FX View - Month-end pause?

So far this morning, we have seen upside surprises in UK Q2 GDP (0.5% q/q, 1.4% y/y), albeit largely due to unusually strong exports; Higher-than-expected French CPI (3.4% y/y), and a larger-than-expected increase in German unemployment (+12k, with the unemployment rate unchanged at 6.4%). The day's main data focus is the US core PCE deflator, but it will likely need to deliver a significant surprise to generate a meaningful market reaction. Meanwhile, oil prices and bond yields are slightly lower, equities are firmer, and the dollar is consequently a little weaker. Month-end flows may be partly responsible.

The main movers are GBP (stronger after the GDP data), JPY (as markets anticipate further intervention to support the currency), and AUD (weaker following the RBA meeting, particularly against NZD). The key question for today, however, is how far the dollar might slip, given the favourable conditions for a correction. If EUR/USD fails to move back above 1.14, at a minimum, this rebound will likely be widely viewed as another opportunity to sell the euro. ISM and NFP data are due this week, but softer European data only reinforce the negative sentiment.

With a strong market perception that further USD/JPY intervention is likely in the near future, EUR/JPY is also likely to be sold on any rally today. The yen has been the strongest of the G10 currencies this month, and the market's reluctance to be caught out by intervention is clearly having an impact. Another spike in oil prices could easily reverse the recent improvement in risk sentiment, however, and caution still seems warranted.

Relative interest-rate differentials continue to move in the dollar's favour, while markets still price in three ECB rate hikes before the middle of next year. Is there really enough growth in the Eurozone to justify that? It feels like an overreaction to a temporary inflation shock, albeit one that may persist as long as the energy crisis continues. However, the growth outlook is also likely to deteriorate for as long as the energy crisis remains unresolved.

The chart shows EUR/USD alongside two-year interest rates, suggesting that while President Trump succeeded in weakening the dollar more than interest-rate differentials alone would have justified last year, the "Trump effect" is fading. Long may that continue.

EUR/USD and rates – the Trump effect has faded



Source: SG Cross Asset Research/Forex



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