Week Ahead 9th – 13th August 2021

MONEX

Authors

Simon Harvey
Senior FX Market Analyst
+44 (0)203 650 6472
Simon.Harvey@monexcanada.com

Olivia Alvarez Mendez
FX Market Analyst
+34 91 198 84 47
Olivia.Alvarez@monexcanada.com

Ima Sammani
FX Market Analyst
+31 (0)20 808 3644
Ima.Sammani@monexcanada.com

To hike or not to hike, that is the question

Markets this week have largely focused on underlying growth conditions, FOMC speakers and Friday's labour market data, with US bond markets sending conflicting signals to FX traders. However, Friday's labour market data gave the clearest signal yet; upcoming Fed meetings are now live events with the labour market showing signs of progress. Outside of the US, the Bank of England kept both markets and economists busy with a bumper release outlining the sequencing of its exit path and a downward revision to its effective lower bound estimate now negative rates are a viable option. Next week, the key pieces of data centre around rate decisions from Banxico and the CBRT, both of which have reasons to hike rates due to rising inflation but also have grounds to stay pat.

Calendar

Monday – 09/08

The week kickstarts with both **consumer and producer inflation data from China for July at 02:30 BST**. The data comes hot on the heels of Saturday's trade data release, which likely showed a further expansion in China's trade surplus. Both pieces of data will be in focus as China's economy starts to battle the latest Covid-19 outbreak, while factory-gate inflation will be heavily focused on due to its impact on global inflation measures. CPI YoY for July is expected to moderate from 1.1% to 0.8%, while PPI is expected to slow only slightly from 8.8% to 8.6% despite a higher base a year ago. **At 07:00 BST Germany then releases its trade balance data for June**, which is likely to show a continued trade surplus, with the rise in exports viewed closely given the improvement of growth conditions globally during that period. **Swiss sight deposits at 09:00 BST** will then draw focus. With the Swiss franc rapidly appreciating against the euro towards the previous intervention threshold of 1.05, markets will keep a close eye on any efforts by the SNB to moderate the appreciation in the franc.

At 12:00 BST inflation data from Mexico is then released for July ahead of the Banxico meeting later in the week. With inflation dynamics proving extremely significant to Banxico's policy path, an upward surprise might trigger speculation of an additional rate hike later in the week. However, expectations paint a smooth downward trajectory for headline inflation after it peaked at 6% in April. On the other hand, core inflation is expected to accelerate slightly more. This could leave question marks around the Banxico meeting. To wrap up the day, **US JOLTS data is released at 15:00 BST for June**, with job openings data viewed in light of Friday's Nonfarm Payrolls data. Job openings are indicative of the underlying demand for labour, although the data is somewhat lagged.

Tuesday – 10/08

Norway's CPI data for July at 07:00 BST marks the start of the data calendar on Tuesday. With headline inflation sitting at 2.9% in June, the print is unlikely to move the needle for the Norges Bank who are steaming towards the start of a hiking cycle, but a moderation in core CPI is a risk (as outlined in our latest NOK outlook). Underlying CPI is expected to fall from 1.4% YoY to 1.1%. The focus then shifts to Germany at 07:00 with the **ZEW measure of expectations released at 10:00 BST**.

At **11:00 BST, the NFIB small business optimism** measure is released for July, with a slight moderation from 102.5 to 102 expected. This likely reflects the moderating pace of the US recovery and some health concerns going forward after some US states tightening Covid restrictions at the margin. To complete the day's data releases, **Brazil's IGBE inflation data for July at 13:00 BST** will likely show the pace of price increases rising further from 0.53% MoM to 0.93%, bringing the headline rate to just shy of 9% YoY.

German ZEW

"Expectations are for it to moderate from 63.3 to 56.0 as optimism spills over into the current situation index, however, concerns over the health outlook and a fourth wave will also weigh on the expectations reading."

Wednesday – 11/08

At 01:30 BST, Westpac's Australian consumer confidence measure for August is released and will likely represent the recent deterioration in the health backdrop and tightening of restrictions. The measure for July sat at 108.8, but could very well dip below 100 for the first time since September 2020 depending on when the information was collected and whether it captures the latest provincial lockdown measures. Afterwards, markets can then expect **US CPI data for July at 13:30 BST**.

"The overshoot in inflation has had a limited impact after the concerns it caused back in Q1, but any further increase from the current 5.4% YoY reading is likely to stoke expectations of **Fed** normalisation given Friday's strong jobs data."

Expectations currently sit at a moderation to 5.3%, driven by a cooldown in the monthly measure from 0.9% to an expected pace of 0.5%.

Thursday – 12/08

Thursday's data calendar starts off with **UK preliminary Q2 GDP being announced at 07:00 BST.** Data is expected to show the economy expanded at 4.8% in the second quarter as government restrictions were loosened.

Market expectations sit just shy of the Bank of England's assessment of 5% growth. **The CBRT is then up at 12:30 BST** with the meeting expected to be highly deterministic for the lira after President Erdogan called for lower rates while the central bank remains committed to keeping the real rate positive. With inflation printing at 18.95%, just 0.05% shy of the one-week repo rate, there is little wiggle room for the central bank. More details on this below. **At 13:30 BST, markets get another inflation measure from the US,** this time in the form of PPI. Released alongside it are **initial jobless claims for the week ending August 7th.** Then, the market attention heads south of the border, with **Banxico expected to release its latest decision at 19:00 BST.** Banxico's policy decision will be closely followed with investors still undecided on whether June's hike was the start of a tightening cycle or a one-off signal to re-anchor inflation expectations and policy credibility. We argue that the Bank can afford some more patience before resuming hiking, especially in a context of falling US yields, loose Fed guidance and economic uncertainty around renewed virus risks. The bar for surprises is low, though, as Banxico sits on the prudent side of high inflation dynamics. More details are expanded on page 5.

Friday – 13/08

To round off the week, **Turkish current account data for June is released at 08:00 BST** and will likely show the deficit narrowing from -$3.08bn to -$1.1bn, although whether this is enough to distract investors from the potential fallout from Thursday's decision is to be seen. Then, at **08:30 BST, Sweden's inflation data for July** is released. Headline inflation is expected to remain on hold at 1.3%.

CBRT Primer

One-way traffic for the lira, regardless of Thursday's decision

August has been a difficult month for the Turkish lira so far with political pressures rising for the CBRT to cut interest rates despite the strong headline CPI print in July. The inflation figure printed at 18.95%, which means real rates currently stand at 0.05%, only just in positive territory.

While the CBRT has pledged to maintain the policy rate above both realised and expected inflation, which means the bank has little room to ease policy in August, recent commentary by both President Erdogan and Governor Kavcioglu make a policy misstep a more serious risk event for the Turkish lira in the short-term. Despite their comments, markets seem to focus on the CBRT's positive real rates pledge and the recent high inflation print as market pricing hasn't changed for shorter-term tenors since the commentary.

Below we argue different scenarios of next week's policy decision and their implications for FX markets.

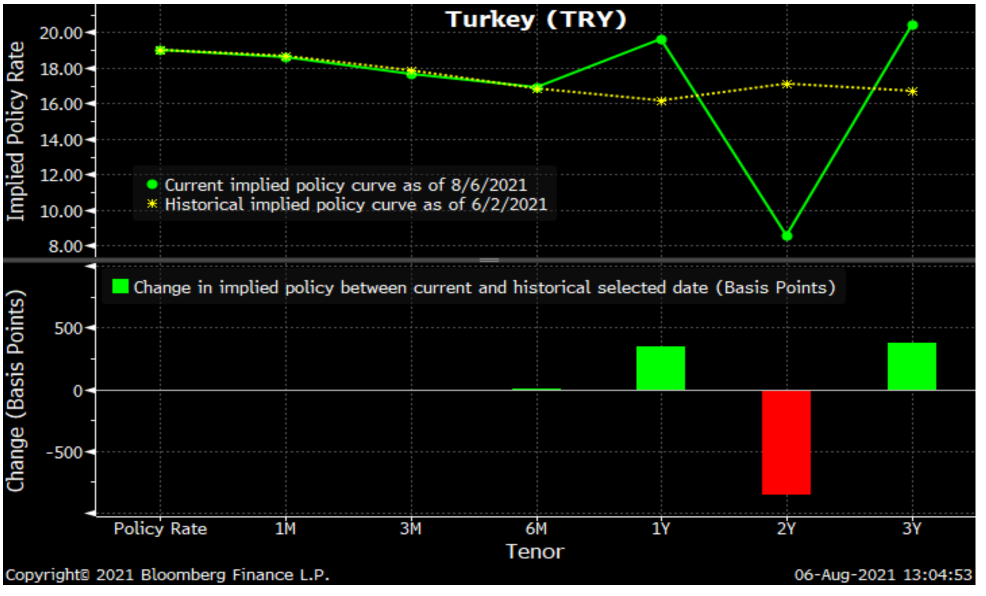
Rates on hold, potential statement adjustment

While money markets envisage a rate hike in the next 3 months, they don't believe this will occur within the next month (chart). Current inflation levels are too high for the CBRT to ease policy while keeping their pledge to maintain positive real rates.

> While a hold in rates would satisfy markets' needs in the short-term, it begs the question of what happens when inflationary pressures increase further.

On the other side of the balancing act, Governor Kavcioglu will feel political pressures from Erdogan's call for a rate cut. In order to ease these pressures, it is possible the CBRT will remove the phrase in the policy statement that pledges for positive real rates while keeping rates on hold this time around. Markets will still take a cue from this action, which will likely see the lira tumble.

Chart: shorter-term market pricing unfazed by increased political pressures



Rates are hiked, pledge for positive real rates remains

This option may sound like music to the ears of markets at first, as increasing interest rates and keeping real rates in positive territory could be the main rescue to the lira sell-off. Initially, this may strengthen investors' trust in the CBRT as it sends a message to markets that policymakers are committed to stepping up their game in their fight against inflation. However, this option is fighting a losing battle, as it opens the door for the possibility of Erdogan appoints new Governor who knuckles under his preference for lower rates – a major downside risk for the Turkish lira.

Rates are cut, unorthodox mantra wins

Under this scenario, the CBRT gives in to lower borrowing costs to stimulate the economy and, according to Erdogan, help slow the pace of price growth. Markets won't enjoy this, and this option would likely see the fastest and most significant drop in the lira. As a result, the impact of the weakening currency will further filter through to inflation, leading to a ripple effect in both inflation and the Turkish lira.

All scenarios have one thing in common, and that is the prospect of a **weaker lira**.

Given the backdrop of increased political risks and increased economic risks from mounting inflation pressures, we expect USDTRY to rise to record highs above the 9-handle in a matter of months. A risk to this outlook arises if the CBRT opts for holding rates, this is received neutrally by President Erdogan, and inflationary pressures ease in the months ahead, as the manifestation of these three actions will keep a lid on TRY.

Banxico preview

Inflation prints leave question marks around Banxico policy decision

Banxico's monetary policy meeting on August 12th keeps markets on edge, with both investors and analysts undecided about the Bank's next steps. Despite Banxico's stronger guidance on battling inflation, there are reasonable doubts on whether last meeting's hike was just a pre-emptive signal for markets or the outright start of the normalisation cycle. Our read at this point is probably the former; a scenario in which the Bank will likely wait for stronger indications to resume the tightening path. The rationale behind this is twofold. On the one hand, domestic inflation might be around the inflection point, while renewed virus risks warn of potential effects on global and domestic growth. Second, protracted guidance on the Fed´s tightening of QE grants some leeway to Banxico, especially in the context of falling US yields. The Bank feels comfortable with surprising markets, though, as proven last month with the unexpected 25bps hike. That leaves some margin of uncertainty to the event, rendering the bar for peso volatility upon the announcement low.

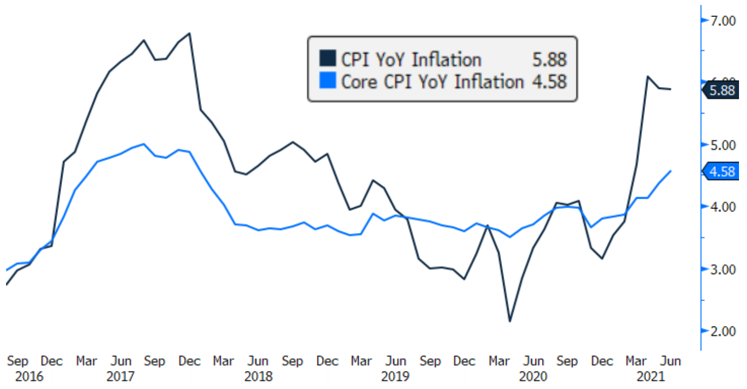
"Markets are currently pricing in 18 basis points of additional interest rates over the coming month, indicating that a decision to hike rates next week will likely **trigger a slightly oversized impact on the currency**."

The Mexican Bank has made remarkable efforts in consolidating its inflation mandate for investors. Despite acknowledging that the recent inflation pick-up is likely temporary, the hiking decision last time around intended not only to cool down price dynamics, but to anchor inflation expectations back to the target. Their decision to hike rates has been a success in this regard, with 1-year implied inflation expectations pivoting back to the 2%-4% target range. However, the re-anchoring of inflation expectations can't be solely merited to Banxico. Stringent fiscal expansion and limited political risks in the short term have aided the Bank in getting the job done. This probably makes Banxico stand above peer central banks like the Brazilian and Russian ones, where fiscal or political factors outweigh policy efforts to control inflation. In this perspective, while other "early-hikers" would need to pursue far more aggressive tightening, Banxico will likely be able to manage inflation with a softer normalisation path. Implications for the currency are straightforward, with EM high-yielders like the BRL and RUB probably taking the advantage, while the MXN follows a smoother appreciation road.

1-year inflation expectations are back to the target range after June's hike surprise

The domestic inflationary path will ultimately lead Banxico's tightening agenda, with the Bank already exposing a greater sensitivity of its reaction function to price dynamics. Headline inflation seems to have peaked at 6.12% in April, but core prices have been accelerating to 4.6% from 3.8% at the end of 2020. Cost pressures and a solid economic recovery are likely to keep inflation at a significantly above-target level this year and until at least the first half of 2022. Still, Banxico could strike a more patient tone on gradually stabilising inflation as the gap between core goods and services triggered by the pandemic narrows, especially since expectations within the policy horizon are under control. July's inflation figures next week ahead of the Banxico meeting will be key to assessing the chances of an additional hike. If consensus forecasts are met and the downward headline narrative lives up to expectations, there might not be an urgent need to push up the policy rate at this juncture, at least until the Fed takes a deeper look into asset purchases and its policy forward guidance.

Headline inflation seems to have peaked, but core dynamics remain stubbornly to the upside



Disclaimer