

FX Daily: Ukraine optimism and China pessimism

Markets' sanguine approach to peace talks between Russia and Ukraine (despite no signs of de-escalation) are lifting sentiment and supporting European FX in particular. Meanwhile, China-related currencies are suffering from the PBOC's weak CNY fixing, some re-pricing of China's growth expectations, and US-China geopolitical tensions.



Source: iStockphoto

➔ USD: Mixed performance

Military action by the Russian army in Ukraine has shown no signs of de-escalation, but markets are looking with favour at the intensification of peace talks despite the lack of success of the latest summits. In global markets, tentative optimism on Ukraine dealt a blow to commodities and sovereign bonds yesterday, with WTI back to trading below 100\$/bbl and UST 10Y yields breaking 2.10%. In FX, the battered and highly-volatile SEK rallied by nearly 2% yesterday – also thanks to an above expectation inflation read in Sweden – and EUR/USD climbed back to 1.10 as markets priced out some Ukraine-related downside risks. The bond sell-off weighed on JPY, which appears on track for move towards the 120.00 mark.

The PBOC's stance on CNY has been the other key theme at the start of the week. This morning, the Bank fixed USD/CNY significantly above the model estimate (6.3760 vs exp. 6.3531/6.3677) for a second consecutive day, reinforcing market speculation that Beijing's tolerance for a stronger yuan has reached a limit. Incidentally, appetite for the yuan has been dented by new lockdowns in China (that have caused some growth expectations re-pricing despite good data) and speculation that potential military support to Russia could see Beijing being also the target of Western sanctions.

There are obvious negative implications for Asian currencies that had counted on an outperforming CNY as an anchor amid a turbulent risk environment. The soft momentum in regional FX is extending to AUD and NZD, which are also seeing their appeal as attractive pro-cyclical alternatives amid geopolitical risk being dented by the rebound in European high-beta FX and lockdown-induced re-pricing of China's growth expectations.

In the US, the calendar includes the Empire Manufacturing index, PPI and TIC flows data today, all unlikely to generate any tangible market reaction ahead of tomorrow's FOMC announcement. The dollar may continue to show some selective strength into the FOMC, with the yuan's soft momentum and rising UST yields keeping both the antipodeans and JPY under some pressure. Some optimism around Russia-Ukraine peace talks offers some support to European currencies (which however remain highly vulnerable to any re-pricing of such optimism). The highly EUR-weighted DXY may stay capped below 99.00 today.

📈 EUR: Grim ZEW should have little impact

With markets having now fully processed the ECB's hawkish surprise from last week, EUR/USD is back to being fully driven by sentiment around the Russia-Ukraine conflict. As highlighted in the USD section, markets appear to be taking a relatively sanguine approach when it comes to ongoing peace talks despite no signs of de-escalation, and have continued to gradually price some geopolitical risk out of commodities and European currencies.

Today, some focus will also be on data in the eurozone, with the German ZEW set to show a very significant contraction given the impact of the war and high energy prices. Still, this should not itself prevent a move back above 1.1000 in EUR/USD today, given the ECB's rhetoric that fighting inflation now matters more than growth considerations.

SEK, a key benchmark for Ukraine-related sentiment, has rebounded strongly on the back of peace-talks optimism. Still, the krona's good momentum is – for the first time in several weeks – also linked to a hawkish re-pricing of Riksbank's rate expectations, which were fuelled first by the ECB meeting last week and by yet another above-consensus CPI read in Sweden yesterday. With core CPI inflation running at 3.4%, a hike by the Riksbank already in 2022 no longer appears as a remote possibility. Still, 100bp of tightening is already in the price for the next 12 months, which means that more optimism on the Ukraine war will be needed for EUR/SEK to consistently trade below 10.50.

➡️ GBP: Jobs data endorse BoE hike

This morning's UK jobs report for the month of February continued to signal tightness in the labour market and accelerating wage-growth dynamics, which support the prospect of another hike by the Bank of England on Thursday. A 25bp hike was already fully priced in by the market, so the jobs data had no positive impact on GBP this morning.

The pound is set to remain entirely driven by sentiment on the Russia-Ukraine war, where the recent optimism can help GBP/USD avert a break below the key 1.3000 support but will likely continue to put upward pressure on EUR/GBP, given the euro's higher beta to the conflict.

📈 CZK: Back on track, supported by record interest rate differential

With ten days to go before the CNB media quarantine begins, we should see more statements from board members in the coming days, which we believe should push market pricing higher. Currently, the market expects an almost 50bp hike at the March meeting and with a 50% probability of another 25bp hike at the May meeting with the terminal rate in the 5.0-5.25% range. Inflation surprised to the upside again in February (11.1% vs. market estimate of 10.4% vs. CNB estimate of 9.7%), pushing the forecast for the coming months to the 13-15% range, which we believe will maintain the current strong hawkish line and push market pricing higher.

In the FX space, the CZK has recoupled in recent days with the interest rate differential pair hovering near its recent highs. Barring further escalation in the Russia-Ukraine relationship, we expect the higher interest rate differential to support the koruna to make fresh gains. On the other hand, we believe that the CZK has a long way to go to return to pre-conflict levels.

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