Monthly Report

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Introduction – Politics enters the spotlight

Several themes drove FX in June

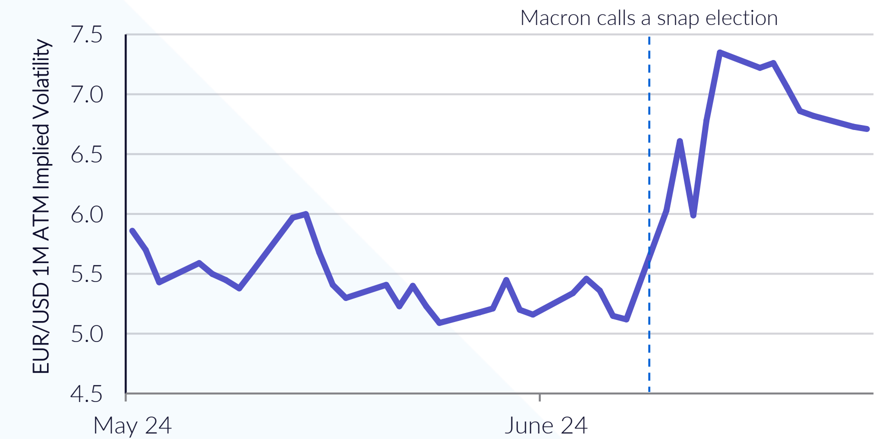
No one overarching theme dominated the story in June. Monetary policy remains key, of course, but politics gave some relief from the dominance of the rates story, with softer data in the US ultimately offset by election risk in the eurozone.

In isolation, the bearish case for the dollar continued to grow. The data is still steering in the right direction for Federal Reserve rate cuts, having seemingly broken out of the Q1 rut. That has hurt US yields and markets have now ascribed around a 65% probability to the September cut. On that basis, this report should be talking about a higher EUR/USD.

But it was French President Macron that had markets position defensively on the euro. Political concerns caused ruptures in the European bond markets, with significant National Rally gains in the EU Parliament and the resulting snap election call from Macron putting the French debt pile under the microscope. Concerns about the future of an already deep budget deficit drove the OAT-Bund yield spread to levels not seen since the debt crisis twelve years ago. That's the compensation demanded from investors for investing in French government debt, versus its safer German equivalent. Traders quickly priced in a negative risk premium for the common currency, and to a lesser extent for the rest of European FX.

Elections are having greater influence more broadly, too. The July UK general election result is something of a foregone conclusion given Labour's poll lead, but there will be some volatility after the event when BoE speakers break their silence. The US vote began to capture some attention too, as a poor showing from Joe Biden at the first debate saw the odds of a Trump presidency rocket.

The French election injected some fresh volatility into FX



More join the rate cut club

While Fed policymakers wiped away two of the three cuts that it had projected in the March dot plot, most in Europe took further dovish steps. As expected, the ECB and the Bank of Canada joined the Swiss National Bank and the Riksbank in cutting rates for the first time this cycle. The SNB surprised with its willingness to lead the way, easing policy for a second time whilst also signalling more with a downgrade to its inflation forecasts. While the Bank of England shunned the invite, its optimistic view on the trajectory for services inflation bolstered the case for a first rate cut in August.

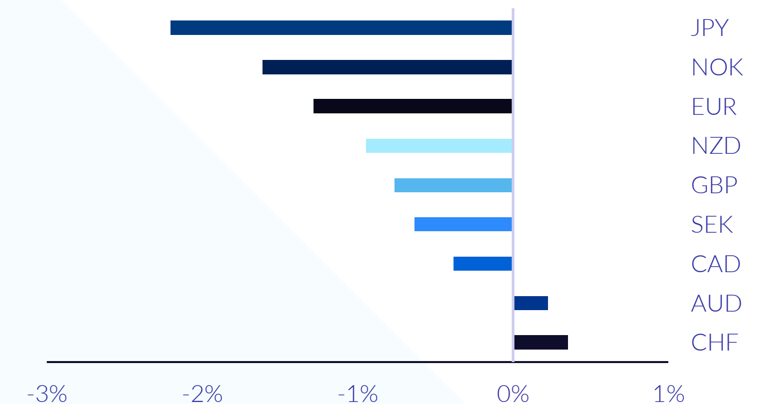
But there were some inflationary bumps

There were some notable inflationary resurgences, however, most notably for CAD and AUD. While the details suggested that the rebound could be transitory, month-on-month CPI in Canada *doubled* the forecasted figure. And in Australia inflation continued to head in the wrong direction, this time back to 4.0%. Markets are 50/50 on a restart to the RBA's hiking cycle, potentially in September.

The one central bank that wants to be hiking rates is struggling to justify the move: the Bank of Japan. With Fed rate cuts some months away at least, the still vast rate spread continues to generate seemingly unstoppable selling pressure for the yen. The BoJ disappointed again, postponing an announcement on tapering their enormous bond-buying program and declining to give any concrete hints on the timing of any further rate hikes, if they can come at all. USD/JPY is now at a near four-decade high, and markets are primed yet again for intervention from Tokyo.

Watch central banks and politics in July

Central banks and politics will dominate again in July. The ECB is almost certain to pause, it's a 50/50 in Canada, and markets will be closely watching any hawkish signalling from the BoJ. Traders will be looking for some further softening in the data to encourage first rate cuts from the BoE and the Fed later in the summer. And in the eurozone, whether the 33% vote share in the first round can translate into an RN majority in the second will be critical for the euro.



FX Reviews

USD

Softer data but stronger dollar

From a domestic standpoint, June was much the same as May for the US dollar, back when it ended the month nearly 2% lower. The modest disinflation that marked a shift in direction from the Q1 reacceleration continued and, despite a strong set of activity indicators, the labour market cooled further. September rate cut bets were revived, and US yields fell – not exactly a cocktail for dollar strength. Yet safe-haven flows and further dovishness in Europe, alongside a renewed decline in the Japanese yen, saw the greenback tick upwards by nearly 1%.

The macroeconomic data steered towards a softer labour market and cooler inflation than had been expected, and so much so that the Citi US Economic Surprise Index fell to its most negative level in years. Job openings fell considerably more than expected to 8.06M - now some 2.8M down from the 2022 peak – and the quits rate remained at a low level. Unemployment claims began to break to the upside of its narrow ranges, and the overall unemployment rate ticked higher to 4.0%. The 272K non-farm payrolls number was an exception, although much of this can be pinned down to immigration and growth in just two sectors.

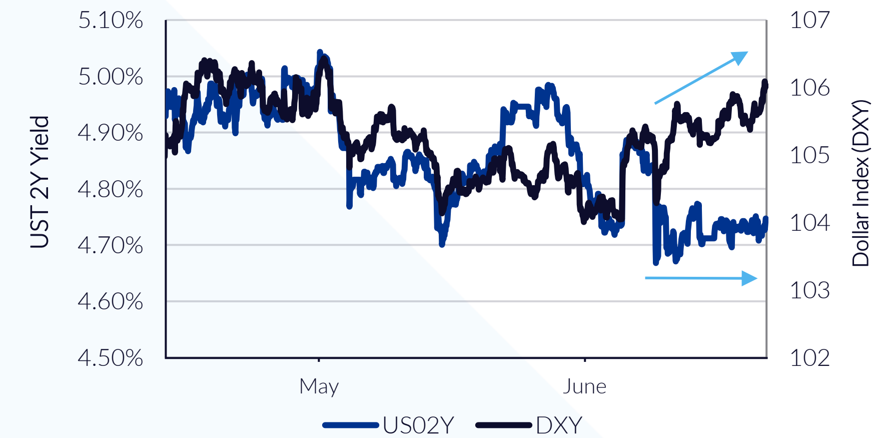
Both CPI and PPI inflation posted distinctly cooler month-on-month prints, with headline CPI unchanged in May, while the Fed-favoured core PCE fell to 0.1% for the first time in six months. Although still modest, the renewed disinflationary momentum revived rate cut bets for this year and shrunk yields, but this did not translate into lower yield *spreads* against its dovish and politically-shaken peers.

The market may be getting excited about rate cuts again, but the Fed isn't ready just yet. The rate decision statement dropped the line saying that disinflation had stalled, citing 'modest progress', but slashed the median forecast for the number of rate cuts this year from three to just one. And for the first time for several meetings, Powell toned down the optimism that had previously been persistent despite stronger inflation. Michelle Bowman took it one step further to say that she did not expect any rate cuts this year and would be prepared to vote for a hike if necessary, although the likes of Cook and Bostic were more balanced in their caution.

The data story spoke louder, however, and markets largely brushed off the Fed to price in around a cut and a half this year, beginning in September. That will likely require a solid stream of 0.1-0.2% core PCE prints in the months ahead, and a continued cooling in the labour market. The trajectory for inflation increasingly appears to be downwards, particularly when the measure for housing catches up with leading rent indicators, although policymakers will no doubt be concerned by the June PMIs, which rose to a 26-month high and dashed hopes in Europe for a convergence in the growth outlook.

The election is beginning to capture significant attention, with the broad consensus being that a Trump presidency means tariffs, expansionary fiscal policy, and geopolitical tensions, and hence inflation, higher rates, and a stronger dollar. The odds of that scenario jumped sharply at the first presidential debate, as a shaky Joe Biden exacerbated widely held concerns about his cognitive state.

The US dollar detached from the softening macro data as political risk took over in Europe



GBP

2% inflation not enough - yet

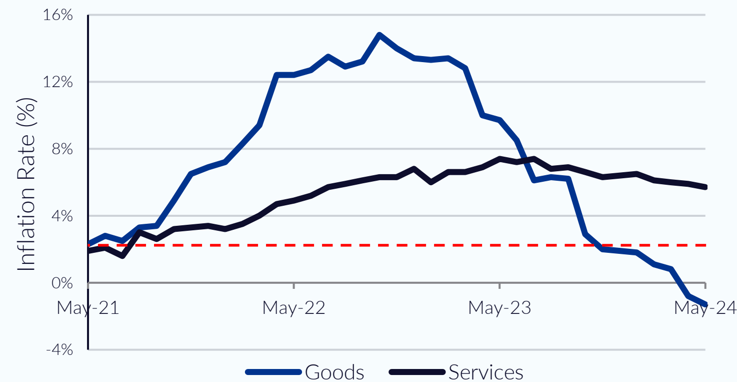
High services inflation took sterling to a 3-month high against the dollar in June, and triggered a test of the 1.19 mark versus the euro for the first time in nearly two years. By the end of the month, though, it struggled to hold on, and dovish signalling from the Bank of England left sterling in the middle of the pack.

While aggregate inflation fell back to the 2% target for the first time since July 2021, the services component – nowadays at the top of the bank's watchlist – surprised to the upside again, this time at 5.7% versus the BoE's 5.3% forecast. The fall to 2.0% in the headline is largely the result of deflation in food and energy prices; these impacts are transitory and need to be replaced by a cooling in the second-round effects to keep inflation at these low levels.

The Bank of England held rates steady as a result with a repeat 7-2 vote in favour of a hold, but several of those who opted to stay steady said that the decision was 'finely balanced'.

> *Most importantly, the minutes played down the stall in progress in services, pinning it down in large part to one-off annual price hikes that would likely subside over the coming months. That view makes an August rate cut a real possibility, which the swap markets now price at around 65%.*

Goods are now deflating, but services are catching up only slowly



The problem – thanks to a pre-election blackout - is that we don't really know what each MPC member is thinking. With a possible August cut in focus, the lifting of the blackout is likely where the election will have the biggest impact. With a Labour win a near certainty and continuity in fiscal policy the likely outcome, the vote itself should have minimal impact. Over the long term, stability in government and the prospect of closer ties to the EU could bode well for sterling, but for now it's the Bank of England driving the pound.

The growth outlook continues to be relevant too, with last month's GDP and services PMI prints coming in a bit softer. Although election uncertainty and wet weather were largely to blame and it's too early to call a stall in the recovery, the turn in direction is worth watching.

EUR

All eyes on French fiscal discipline

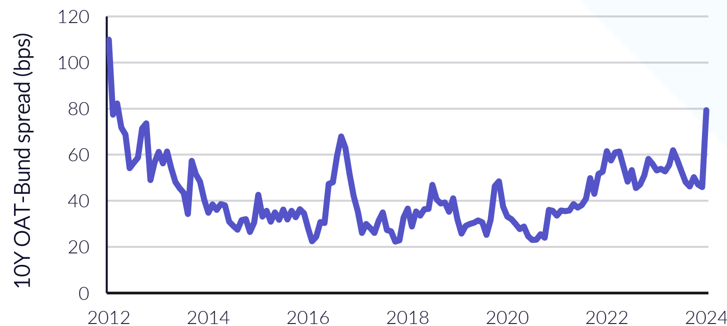
Despite a first rate cut, pricing for the ECB rate trajectory fell to the sidelines, and it was politics that emerged as the primary driver for the euro in June as it fell 1.2%.

Admittedly, the ECB's cut surprised no-one. Recent upticks in wage growth and inflation could have easily justified holding on a little longer, but policymakers had spent so long backing themselves into a corner that to do so would have damaged credibility. Instead, their only option was a 'hawkish cut' that stressed a calculated, meeting-by-meeting approach rather than a linear downward path for rates. There was also a marked change in the bank's strategic view, which placed more emphasis on what they believe to be an improved forecasting ability, and toned down the obsessive, backwards-looking data dependence. There is a consensus now that the ECB will pause in July, although that could depend on the next set of inflation and growth data.

The biggest market impact came from the risk premium that was embedded into the euro given the prospect that a fiscally irresponsible party forms a government in France's National Assembly. After losing heavily to Le Pen's far-right National Rally (RN) party in the EU Parliament elections, Macron threw the dice by calling a snap election in the hope of catching his rivals off guard. It backfired – the RN won the first round of voting and is within spitting distance of at least forming a ruling coalition, while the rise of the New Popular Front (NFP), a new alliance on the left, has put Macron's centrist alliance in third. A 'cohabitation' arrangement with a President and Prime Minister from different parties looks to be almost certain, barring Macron's resignation.

Both parties are bad news for fiscal discipline and the bond markets. The debt pile is above 100% of GDP and the government budget deficit is already at 5.5%, which is well above the EU target and the reason that France was placed under the Excessive Deficit Procedure by the EU last month. Warnings of a Liz-Truss-style debt crisis may be overblown, and the memory of that event is fresh enough to remind the incoming government that the bond market stands ready to discipline reckless spenders. But the deficit and the debt pile are now set to remain steady at best. While Le Pen's party has repeatedly pledged to be fiscally responsible, promises of a lowered retirement age and €7bn in energy VAT cuts depend on tenuous funding sources, some of which risk clashes with the EU. The NFP is even scarier for bondholders, with its tax-and-spend agenda and lack of any intention at all to improve the deficit. The risk premium in yields demanded for French versus German bonds exploded to the highest levels since the debt crisis 12 years ago, and uncertainty is set to prevail until the outcome of the second vote.

French-German sovereign spreads are back to debt crisis levels



One-month implied volatilities spiked in June, the euro slumped, and ECB officials had to come out and say that there was not yet a need to step in and stabilise the market.

The growth outlook proved a headwind too, and this could be a key dynamic over the coming months. The June PMIs strongly disappointed, reversing the trend of improvement from so far this year. It's too soon to argue that the rebound has peaked already, particularly as election uncertainty played a part, but traders will be watching closely in July.

CHF

Charting the dovish path

The Swiss franc was the best-performing G10 currency in June, having strengthened enough in the first half of the month to hold onto a net gain despite a 2% knock from a dovish Swiss National Bank outlook.

A Q1 growth surge, a recent uptick in inflation, and an election-induced safe-haven bid drove a sharp turnaround from the steady depreciation of the first five months of the year. At its trough, USD/CHF declined more than 4% compared to its year-to-date high in early May. The pair regained some 2% over recent weeks, however, beginning with back-to-back rate cut from the SNB. The cut itself was priced in at a 65% probability, but the projections were markedly dovish – despite being conditioned on a lower interest rate compared to March, the inflation forecast was revised even lower in the long term. That implies further cuts to come this year, and residual restrictiveness yet to be squeezed out.

JPY

Back to the 80s

A gulf in interest rates between Japan and the rest of the world took the yen back to a test of its multi-decade lows, breaking through 160 on USD/JPY again and this time touching its weakest level since 1986. Traders are back on intervention watch, with each move and every piece of data risking a return of yen-buying in Tokyo.

The Bank of Japan again failed to deliver on what the yen needs to genuinely recover: a compression of the rate gap. Policymakers disappointed markets looking for an announcement on the tapering of its enormous bond-buying scheme, which it pushed back towards July. Although some policymakers in the opinions summary expressed a desire to begin hiking rates soon, there was no specific guidance on the timing. And given the concerns about weak domestic consumption, there is still no guarantee that a hike will even come – propping up the yen would likely be a primary motivator for the BoJ if it did.

Until we get a significant dovish turn from the Fed, though, everything appears to be just a bump on the road to a weaker yen. Top currency official Kanda escalated warnings on intervention, saying that authorities were on 'high alert' under the usual guise of the undesirability of 'excessive volatility' (it's hard to picture them worrying about strong volatility in the other direction). The MoF will not want to give the appearance of picking a cap for weakness because this upends justifications based on volatility, so it's likely that if it comes in July, USD/JPY will have to move closer to the 165 level rather the 160 that triggered it in May.

SEK

Adjusting gradually

Political uncertainty in France and an upside CPIF inflation surprise helped to lift the Swedish krona against the euro. Despite some initial gains versus the dollar, however, a broad deterioration in risk conditions and a dovish Riksbank in late June saw it close lower overall.

After undershooting the market's projections in the three months up to April, CPIF inflation surprised to the upside with a 2.3% print in May that was 0.2 percentage points higher than expected. Given that underlying pressures have come down considerably and it remains close to the target, it will not be a major concern for the Riksbank. But it did serve as a reminder of the residual risks to the disinflationary outlook.

Acutely aware of these risks, the Riksbank noted a strategic preference for a 'gradual' adjustment to its policy rate and held off cutting for a second time in June. At the same time, though, the signalling for the number of rate cuts in the second half of the year was tweaked from 'two' to 'two or three'. The Riksbank only have four more meetings to enact those two or three cuts, suggesting that a move in August is all but guaranteed. As always, however, Sweden's position as a small, open economy means that this is conditional on global developments. A three-cut call is dependent on the krona remaining reasonably buoyant, geopolitical tensions keeping in check, and no real resurgence in inflation abroad, tentative signs of which have appeared in Canada and Australia.

CAD

An inflationary bump

USD/CAD continued its steady grind higher as central bank divergence and a broadly strong dollar hit the loonie again in June. A snap to the disinflationary streak in Canada took markets by surprise, but the details were far less damning than the headline and it failed to spark a recovery.

The Bank of Canada kicked off the month with a rate cut to 4.75%, which the market had priced at a 2/3 probability. The press statement repeated familiar warnings about the still present upside inflation risks, and pledged a meeting-by-meeting approach that would keep one eye on the Fed. But the outlook was markedly dovish - Governor Macklem pointed to 'sustained evidence' of a disinflationary trend, saying that it is 'reasonable to expect' further cuts down the road if it slows further.

For the first time in five months, however, inflation grew hotter. Headline CPI landed at twice the forecasted rate on a month-on-month basis, at 0.6%. While this has cast some doubt on a back-to-back July cut, bringing down the market-implied probability from 65% to around 50%, it was a surge in travel tour prices that caused the monthly figure to balloon, primarily to the US. That detail gives a good case to argue that this increase in inflationary pressures is likely to be transitory. As far as the market is concerned, the disinflationary trend is still intact, and a July cut is not an unreasonable bet. We do get one more set of figures before then, however, and a more sustained pause in progress could trigger a repricing in the Canadian rate path.

AUD

A rate hike revival

The hawkish divergence story continued to buoy the Aussie dollar in June. The Reserve Bank of Australia meeting was relatively quiet but came with a few hawkish tweaks - it kept the line about not ruling 'anything in or out' but reinserted the pledge to 'do whatever it takes' for the first time since February. Policymakers only briefly discussed a hike, and ultimately decided against it.

Markets suspect that that may change in the next few months, however, after the May CPI figure surged more than expected from 3.6% to 4.0%. Australian inflation is moving firmly in the wrong direction for the RBA at this point, and a restart to the hiking cycle by September is priced in as the most likely scenario. If that materialises, and global risk sentiment improves amid rate cuts elsewhere, there will be a robust case for stronger Aussie dollar in the second half of the year.

Economic Calendar – July 2024

Policy decisions from the RBNZ, ECB, BoC, BoJ, and Federal Reserve share the spotlight with elections in the UK and France in July.

Date	Time (CET)	Currency	**Event**	Previous
Tues 2nd	11:00am	EUR	Eurozone CPI y/y	2.6%
Tues 2nd	4:00pm	USD	JOLTS Job openings	8.06M
Thu 4th	8:30am	CHF	CPI y/y	1.4%
Thu 4th	All Day	GBP	UK General Election	
Fri 5th	2:30pm	CAD	Employment Change m/m	26.7K
Fri 5th	2:30pm	USD	Non-Farm Payrolls m/m	272K
Sun 7th	All Day	EUR	French Parliamentary Election Second Round	
Wed 10th	4:00am	NZD	Reserve Bank of New Zealand Policy Decision	5.50%
Thu 11th	8:00am	GBP	GDP m/m	0.0%
Thu 11th	2:30pm	USD	CPI y/y	3.3%
Fri 12th	2:30pm	USD	PPI m/m	-0.2%
Tue 16th	2:30pm	CAD	CPI y/y	2.7%
Tues 16th	2:30pm	USD	Retail Sales m/m	0.1%
Wed 17th	8:00am	GBP	CPI y/y	2.0%
Thu 18th	3:30am	AUD	Employment Change m/m	39.7K
Thu 18th	8:00am	GBP	Claimant Count Change Average Earnings Index 3m/y	50.4K 5.9%
Thu 18th	2:15pm	EUR	ECB Monetary Policy Decision	3.75%
Fri 19th	8:00am	GBP	Retail Sales m/m	2.9%
Mon 22nd	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	45.6 52.6
Mon 22nd	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	51.4 51.2
Mon 22nd	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	51.7 55.1
Wed 24th	3:45pm	CAD	Bank of Canada Monetary Policy Decision	4.75%
Thu 25th	2:30pm	USD	Advance Q2 GDP q/q	1.4%
Fri 26th	2:30pm	USD	Core PCE Price Index m/m	0.1%
Wed 31st	3:30am	AUD	CPI y/y	4.0%
Wed 31st	5:30am	JPY	Bank of Japan Monetary Policy Decision	0.0-0.1%
Wed 31st	11:00am	EUR	Eurozone CPI y/y	2.6%
Wed 31st	2:30pm	CAD	GDP m/m	0.0%
Wed 31st	2:30pm	USD	Employment Cost Index q/q	1.2%
Wed 31st	8:00pm	USD	Federal Reserve Monetary Policy Decision	5.25-5.50%

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