FX Daily: Dollar supported as US yield curve flattens further

Of many themes driving FX markets over the last week, two stand out. The first is the uncertainty caused by the new Omicron variant. The second is that the Fed seems more concerned by inflation and will push ahead with normalising policy. Barring any clear Omicron news, today's US jobs data should drive the Fed story and will probably keep the dollar supported

Source: Shutterstock

USD: NFP to keep early Fed tightening expectations in play

We mentioned this earlier in the week, but it seems the US Treasury yield curve sums up the global environment pretty well. As usual, the long end of the bond market is taking the strain from the uncertainty around Omicron. US 10 year yields are 23bps off their recent highs. But Fed Chair Jay Powell's comments earlier this week that inflation is effectively no longer transitory has seen the policy-sensitive US two year yield stay firm above 0.60% (now just 2bp off its highs for the year) on the view that the Fed's normalisation of monetary policy is locked and launched. Therefore US yield curve flattening is a stand-out story.

That story should today be fed by the November US jobs release, where another 500k+ increase in the headline number, a decline in the unemployment rate and an increase in hourly earnings should all keep short-dated US rates supported on the view that the Fed could exit super-loose policy more quickly. Any sharper than expected drop in the unemployment rate (3.8% has been suggested as a metric for full employment and the start of tightening) or sharper rise in average hourly earnings (e.g. more than 0.4% month-on-month) could drive the dollar higher today.

Typically, US yield curve flattening tends to see the dollar go bid against the more pro-cyclical currencies - understandably if the monetary brakes are being applied and growth expectations are being revised a little lower. That is nearly the case in the G10 space over the last week, where AUD, NZD and NOK have been the worst performers. But Omicron means that the JPY and CHF have outperformed the dollar. A strong US jobs report today could swing the pendulum more fully in favour of the dollar - sending DXY back to the 96.60 area.

EUR: In harm's way

EUR/USD is sitting exactly in the middle of what could prove a multi-week 1.1180-1.1380 trading range - bordered by Omicron and Fed news. While a strong nonfarm payrolls report today could see the lower end of that range tested, investors may be reluctant to chase the move too much lower for fear of some more damaging Omicron news or uncertainty about the European Central Bank's attitude to inflation and ending emerging QE schemes when it meets on Thursday 16 December. That certainly is going to be a big meeting.

In the meantime, news of further lockdowns across continental Europe hardly proffers the euro as a safe haven currency of choice and one suspects that EUR/JPY stays under pressure. And while it is not a very fashionable view, we doubt EUR/NOK holds above these 10.30+ levels for long. Our team forecasts Brent averaging close to $75/bl next year despite the OPEC+ decision to keep supply plans intact, which should keep the undervalued NOK in demand on any near term weakness.

Elsewhere we see the Polish zloty starting to outperform in the region, with PLN/HUF now trading above 79. We mentioned earlier in the week that the National Bank of Poland seemed to want a stronger zloty. And the market looks to be expecting a 50-75bp hike from the NBP next week. And despite the Omicron news, 3x6 Polish Forward Rate Agreements have already recovered 30bp of their 40bp sell-off - suggesting a market conviction that the NBP will push ahead with tightening. We like further gains in PLN/HUF.

GBP: Steady as she goes

Despite the gyrations in cable this year, the Bank of England's broad trade-weighted sterling index has traded out a tight 80.50-82.50 range since March. It now sits not far from mid-range. The BoE's rate decision of 16 December will no doubt have something to say about this - i.e. generating some independent GBP move. Until then, expect other FX drivers to take charge - probably dollar strength - such that cable will occasionally stay vulnerable to dropping to the 1.3150/3200 area.

CAD: Labour market set to keep pressuring the BoC

After some very strong growth numbers for 3Q earlier this week, Canada releases the November jobs report today. The pace of hiring was understandably slower in October following the very strong summer gains, and markets are likely expecting another read around +30k today. A greater focus is being put on wage growth, which rose to 2.1% in October: more indications of upward pressure on wages will easily fit the narrative that inflation in Canada should prove quite persistent.

The Bank of Canada, which holds a policy meeting next week, is set to continue facing the pressure from domestic data – in our view – although the developments on the virus side naturally hold the key for the policy response in the near term. Markets have changed their expectations in Canada over the past week, shifting from pricing a March rate hike to seeing the first move in June. This has contributed to keeping CAD under pressure amid the unsupportive risk environment and the oil sell-off. Given the high beta to sentiment and commodities, any view on CAD is strictly dependent on incoming news about the danger associated with the new variant, but if we exclude a return to draconian measures in highly-vaccinated communities, we think USD/CAD can gradually decline towards 1.2600 into year-end.

Author

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