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FX Daily: Dollar shows fresh vulnerability to oil price drops

Some lingering AI concerns appear to have left the dollar in a more fragile position overall. Yesterday, the greenback briefly dipped on some tentative news about progress in the Middle East. Further drops in oil prices now show greater potential to harm the USD. France remains in focus for the euro, with EUR/CHF still facing downside risks



USD: Softer momentum continues

The dollar continues to trade with a soft undertone. That, to us, is a mix of some aftereffects of AI-related concerns (Corewave bonds had another wobble yesterday) and stretched longs/ short-term overvaluations being unwound. That said, the dollar no longer looks particularly stretched on our short-term valuation metrics. Across the G10, GBP, NOK and AUD are trading slightly rich versus the USD. CAD and CHF are broadly at fair value, while EUR, JPY, SEK and NZD remain undervalued. Importantly, all sit within the 1.5 standard deviation band, leaving little in the way of strong valuation signals.

Yesterday, there was also a reminder that lower oil prices can damage the dollar. A short-lived drop in Brent on unconfirmed reports of Middle East negotiation progress was enough to send DXY briefly to 101.50. With the supply picture improving, elevated oil prices are relying

increasingly on geopolitical risk. FX markets may therefore start to price in a sharp decline in crude if signs of genuine progress emerge.

And the dollar's reaction function to oil may have changed over the past week or so. Rising concerns about tech stocks have somewhat dented the market's hawkish conviction on the Fed, allowing for greater dovish flexibility at the front end in response to non-data inputs like an oil selloff.

We recognise that the softer dollar backdrop has shifted the balance of risks somewhat further in a USD-bearish direction. Even so, we continue to favour a gradual and orderly dollar decline rather than a sharper depreciation. The broader Fed, oil and rates narrative remains supportive.

The US calendar is quiet today. Yesterday's surprise drop in housing starts reinforced the notion of a deteriorating real estate market. Attention will instead centre on any follow-up headlines pointing to progress in US-Iran negotiations today.

Francesco Pesole

EUR: French spreads widen further

French bonds sold off again yesterday, with the 10yr OAT-Bund spread widening to 157bp at one point, close to the 159bp 2 October high. Lingering concerns about the budget are clearly being compounded by rising social unrest. Our France economist discusses here the potential economic implications of the riots. And on Friday there is a looming Moody's rating review of France, which could keep sentiment on OATs soft.

With EUR/USD affected by softish USD momentum, EUR/CHF remains the clearer exhaust valve of French risk into FX. Yesterday saw another attempted break lower, with support emerging again around 0.9230, close to the 200-day MA. A break below that level could prompt a gap to below 0.920. Risks remain on the downside there. In EUR/USD, we could see some further consolidation at 1.120-1.125.

EUR/GBP also continues to show intense selling pressure, having broken below 0.840. While French risk is playing a role, the pound is emerging as an outperformer in G10. Markets are sinking their teeth into a positive UK growth story and BoE tightening alongside expectations that next week's budget won't deliver any real surprises (here's what could go wrong).

This morning, UK headline inflation for September came in slightly hotter than expected at 3.5%. Services CPI also beat expectations with an acceleration to 3.7%, but was probably exaggerated by airfares. By our calculations, 'energy intensive' inflation is still showing no signs of picking up and is in fact lower than it was earlier this year. Food prices fell on the month, capping a remarkably benign period of supermarket inflation. In short, still no sign of second-round effects in these numbers.

While a November hike by the BoE appears likely now, expectations for 100bp worth of tightening by June remain way too hawkish in our view. The pound's rally is looking stretched by short-term valuation metrics, and we see growing risks of corrections, both vs EUR and USD.

Francesco Pesole

NZD: Barring an inflation surprise, RBNZ should hike next week

New Zealand releases important 3Q CPI figures overnight. We expect the headline to slow from 4.1% to 3.8%, in line with consensus and marginally below the RBNZ's 3.9% projection. Any, even small, upside surprise will, in our view, consolidate expectations of an October hike further.

Markets have been pricing around 18-21bp for next week's meeting since RBNZ's Chief Economist Paul Conway delivered hawkish remarks last week. He explicitly said this month's decision is wide open, that he sees risk to the upside for 4Q CPI and that the NZD weakness is worrying. It felt like an attempt to drive market pricing higher, and barring a major surprise lower in CPI tomorrow, we expect a 25bp hike next week.

NZD remains cheap relative to its short-term fair value model, and we expect it to keep recovering ground against its closest peer, AUD. We see NZD/USD trading above 0.570 into year-end.

Francesco Pesole

HUF: Improving domestic outlook meets global headwinds

Yesterday, Hungary unveiled a full fiscal path plan, under which the deficit is projected to decline from 4.9% next year to 2.8% by 2030. According to the prime minister, Hungary aims to adopt the euro as soon as possible. The National Bank of Hungary kept interest rates unchanged at 5.50% yesterday and reiterated previous statements regarding euro adoption, noting that the fiscal path aligns with the euro adoption plan. At the same time, the governor pointed out that rising core yields, uncertainty, and inflationary risks necessitate a cautious monetary policy.

In our view, this accurately captures the current situation: while the domestic narrative is evolving positively – to the market's satisfaction – the global environment remains unfavourable. Our economists see a possibility of a rate cut toward the end of the year, provided that the global situation, particularly energy prices, stabilises.

Following the release of the budget plan for next year on Monday, the market is undergoing a correction after a rally in previous weeks. As we have discussed, long positions on Hungary had

become overly crowded; the "buy the rumour, sell the fact" scenario has fully played out, and we are likely to see further profit-taking. Nevertheless, as we noted in recent days, the domestic story is moving in the right direction, and we believe the market will soon take advantage of lower price levels to re-enter new positions.

EUR/HUF has experienced some upward pressure, tracking movements in rates and bonds. However, positioning is likely not overly crowded as in fixed income, and the NBH is not currently signalling imminent rate cuts, which should keep the exchange rate anchored. Over the past two weeks, EUR/HUF has remained within a tight range of 362-364, and its next direction will likely depend more on global developments. Yesterday's signs of a potential easing of tensions between the US and Iran could provide a positive boost, helping the pair move toward the lower end of its current range.

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