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FX Daily: Dollar caught between many fronts

The dollar is starting the week on a firm footing, juggling several drivers at once: the bond market remains a key focus, while trade headlines are increasingly moving currencies, especially CAD as US-Canada trade tensions keep escalating. Attention today will also turn to data, with US consumer confidence and the German Ifo survey in the spotlight

Canada's auto industry remains in the crosshairs of US trade policy

USD: Bond market helping a small recovery

Developed currencies have started the week on a quiet note despite the abundance of headlines. The dollar continues to take cues from the US bond market, with a good session for the back-end allowing the greenback to find some support. *CNBC* reported yesterday that the Treasury may use its account at the Fed (TGA) to fund its buyback operations for long-dated debt. Our rates colleagues argue that this would not be a big deal for the bond market, as buybacks funded through bill issuance today versus buybacks funded by running down the TGA and issuing bills later are largely equivalent.

On Canada, the situation is still in the escalation phase. Trump has announced 50% tariffs on Canadian autos and parts from 1 January. The distant implementation date suggests some caution around disrupting the auto sector ahead of the midterms, while also leaving ample room for negotiations. At the same time, both sides remain firmly in trade-conflict territory. We think the rebound in USD/CAD can extend beyond 1.390.

On Iran, the US announced a large sanctions package and, more importantly for markets, threatened other countries with economic punishment if they do not cut ties. China is the main focus here. Any serious revival of the US-China trade spat would be negative for the dollar in our view, mirroring last year's USD correlation with the issue. The US-Canada dispute could incidentally amplify that negative dollar reaction.

On the data side, along with some housing figures, we will look at August consumer confidence figures following soft prints in June and July. The balance of risks for the dollar remains skewed to the downside, but our baseline is for further consolidation into the Jackson Hole risk event later this week.

Francesco Pesole

EUR: Still a bit expensive

Our models suggest the short-term fair value for EUR/USD sits just below 1.160, an indication there is probably some – albeit contained – risk premium on the dollar linked to the US Treasury buyback announcement from last week. That helps our view that EUR/USD is more likely to stabilise than take another leap higher – i.e. above 1.170 – at this stage.

On the macro side, the German Ifo is in focus this morning. Remember that the index has shown some improved optimism in the German business environment this summer, and expectations are of another robust read.

Francesco Pesole

GBP: Volatility may stay subdued

EUR/GBP has gradually eased back to the pre-UST buybacks 0.8550-60 area – a signal the positive premium on the euro has been scaled back. If calm is indeed restored in the bond market, expect the pair to return to tracking short-term rate differentials closely.

That could mean a low volatility environment though, as the UK calendar is rather empty for the next couple of weeks. Anyway, we retain a preference for higher EUR/GBP as market pricing for 32bp of Bank of England tightening by year-end remains too hawkish. We still expect no hikes and a move to 0.870 in the coming months on the back of dovish repricing in the GBP front end.

Francesco Pesole

AUD: Limited dovish room ahead of CPI release

Australia releases July inflation data at 02:30 BST tomorrow. Consensus expects headline CPI to slow from 3.8% to 3.3%, although the volatility of the series means the trimmed mean is likely to attract greater attention. Expectations are for a modest easing from 3.6% to 3.5%.

In our view, such an outcome would remain consistent with our call of no further RBA hikes this year as inflation continues to moderate. At the same time, it is unlikely to be enough for Governor Michele Bullock to adopt a more dovish tone.

Bullock has remained notably hawkish, yet markets continue to price only a 50% probability of a hike by year-end. Even a small inflation surprise could narrow the gap between market pricing and Bullock's rhetoric, providing near-term support for AUD.

More broadly, we remain constructive on AUD/USD. Our 0.72 end-3Q target has nearly been reached sooner than expected, but strong fundamentals and attractive carry still make a move above the May 0.7260-70 highs before year-end a compelling scenario.

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