FX Daily: ECB slams brakes on growth and the euro

Volatility picked up in FX markets yesterday as the ECB traded the softening to a 50bp hike for an exceptionally hawkish message. News that one of the world's largest economic blocs would need to face significantly higher rates for longer hit global growth prospects and lifted the dollar. We think it is still too early to expect a big rally in pro-cyclical FX

ECB President Christine Lagarde at a press conference following the meeting of the ECB Governing Council on 15 December 2022

USD: Overnight deposit rates at 4.35%

The dollar mounted a modest fightback yesterday – and saw some decent gains against the high-beta commodity currencies. This came after the ECB delivered a very hawkish message yesterday. The move was described as a "hawkish pivot" by our colleague Carsten Brzeski. The FX market reaction proved instructive of how investors are looking at the world right now, i.e. through the lens of growth and whether the economic landing in 2023 will be soft or hard. The ECB's actions yesterday weakened the case for the soft landing and sent funds into the dollar – where overnight deposits now pay 4.35%.

With the US yield curve staying very inverted after this week's hawkish FOMC communication, and now the ECB's hawkish message sending the EUR swap curve deeper into inverted territory, we now have two of the world's largest trading blocs with increasingly restrictive monetary policy. Slowdown fears will remain in the ascendancy and this looks like a poor environment for equities and commodities (though this latter asset class could find support from the supply side).

On the subject of global demand, reports do seem to suggest that China's exit from its zero-Covid policy is heading into disorderly territory – a development which may pour some cold water on those backing a China re-opening/2023 global recovery story.

We would like to think DXY has put in some kind of low near 103.50 on Wednesday and that this week's re-assessment of global growth can provide the defensive, high-yielding dollar with some support. Let's see whether 104.00/104.20 support can hold out short-term and indeed whether the dollar can hold out at these levels until January when seasonal trends turn more supportive.

Chris Turner

EUR: ECB would like a stronger euro

The trade-off for softening to a 50bp hike yesterday was clearly for a much more hawkish ECB message. It is quite rare that central bankers want to tell the market that it is mispricing the policy cycle, but that is exactly what ECB President Christine Lagarde did yesterday. Two-year EUR swap rates rose 25-30bp and EUR/USD initially spiked to 1.0735. However, as European and global equity markets started to bear the brunt of this hawkish shift, EUR/USD sold off quite sharply yesterday.

That is consistent with indications from our Financial Fair Value models which suggest that over the last 12 months, EUR versus USD short-term rate differentials have had very little say (correlation) over spot EUR/USD moves. More relevant for spot FX pricing has been: a) the relative performance of eurozone equities versus US equities and b) the global risk environment represented by the MSCI world equity index. Eurozone equities have outperformed their US equivalents by 14% since September, but that may change. We also think the global equity environment will be challenged into the first quarter of next year as central bankers hike into recessions.

For the time being, then, we will stick with our bearish EUR/USD views into the New Year. Today's data calendar features the provisional PMI releases for December. These are all expected to remain firmly in recession territory. And we will also see the eurozone October trade balance, which is expected to bounce back from a €37bn deficit in the prior month. Let's see whether today's EUR/USD rally stalls at the 1.0665/0680 area. However, as long as EUR/USD continues to trade and close above 1.0600/10, it is hard to say with any confidence that a short-term top is in place.

Chris Turner

GBP: Sterling suffers as end to the BoE cycle approaches

Our colleague James Smith described yesterday's move by the Bank of England (BoE) as a "dovish hike". UK rates certainly defied the widespread rise across Europe and EUR/GBP bore the brunt of yesterday's euro strength. Interestingly, the Swiss National Bank (SNB) will protect the Swiss franc a lot more than the BoE will protect sterling and that is why we see GBP/CHF heading lower too.

EUR/GBP also faces the double whammy not only from the hawkish ECB but also from what the hawkish ECB means for the global risk environment. Sterling is a high beta on global risk given its large current account deficit and the large role of financial services in the UK economy. We have an 0.89 forecast for EUR/GBP in 1Q23 and yesterday's ECB move supports the forecast. We have also just seen November UK retail sales figures, which all look very poor.

Chris Turner

MXN: Banxico dances toe-to-toe with the Fed

Banxico followed the Fed again by hiking the policy rate by 50bp to 10.50%. That keeps the 600bp+ policy spread over US rates and should keep the Mexican peso (MXN) supported. Banxico also said that further rate hikes should be expected. In practice, this should mean another 50bp hike in February to match the Fed.

The Mexican peso has been underperforming recently. We can only speculate that this may have something to do with Citigroup's US$7bn reported sale of its Banamex retail unit – where two local Mexican groups are bidding. However, MXN underperformance should not last long. High rates, low volatility, and Mexico proving the most likely candidate for nearshoring benefits all suggest that USD/MXN should be trading back at 19.00 sooner rather than later.

Chris Turner

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

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com