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FX Daily: Fight the yen at your own risk

The yen's hectic rally is relying on quite optimistic bets on tightening and GPIF changes, and was probably exacerbated by thin liquidity around the US holiday. We have our doubts that it can be sustainable beyond the near term, but for now, it still looks too risky to catch the falling USD/JPY. The broader USD sentiment remains affected, but has room to improve

The yen can still extend its rally in the near term

We have published the September edition of [FX Talking: Don't call it a dollar comeback](#) with our latest FX views and forecasts.

USD: USD/JPY story dominates

Yen moves have continued to dominate the start of the week. Thin liquidity due to the US holiday likely amplified yesterday's USD/JPY sell-off, pushing the pair through the key 155.0 level before extending to 153.0 overnight. This still looks primarily like a JPY story rather than evidence of a broader shift in sentiment towards the dollar. Fast money appears increasingly focused on a combination of a hawkish Bank of Japan and GPIF increasing domestic ownership.

Despite short-term fundamentals suggesting the move is overdone, it remains risky to stand in its way, particularly given the scope for further carry trade unwinding. The next meaningful support only comes in at 152.0, where the yen rally stalled in January and February. A break below that could quickly open the way towards 150.0. Whether such a move would prove sustainable if the Fed hikes next week remains an open question, but current volatility argues against trying to catch the falling knife.

The yen rally continues to spill over into broader dollar weakness, even as the wider USD narrative remains unresolved. Strong payrolls and elevated energy prices (Brent close to $100/bl) remain supportive, yet markets are still only pricing around 15bp of tightening for September and risk sentiment has held up well.

US equity futures point to a softer reopening today, which could lend the dollar some support against an otherwise empty calendar. We continue to think the bullish case for the dollar will prove stronger in the near term, although Friday's US CPI release remains a clear risk event.

Francesco Pesole

EUR: Downside risks remain

Second-quarter eurozone growth was revised up from 0.4% to 0.6% QoQ, driven by stronger Irish growth on the back of robust multinational performance. More broadly, Europe's resilience despite geopolitical developments and higher commodity prices remains a key theme of the summer and has likely helped keep the euro relatively expensive.

Our short-term downside preference in EUR/USD is still mainly driven by our USD view and expectation of a September Fed hike. That said, the latest rise in energy prices adds further support. Real-time estimates suggest the eurozone's commodity terms of trade are now worse than at the previous low in March.

Ahead of Thursday's ECB meeting, we see some dovish risks given the market's aggressive tightening expectations. In that context, a move towards 1.150 over the coming weeks remains realistic in our view.

Francesco Pesole

GBP: Healey keeps markets calm

Sterling enjoyed a decent session yesterday, with some marginal support potentially coming from Chancellor John Healey's first major speech. He delivered a firm message on fiscal discipline, helping to keep the increase in long-end gilt yields broadly in line with the wider global bond sell-off. That stance is likely intended to reassure markets ahead of what could be a steady flow of headlines about the October budget in the weeks ahead.

How far those headlines test the market remains to be seen. Sterling is currently pricing in no fiscal risk premium, leaving some scope for market concern to emerge. Even so, the government appears highly conscious of market sensitivities and unlikely to engage in a serious confrontation with the bond market, particularly given how quickly higher yields can consume any available fiscal headroom.

We retain a positive bias on EUR/GBP primarily due to our assessment that Bank of England expectations appear way too hawkish.

Francesco Pesole

HUF: Inflation rebounds but not a game-changer for markets

Today's data confirmed the expected rebound in Hungarian inflation, from 1.2% in July, the lowest reading in nearly 10 years, to 1.3% in August, though it again came in below market expectations. Even so, we expect inflation to remain below the central bank's target for the rest of the year. The NBH had forecast 1.8% for August, implying a forecast miss of 0.5pp, compared with 0.7pp in July. The inflation outlook remains benign, but the NBH story has become more compelling since *Bloomberg* reported last week that the central bank was considering pausing rate cuts in September to pave the way for a lower inflation target ahead of euro adoption.

Subsequent NBH comments suggest that any policy shift will have to wait until the September meeting and its new forecast. Since last week, the curve has flattened sharply and the Hungarian forint has strengthened, moves that today's data are unlikely to reverse. We expect euro-area spreads to tighten further, although higher global energy prices may limit additional forint gains. EUR/HUF has fallen below 364, but if gas and oil prices continue to rise, we may return above this level again given how the forint has recently returned to its previous high-beta behaviour.

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