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FX

FX Daily: Dollar struggling to shake off debasement trade

The dollar has failed to hold on to post-Jackson Hole gains. We suspect underperformance in long-dated US rates is keeping markets on high alert for more Treasury interventionism, feeding the debasement trade. But ultimately, we expect markets to cement hawkish Fed expectations this week, which should emerge as the key driver and offer USD good support

Federal Reserve Chair Kevin Warsh

USD: Warsh support already vanishing

The dollar has given back roughly half of the gains sparked by Federal Reserve Chair Kevin Warsh's hawkish speech on Friday. Importantly, this does not reflect any fading conviction on Fed tightening. The 2-year SOFR rate has held above 4.20%, more than 10bp higher than before the speech. Markets are pricing in 16bp for September and 37bp for year-end.

Despite support from the front end, every G10 currency gained against the dollar on Monday. We suspect the rise in US back-end yields is the main culprit, even though that move was driven by higher oil prices as the US and Iran exchanged strikes.

That is somewhat concerning for dollar bulls. It suggests markets still view higher long-end yields through the lens of potential Treasury interventionism, feeding the debasement trade, which a hawkish repricing of Fed expectations has still not been able to fully unwind. That speaks to the lasting FX impact of Treasury Secretary Scott Bessent's buyback move.

Still, we'd be very cautious about chasing a dollar correction further this week. In our view, markets would need a string of materially disappointing data releases over the coming days to meaningfully reassess September FOMC expectations after Warsh's hawkish message last week. We do not think that is likely.

Our baseline is for ISM manufacturing to remain above 55.0 today (JOLTS is the other main release this afternoon), ADP payrolls to print at 40k tomorrow, ISM services to stabilise on Thursday, and most importantly, payrolls to come in at a robust 65k on Friday.

For now, we are not prepared to argue that the relationship between the dollar and the front-end has been structurally impaired. As conviction around a 16 September hike is cemented, the dollar should find decent support at the start of the month. September is also a seasonally strong month for DXY. Barring a fresh surprise announcement on Treasury market intervention, the index can reclaim the 100.0 level.

Francesco Pesole

EUR: Downside risks prevail

German inflation inched higher to 2.9% in August, slightly below the 3.0% consensus. Today's eurozone-wide figures are expected to rise to 3.3% in the headline print, but the core rate is still seen unchanged at 2.5%.

Despite little evidence of ongoing second round effects, the European Central Bank is almost guaranteed to hike rates again next week. In our interpretation, this still falls into the "insurance" hike classification, but further tightening from there – which is widely priced in by markets – would instead imply that the ECB sees restrictive policy as necessary, a much bolder move unless data shows a core inflation uptrend.

The market's high conviction about a September ECB hike means EUR/USD is even more a dollar story now. We aren't optimistic 1.1600 can hold much longer as markets grow confidence of a Fed hike already in September, and instead see risks skewed to a retest of 1.150 in the first half of September.

The ongoing re-escalation in the Middle East and Russia-related headlines are not helping the bullish euro case at the moment. European natural gas prices are at the March peaks, keeping the euro's terms of trade under pressure. The positive impact on the euro of recent upward surprises in eurozone growth may run out of steam rapidly against such a commodity backdrop.

Francesco Pesole

NZD: Dovish surprise risk as RBNZ hikes

We expect the Reserve Bank of New Zealand to hike rates by 25bp to 2.75% tomorrow morning (announcement 0300 BST). Consensus is unanimous and markets are fully pricing in the move, so the impact on the New Zealand dollar will be highly dependent on whether the statement will still include firmly hawkish guidance, and on updated rate/economic projections.

As discussed in our preview, we see some downside risks for NZD. Market pricing (95bp by June 2027) looks way too hawkish. To validate such expectations, the Reserve Bank would need to revise rate projections materially higher, as they currently embed only another 25bp hike for the next three quarters. We don't think they will, as we instead expect CPI projections to be revised lower on the back of softer oil prices.

We see NZD/USD trading back below 0.590 in the near term as the RBNZ may fail to meet hawkish expectations and USD finds some support.

Francesco Pesole

CEE: Inflation signals and hawkish repricing in focus

Polish inflation surprised to the upside in August, rising from 3.0% to 3.4%, mainly due to higher fuel prices, as the statistics office likely did not account for the government's VAT reduction in the latter part of the month. By contrast, food prices fell further, offering a dovish signal for inflation elsewhere in the region. CEE PMIs are due today. On Thursday, the Czech Republic will release second-quarter wage data, where we expect growth to slow from the unexpectedly strong 8.1% recorded in the first quarter. Turkey's August inflation is also due; we forecast only a modest decline from 1.8% to 1.6% month on month. On Friday, Czech inflation should rise from 1.7% to 1.9%, in line with the central bank's forecast, while the Czech Republic and Hungary will publish retail sales data.

Regional markets are firmly back in hawkish mode following the Fed chair's comments and renewed escalation in the US-Iran conflict. With UK markets closed yesterday and CEE trading subdued, some catch-up is likely today. The Czech market is still pricing in almost four rate hikes and the Polish market nearly three, which should limit further weakening and could support gains today given further widening of rate differentials versus euro.

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