

FX Daily: Breaking new ground with the Fed

A very hawkish set of FOMC minutes on Wednesday is still reverberating across markets, driving bond yields higher, hitting growth stocks and keeping the dollar reasonably well-supported. With the minutes revealing that the Fed already feels that conditions have been met for a first hike, today's December jobs data should keep the dollar bid on dips



USD: Fed would welcome a stronger dollar

Going into today's US December jobs release, FX markets remain reasonably calm. Broader trade-weighted measures of the dollar remain within 1% of their late November highs and local stories, such as aggressive hiking in Eastern Europe, continue to play out in local currency markets - the Hungarian forint being the strongest performer over the last week.

But the Fed now stands centre stage after the release of those minutes. Please see James Knightley's and Padhraic Garvey's thoughts on the minutes [here](#). Not only is the focus shifting to how quickly the Fed can hike rates - the Fed's out-riider James Bullard suggested the Fed could start in March - but also how quickly the Fed will start to shrink its balance sheet. It seems clear that the start of balance sheet reduction - or quantitative tightening - will start much quicker than the two-year gap from the first hike - seen in the last cycle. This is pressuring the entire US yield curve higher and weighing on the more interest-rate sensitive growth stocks. For example, the

Russell 1000 Growth index is now 6% off its highs - the Russell 1000 Value Index is barely off 1%.

This makes a tricky environment for FX - one in which investors might favour the high yield/commodity FX space on the back of growth/tightening stories - but one that could be easily undone were equities to start correcting too quickly. Given that the Fed seems to have fully swung behind the hawkish narrative, we would expect the dollar to stay strong today and be bid on dips even if the nonfarm payrolls disappoint. The consensus seems to be for a 450k headline jobs number, a 4.1% unemployment rate, and 0.4% month-on-month average hourly earnings. Right now, with the Fed's rotation to inflation, it feels like the unemployment rate and average earnings will be more important. Any strong readings there could see the dollar pop higher.

DXY is in the middle of its six-week trading range, but today could be a catalyst for a push back to the highs near 97.00.

⬇️ EUR: Inflation on the turn?

EUR/USD remains firmly trapped in its 1.1180-1.1380 range. In the eurozone today the focus will be on whether headline CPI has turned the corner. December CPI is seen at 4.8% year-on-year versus 4.9% prior. The narrative of inflation turning lower in the eurozone before it does in the US, and particularly in the UK, is one which we think can weigh on the EUR in the first half of 2022. And we have [recently revised our EUR/USD profile](#) to allow for a brief move to the 1.08 area this summer before a recovery back to 1.10 by year-end ahead of the first European Central Bank hike in March 2023.

The biggest risk of a EUR rally probably comes from a disorderly equity correction that triggers a squeeze in EUR-funded carry trades. But with the Fed on the verge of starting a potentially aggressive tightening to deal with (as Fed's Bullard calls it) an 'inflation shock', we would favour a lower EUR/USD over the next six months.

For today, any upside surprises to the price components of the jobs report could send EUR/USD back to 1.1180/1220. Elsewhere in Europe, we continue to like the CE3 stories as local central banks try to ride out their inflation shocks with very high rates - e.g. well over 4% in the Czech Republic and Hungary.

➡️ GBP: Holding gains

On a trade-weighted basis, GBP is now trading at the highest levels since that fateful summer of 2016. The strength of sterling seems to correlate with moves in the sterling rates and yield markets, where UK gilt yields have seen by far the largest adjustment in the G10 space over recent weeks.

A lot is priced in for the Bank of England now. A 25bp hike is 80% priced for the 3 February meeting and the Bank Rate is priced at 1.00% for the August meeting. Our rates traders think that may be sufficient pricing for the time being. But that pricing looks unlikely to be unwound before the 3 February meeting and the BoE might feel emboldened by the hawkish shift from the Fed.

Our 2022 FX view has been that the BoE story keeps GBP/USD better supported than EUR/USD in a strong dollar environment - and that EUR/GBP trades lower. We continue to hold that view and any dollar strength on the jobs data today could push EUR/GBP closer to the 0.8280/8300 area. Locally today we have the BoE's Catherine Mann speaking twice. She is on the dovish end of the spectrum

but looks unlikely to shift BoE market pricing.

➔ CAD: Looking at jobs data amid fresh restrictions

Yesterday's oil rally offered some support to the loonie, with USD/CAD now stabilising below 1.2800. Today, expect any positive surprise in the US payrolls to benefit CAD in the crosses, as good US data normally has positive spillovers to the loonie. Jobs figures for December will also be released in Canada today. Consensus expectations are for a moderate increase in hiring, but we flag the risk of a negative reading, which would worsen a domestic economic story that is already facing the strains of tough containment measures (Ontario entered lockdown this week).

The only major data release before the 26 January Bank of Canada meeting is the December inflation report, meaning that disappointing employment data today may offer a reason for policymakers to sound more cautious on tightening given the Omicron spread. Still, we must remember that the Canadian economy (and the jobs market in particular) was in a very good place before Omicron hit, and any re-rating of BoC expectations may be premature.

The short-term outlook for CAD remains mostly tied to risk-sentiment swings and oil performance, although the worsening domestic picture and a market positioning that is not overstretched to the short-side both suggest the loonie is now facing an unusual domestic drag. We think USD/CAD may stabilise around the 1.26/1.28 area for now.

Authors

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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