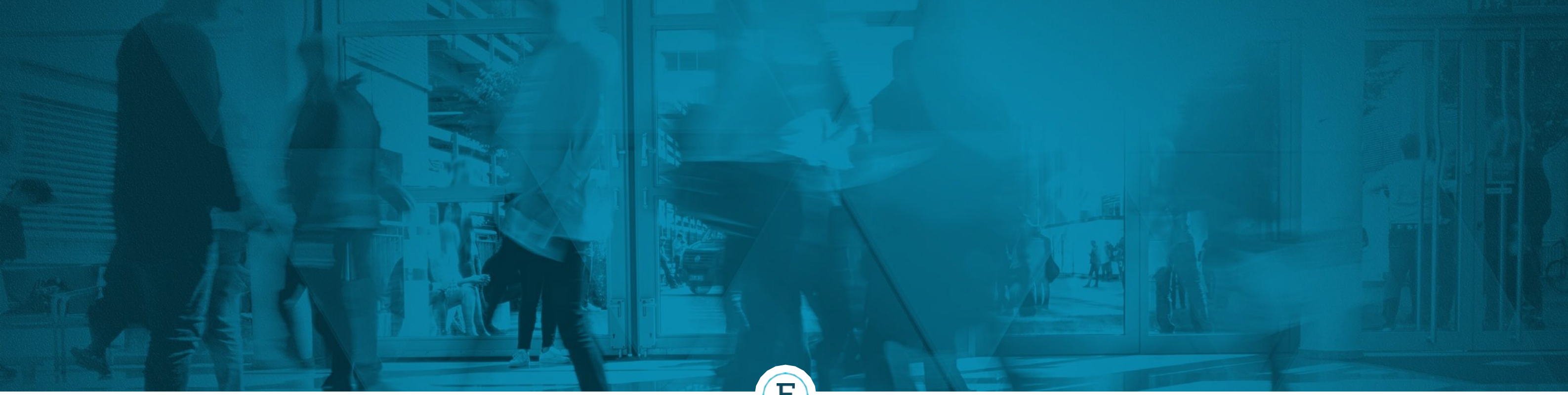
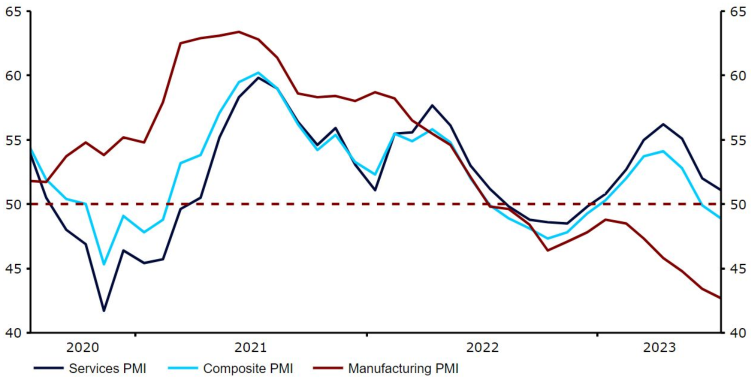


Figure 2: Euro Area PMIs (2020 - 2023)



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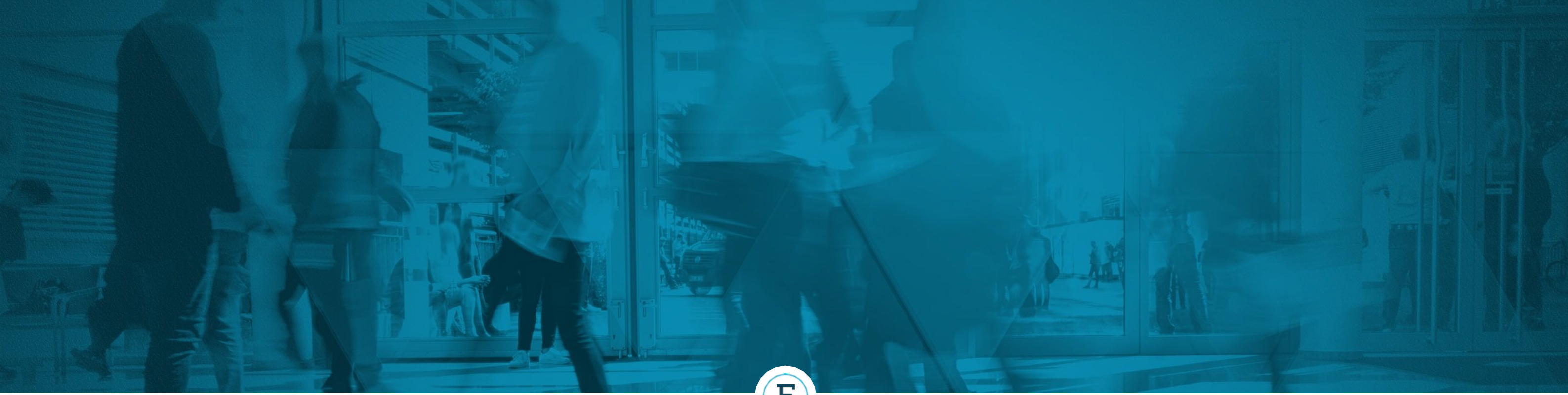
USD

The Federal Reserve's latest policy meeting on Wednesday could yield the final rate hike in the current tightening cycle, although chair Powell and co. are unlikely to explicitly indicate as much. The most likely outcome is another 25bp hike, followed by some mildly hawkish rhetoric that will not change the narrative too much. On the one hand, the US economy continues to perform remarkably well, while on the other, the excellent news on inflation means that the Fed can take its foot off the gas and wait a few months for further developments.

In the event that the Fed kicks the can down the road, and leaves the decision on when to end the hiking cycle until future meetings, then the reaction in the dollar could be limited. By contrast, any indication that this week's rate increase may be the last would be clearly bearish for the greenback. As long as economic growth worldwide holds up decently, we think that this dovish turn would allow for a gradual slide in the dollar against most of its major peers.



JPY

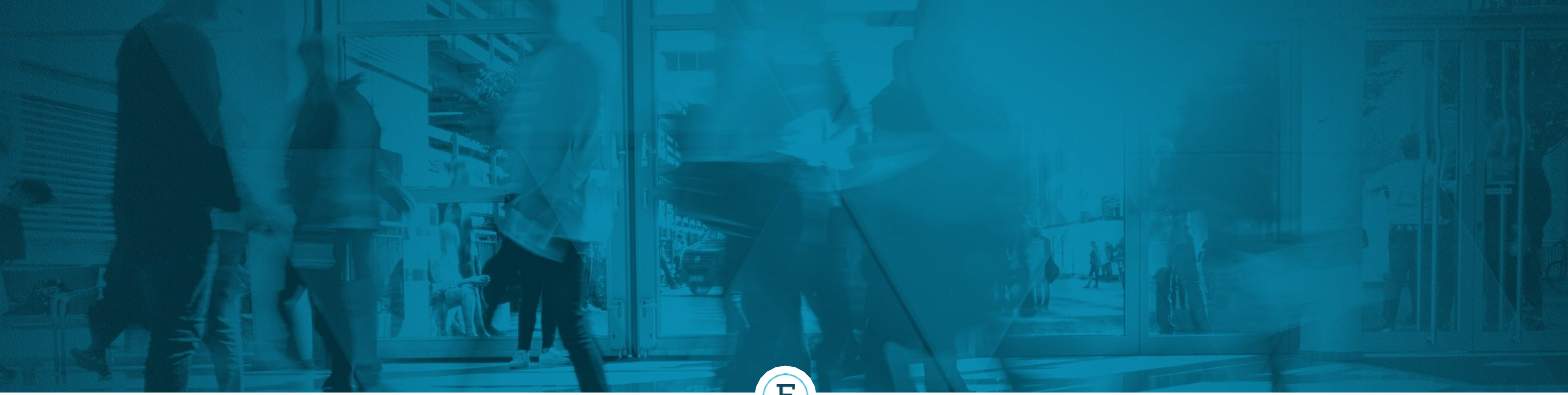
This Friday's Bank of Japan meeting has gone somewhat under the radar, given the importance of the Fed and ECB announcements on Wednesday and Thursday, although it will be no less interesting. Policy is set to remain unchanged, in line with recent reports citing BoJ 'sources'. There does, however, appear to be a growing consensus that a tightening shift in not too far away, and it will be interesting to see whether a handful of rate-setters dissent, and vote in favour of a change in the YCC policy this week.

Should we see a split vote among BoJ members on Friday, then we could see some support for the yen as markets begin increasing bets in favour of higher Japanese rates in the coming months. As things stand, swap markets are not even pricing in a 1-in-5 chance of a 10bp hike by year-end, so there remains plenty of room for some upside. Flash PMI data and the latest Tokyo inflation numbers will likely receive some attention in the coming days, although all eyes will be on the Bank of Japan towards the end of the week.

CHF

The Swiss franc was one of the best performing G10 currencies last week. The EUR/CHF pair fell to another low, and is now hovering just above the 0.96 level. This ensures that the franc now sits marginally above the pound, as the best performing major currency year-to-date, a move that perhaps leaves it open to a correction.

There hasn't been much news from Switzerland lately, with the exception of trade data. What has caught the eye is a strong demand for Swiss watches, with exports up 14% year-on-year in June. In terms of domestic news, this week sets up to be similar to the last one, with no major releases on tap, except for sentiment data. However, the franc is likely to react more to external news, given that it will be a busy week of major central bank announcements.



AUD

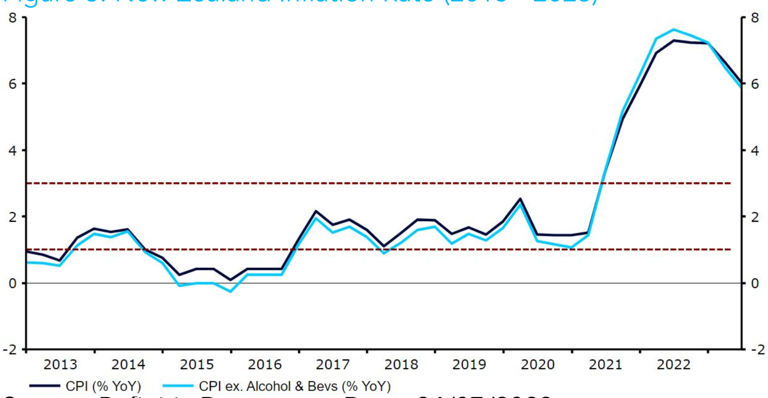
Economic news out last week was largely bullish for the Australian dollar, which comfortably outperformed its New Zealand counterpart. The minutes of the Reserve Bank of Australia's latest meeting were seen as hawkish. According to the minutes, members were in agreement that 'some further tightening may be required', explicitly indicating that another rate hike will be considered at the bank's next meeting in August. Investors had seen little chance of another rate increase next month prior to the minutes, but swaps are now assigning an even 50/50 shot of one.

Last week's strong labour report for June may elicit a hawkish response from the RBA, as both the employment change number (+32.6k) and jobless rate (3.5%) beat estimates. The business activity PMI data this morning was underwhelming, as the composite index slipped below the key level of 50, though we suspect that Wednesday's Q2 inflation data will be far more important for both the RBA and the Aussie dollar.

NZD

The New Zealand dollar was the worst performing currency in the G10 last week, as investors continue to steer clear of the kiwi due to the RBNZ's apparent lack of appetite for additional interest rate hikes. Last week's second quarter inflation data came in a touch above economists' estimates, although not by enough to convince markets that another rate increase is even close to remotely on the cards at the RBNZ's next policy meeting in mid-August. The headline rate eased to 6% in the three months to July, while core inflation edged lower, albeit only modestly, to 7.1%.

Figure 3: New Zealand Inflation Rate (2013 - 2023)



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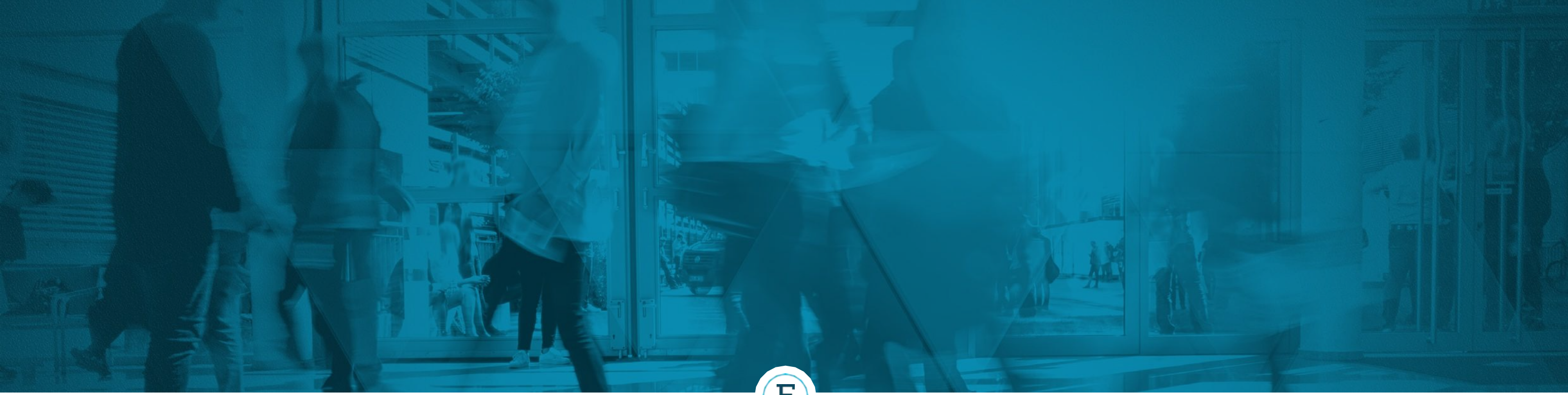
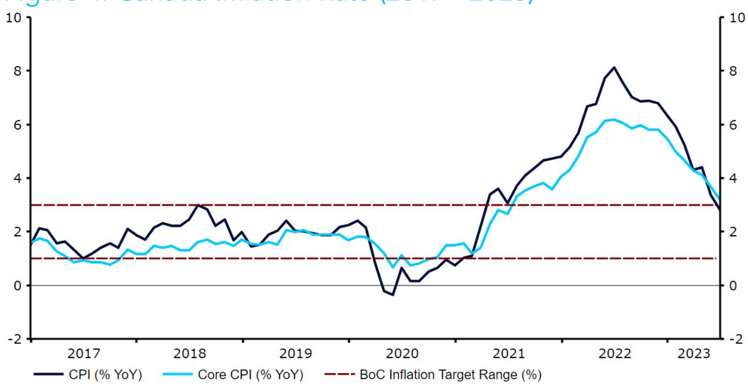


With no major economic data out of New Zealand this week, there appears very little standing in the way of further downside in the kiwi, and we continue to favour a modest underperformance in the currency against its Australian peer.

CAD

As tends to be the case, the Canadian dollar traded in lockstep with the USD last week, ending only modestly lower and outperforming most other major currencies. Domestic news was could actually be viewed as bearish for CAD, although had minimal impact on the exchange rate. The June inflation data missed its mark, with both the headline and core rates of price growth continuing on the trend towards the Bank of Canada's target. At 3.2%, core inflation is now just above the upper end of the BoC's target range, which to us should be enough for the bank to call time on its hiking cycle, albeit markets are not completely convinced.

Figure 4: Canada Inflation Rate (2017 - 2023)



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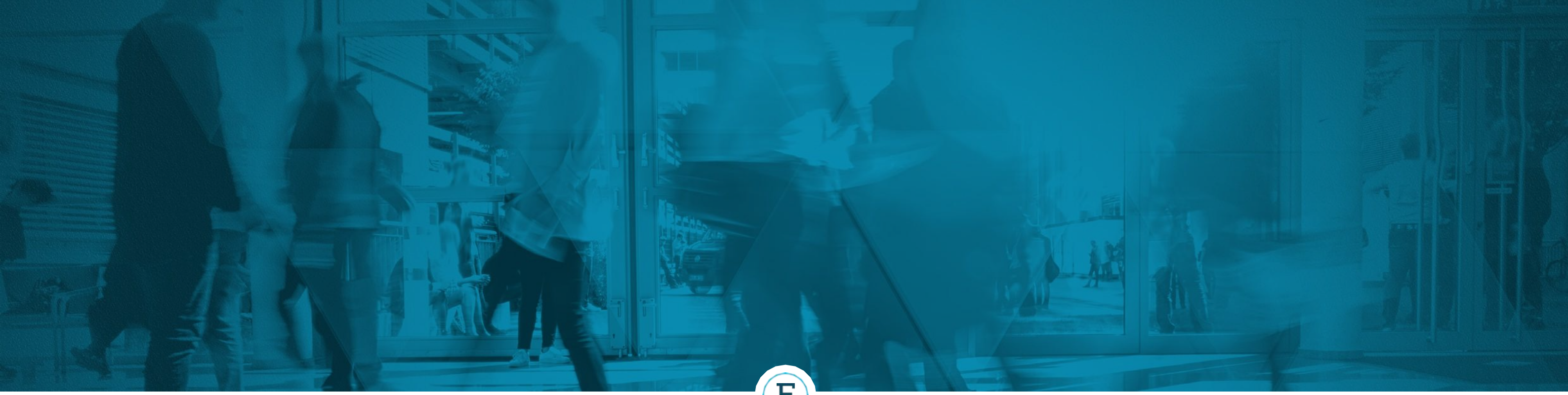
Attention this week will be on both the July PMI number (Tuesday), and Friday's monthly labour report. Even in the event of sizable upside surprises in both, we see additional Bank of Canada policy tightening as unlikely, and that could limit upside in CAD in the coming months.



SEK

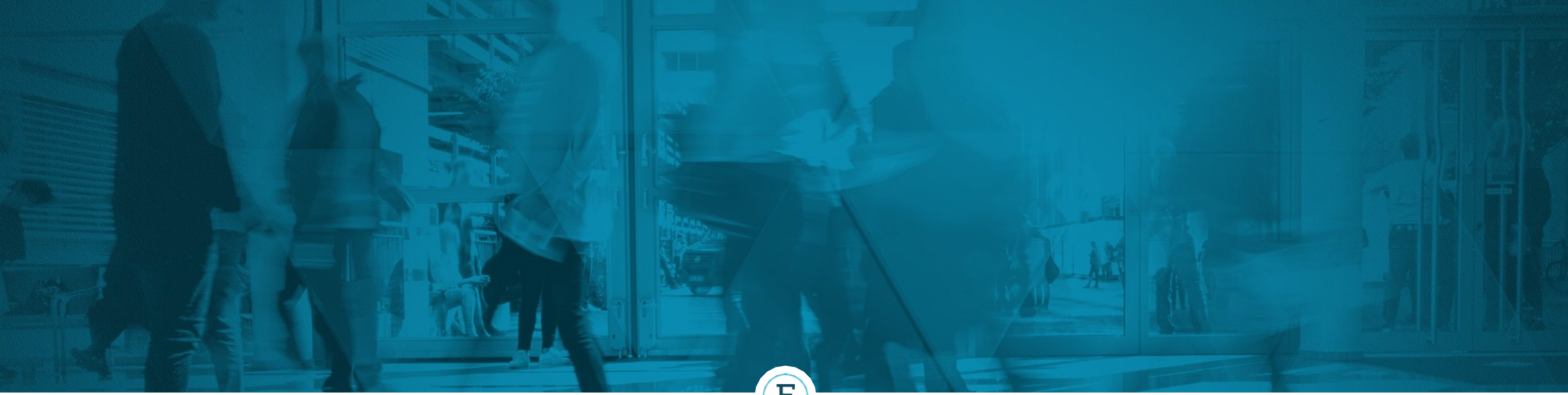
The Swedish krona edged modestly lower against the euro last week, giving back some of its gains after having recovered from the historical lows reached at the beginning of the month. At the time of writing, the EUR/SEK pair is trading around the 11.55 level.

The recent inflation surprise, which has increased bets in favour of a more aggressive Riksbank, has continued to support the Swedish currency of late. Markets are now fully pricing in a 25bp rate hike from the Riksbank at its next meeting in September and another in November is on the cards, particularly should upcoming inflation prints once again beat expectations. This week will see the release of a series of macroeconomic data in Sweden, which could be key for the Riksbank's future monetary policy. Retail sales for June (Friday) are expected to drop slightly from the previous month, while the unemployment rate is expected to fall to 7.6% from 7.9%.

NOK

The Norwegian krone has continued its upward trend, appreciating again against the euro last week and ending just behind the US and Canadian dollars at the top of the FX performance tracker. The surprise in the latest inflation data, which strengthens the case for a more aggressive Norges Bank, and the rebound in oil prices, which have risen by around 7.5% so far this month, can explain this outperformance.

The surprise to the upside in the latest Norwegian inflation data suggests that the Norges Bank now looks likely to continue raising rates in August, after delivering a hawkish pivot at its June meeting. The prospect of another hawkish shift from Norway's central bank, and high oil prices, should be bullish for the krone, which we continue to see as undervalued.



CNY

The yuan ended last week lower against the broadly stronger US dollar, although remained effectively unchanged in trade-weighted terms. Despite some positives, namely stronger industrial production, Chinese data released last week continued to play into an image of a faltering recovery. Following the data, we heard some words of encouragement from officials and a 11-point plan aimed to support household consumption was released, albeit it appears to be rather contained. Attention now turns to this week's Politburo meeting, which may provide some insight into how authorities will seek to address the challenge of weakening growth. That said, expectations are limited, which could mean a potential upside for Chinese assets and the yuan, if they deliver more than just incremental changes.

Importantly, we have seen a shift in authorities' approach to the yuan in recent weeks. The PBoC fixings have been firm of late and, in the latest sign of support, the bank eased rules on overseas borrowing for companies. This reaffirms our view that the currency should not fall further into the abyss, and we believe it has the potential to rebound, particularly if economic data turns a corner.

Economic Calendar (24/07/2023 - 28/07/2023)

Economic Calendar	Country	Day	Date	Time (GMT)
Preliminary PMIs (Jul.)	AUS	Monday	24/07	00:00
Preliminary PMIs (Jul.)	EZ	Monday	24/07	09:00
Preliminary PMIs (Jul.)	UK	Monday	24/07	09:30
Preliminary PMIs (Jul.)	US	Monday	24/07	14:45
Inflation (Q2)	AUS	Wednesday	26/07	02:30
FOMC Monetary Policy Meeting	US	Wednesday	26/07	19:00
ECB Monetary Policy Meeting	EZ	Thursday	27/07	13:15
Retail Sales (Jun.)	AUS	Friday	28/08	02:30
Retail Sales (Jun.)	SWE	Friday	28/08	07:00
Unemployment Rate (Jun.)	SWE	Friday	28/08	07:00

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