FX Daily: Dollar decline gets a little more serious

The prospect of Democrats taking control of the US Senate has sent US Treasury yields higher and the dollar lower, as investors bet that larger fiscal stimulus could fuel inflation

USD: Georgia Senate result adds to reflationary narrative

With 99% of the votes counted in the very tight Georgia Senate run-off it looks as though the Democrats might be able to secure the two seats they require to gain control of the Senate. Vote counting has ceased for the night and a full result may not emerge until noon Eastern Time or late Europe. ING's James Knightley sees a Democrat win unlocking more of Biden's policies, where, given the fragile state of the economy, the early focus would be on fiscal stimulus rather than regulation or tax hikes. That probably explains the market reaction so far, where the notable move has been US yield curve steepening (US 10-year Treasury yields hitting 1%) and US equity futures slightly bid. While the prospect of more fiscal stimulus may seem a dollar positive, a different narrative looks to be at work. With the Federal Reserve promising to keep the policy rate on the floor (December FOMC minutes released tonight), the market is taking the threat of inflation a little more seriously. 10-year inflation expectations from inflation-indexed US Treasuries have jumped 25bp to 2.03% over the last month, driving the real US policy rate deeper into negative territory and weakening the dollar. There is a risk that the narrative slightly switches from a benign dollar decline amidst a global recovery to a more negative dollar devaluation story (US yields up, dollar down) and a defensive pair like USD/JPY starting to make a move towards 100. Let's watch this space.

EUR: Swamped by global trends

While EUR/USD is now trading cleanly through 1.23, it is notable that the European Central Bank's euro trade weighted index (TWI) is only up 0.7% since December and 1.7% from the lows in mid-November. Clearly a broad dollar decline is the dominant force here, but the EUR will also be staying supported from re-cycled flows into Asian equities. Here, Asian FX reserve managers still seem to be active in the market (Korea reported another $7bn rise in FX reserves in December). Re-balancing growing FX reserves into EUR will be a supportive trend for EUR/USD this year. For today, look out for German inflation in December. EUR/USD has come a long way already, but we cannot rule out a move closer to 1.25 before a correction.

GBP: Holding up quite well

GBP is holding up quite well despite the national lockdown looking set to extend until late February. Look out for the final release of UK December services PMI today. Cable could see some strong gains if it can break 1.3700 resistance.

ZAR: Weighed by vaccine strategy

A sad reminder that the vaccine rollout will disadvantage some emerging markets was the sell off in the South African rand yesterday. It looks as though tighter lockdown restrictions may be announced tomorrow at a time when a vaccine procurement strategy is still unclear – and vaccines may not be available until April. ZAR to underperform.

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