

FX Daily: Dollar on unstable ground

Intense scrutiny of the US growth story means that the dollar remains vulnerable to data releases as markets keep scaling back Fed rate expectations. We see more downside risks for USD in the near term. Elsewhere, hawkish ECB minutes and remarks by Lagarde could support the euro, and we expect a 25bp hike by Norges Bank despite rising bets of a hold



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⬇️ USD: Data continues to haunt the dollar

In yesterday's FX Daily, we flagged the risk of fresh US data hitting the dollar given the recent scrutiny (and pessimistic narrative) by the market of the US growth story. That risk materialised as retail sales and industrial production came in softer than expected, triggering another round of dovish repricing in Federal Reserve rate expectations. The USD 2-year swap rate hit 4.35% yesterday, the lowest since early October, and the differential with the corresponding EUR rate is now very close to the -124bp December high. [Our US economist now sees](#) growing risks that the Fed may stop hiking after a 25bp move in February.

The correlation between the 2-year swap rate differential and EUR/USD has not been very strong in the past year but is picking up again. Most importantly, the weakness in the correlation largely

derived from the euro's low sensitivity to European Central Bank policy, rather than to the Fed's. The fact that the ongoing dovish repricing is not only a consequence of slowing inflation but also of a worsening economic outlook in the US has exacerbated the negative implications for the dollar, especially as a positive re-rating of growth expectations is happening in Europe and China.

One could argue that the dollar is facing a rather uniquely-timed combination of negative factors, and that the sustainability of the optimistic growth re-rating in Europe and China may be challenged by fresh commodity price volatility and high infection numbers – respectively. We see value in such an argument, and a straight-lined dollar depreciation in the first quarter is far from assured. But global and US-specific dynamics continue to suggest a bearish bias on the dollar in the near term. DXY may re-test yesterday's 101.55 lows by the end of the week.

Today, markets will watch the size of the increase in initial jobs claims, as well as housing data and the Philadelphia Fed survey. The Fed's Susan Collins, Lael Brainard and John Williams are scheduled to speak.

Elsewhere, Asian G10 currencies are following diverging paths this morning. The yen is recovering across the board as markets seem to cautiously re-enter long positions after the Bank of Japan defied the hawkish speculation yesterday. We continue to see downside risks for USD/JPY despite a dovish BoJ. The Australian dollar has come under pressure after a surprise contraction in employment in December, which endorses the recent cautious stance by the Reserve Bank of Australia. Still, we'd need to see inflation come off more convincingly before making strong calls about the end of the RBA hiking cycle. We continue to favour AUD/USD on the back of positive external developments (China, risk sentiment).

The New Zealand dollar is suffering from some spill-over effects from AUD, while the news that prime minister Jacinda Ardern is resigning at the end of her mandate hardly seems like a key driver considering that her party is trailing in the polls ahead of the October election.

Francesco Pesole

EUR: ECB pushes back against dovish speculation

Yesterday, ECB Governing Council member Francois Villeroy explicitly pushed back against recent reports suggesting a switch to 25bp increases and said that President Christine Lagarde's 50bp guidance remains valid. Lagarde herself will speak in Davos today, and there is a good chance she will reiterate the ECB's hawkish stance despite lower energy prices.

Dovish speculation should be further challenged by the release of the December 2022 ECB meeting minutes, as the details of the dissent to a "too conservative" 50bp hike should emerge, as well as guidance to "multiple" 50bp increases.

We expect to see some consolidation/further upside in EUR/USD by the end of the week when the pair could trade around 1.0850/1.0900.

Francesco Pesole

GBP: Starmer to pledge Brexit fix

The leader of the opposition Labour Party, Keir Starmer, is reported to deliver a rather conciliatory speech in Davos today about the future of EU-UK relationships. In an interview with the Financial

Times, Starmer criticised the Brexit deal and said he aims to rebuild good trade relationships with the bloc. The Labour party is leading by a rather large margin in the latest opinion polls ahead of next year's general elections and evidence of a softer stance on Brexit should benefit the pound in the long run.

Today, there are no events or data releases in the UK. Some recovery in the EUR may still send EUR/GBP back to 0.8800+ by the end of this week.

Francesco Pesole

NOK: Norges Bank may deliver last hike today

Norges Bank announces monetary policy this morning, and the consensus is split between a 25bp and a hold. The latest projections saw the Bank signal a 3.00% peak rate (now at 2.75%) in early 2023, and a combination of resilient underlying inflation, growth and employment suggests – in our view – this should be the right time to deliver the last hike of the cycle.

Indeed, concerns about slowing economic activity, lower energy prices and housing market vulnerability are all important factors in the Norges Bank's decision-making process, and we admit it's a rather close call. There will be no new projections today, but only a brief statement, so the krone's reaction will primarily depend on the hike/no-hike decision. In line with our call, we see upside risks for NOK today. EUR/NOK could trade close to 10.60-10.65 again today, but idiosyncratic EUR strength suggests most NOK gains may be channelled against the dollar.

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