FX Daily: China's yuan is the surprise winner in the energy panic

CNY has had a good week, likely benefitting from the narrative that the PBOC will welcome a stronger currency to shield China from soaring energy prices. That's a key topic today, as markets turn their focus to ISM manufacturing while still monitoring political events in the US. The USD may stay supported as equities exhibit more weakness

USD: CNY and USD both ending the week stronger

The dollar rally paused despite a contraction in US equities yesterday, as quarter-end flows likely saw a slight predominance of dollar selling, and commodity currencies found some (short-lived) respite thanks to another spike in energy prices. Markets have grown even more concerned around the prospect of a supply imbalance this winter after the Chinese government ordered major energy firms to secure supplies "at all costs".

The reasons to suspect an energy supply crunch in China are more deeply rooted and largely boil down to China's new policy aimed at reducing greenhouse emissions, which have put increasing curbs on domestic coal output. At the same time, a historic import route – the one with Australia – has recently come under pressure amid geopolitical and trade tensions between the two countries, which recently saw China impose duties on Australian coal.

One way this is affecting the FX market is through the notion that the PBOC is now welcoming a stronger yuan in an attempt to insulate the country against soaring commodity prices. It appears that markets have increasingly sunk their teeth into this narrative, and CNY's resilience to the Evergrande saga looks like a testament to this.

A further drop in USD/CNH (CNY won't move as a week-long holiday in China starts) to the 6.43 September lows in the coming days may generate a positive spill-over in other Asia EM FX, although that is a scenario that still looks quite tied to the Evergrande story, to which markets may have turned somewhat complacent lately.

Equities came under pressure again in the Asian session, and futures point at a negative open in main Western stock indices. Accordingly, we could see the dollar remain well supported into the weekend with high-beta currencies continuing to drop some of their recent gains.

Looking at events in the US today, markets will keep an eye on September's ISM manufacturing, on any policy/inflation remarks by the Fed's Harker and Mester and on whether we'll see the $550bn bipartisan infrastructure bill secure House approval after House Democrats delayed the vote yesterday.

EUR: Above 4% inflation in Germany leaves markets unimpressed

The euro received no help from yesterday's inflation numbers out of Germany, which saw the headline rate jump above 4% in September, the highest in nearly 30 years. Markets are clearly still reluctant to translate this into more aggressive pricing when it comes to ECB policy normalisation, and as today's eurozone-wide data is released, the EUR may still struggle to find any idiosyncratic strength. Considering the dollar's good momentum, EUR/USD still looks more likely to test 1.1500 rather than to rebound to the 1.1700 area in the coming days.

GBP: Struggling to recover despite hawkish BoE pricing

It's been another grim week for the pound, which remained highly sensitive to swings in sentiment and still struggled to cash in on the recent hawkish repricing of Bank of England rate expectations. Despite this week's more cautious comments on the recovery outlook by Governor Andrew Bailey, the OIS curve indicates that markets have moved to price in around 65bp of tightening by the end of 2022, likely on the back of concerns that higher energy prices will pump up inflation in the coming months.

Another risk-off day today could see EUR/GBP tick higher again, although we expect any fresh rally in the pair to struggle to break the 0.8644 200-day MA for now considering there is no clear EUR-specific bullish sentiment at the moment and the pound appears to have already widely discounted the unsupportive risk environment.

CAD: Growth data to play second fiddle

Canada and Australia are two major natural gas exporters, and their respective currencies were partly shielded from the USD appreciation this week thanks to that. However, they both came under new pressure this morning as they suffered from their high-beta to global risk appetite and

Asian equities dropped.

Today, Canada sees the release of July's growth data, which is expected to show a marginal MoM contraction in activity. We doubt the release will be able to particularly influence the market's upbeat sentiment on Canada's economic recovery, strengthened all the more by up-to-date jobs figures. When adding the steady rise in inflationary pressure, the case for an imminent round of extra tapering by the Bank of Canada should remain strong even if GDP data come on the soft side today.

Ultimately, CAD should still be able to count on a supportive domestic story, but the short-term fate for the currency remains mostly reliant on the global risk dynamics. Today's choppy environment should keep USD/CAD above 1.2700.

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