FX Daily: Euro paying EU's isolation

Markets continue to carefully assess the implications of Russia-US talks, but we are observing an emerging trend of euro underperformance linked to Trump's growing isolationism against EU allies. With plenty of room for tariff risks to be priced into EUR/USD, we remain bearish on the pair

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USD: Still room to recover

The dollar continued its rebound yesterday, although early trading today is favouring some momentum in the yen and Antipodeans. In the coming days, markets will continue to carefully assess how close a truce in Ukraine is, and crucially at what conditions. So far, Russia and the US have held bilateral discussions that have excluded both Ukraine and the EU. Hints at future Moscow-Washington cooperation can reinforce the notion of isolation for Europe from a defence and economic perspective and contribute to a rotation away from European currencies into safe haven USD and JPY. That has also been helped by Trump floating the idea of 25% tariffs on US auto, drug and chip imports overnight.

US Treasury underperformance likely helped the dollar regain some ground too. 10-year yields are back at the 4.55% mark, threatening a retest of the two highs of the past 30 days at 4.65%. We are also seeing a decline in the 30-day S&P500 – Bloomberg Dollar index correlation from the -0.60 peak a month ago to the current -0.35. In the immediate aftermath of the US election, that correlation had turned unusually positive. The S&P500 reaching new highs yesterday did not seem to interfere with the dollar recovery.

The biggest macro event of the week is the FOMC minutes from the 29 January meeting released this evening. Markets have received multiple indications from Fed Chair Powell that there is no rush to cut rates and that the focus has shifted back to inflation concerns. We'll be looking for any assessment of the new US administration policy plans in the minutes, and risks are probably a reinforcement of the hawkish message.

Despite a more balanced picture for DXY after the past two days of dollar gains, the short-term valuation picture has not really moved back to the expensive side and the risks remain skewed to a stronger dollar in the coming days.

Francesco Pesole

EUR: Weakening across the board

The rise in the German ZEW index yesterday was likely due to improved investors' sentiment ahead of expectations for a market-friendly change in government, but does not seem to mirror any real change in sentiment on growth.

The euro continues to follow sentiment on the implications of Russia-US talks, and we are starting to observe some signs of relative underperformance of European currencies that we suspect will be exacerbated by Trump's more transactional approach to European NATO allies.

Our short-term fair value model continues to show zero risk premium (i.e. undervaluation) on EUR/USD, suggesting more downside risks related to a repricing of US protectionism risk into FX. We could see the correction run until 1.040 this week.

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GBP: Inflation rebound not concerning

The release of January's UK inflation data this morning has had little impact on the pound. Headline CPI accelerated to 3.0%, just above our 2.9% forecast and the consensus of 2.8%. However, this is primarily due to an unexpected surge in food prices in January, and markets are attaching little weight.

Services inflation came in marginally lower than expected at 5.0%. Although this marks a 0.6% acceleration from last month, December's figures were artificially low due to improper measurement of Christmas airfares. More significantly, our measure of core services, which excludes volatile items (including airfares) and rents, has shown steady improvement, now at 4.2%, down from 4.7% two months ago. We expect this benign trend in services inflation to persist in the second quarter and support our projection of one rate cut per quarter this year.

EUR/GBP broke below 0.8300 yesterday as the euro continued to show idiosyncratic underperformance likely linked to the EU's geopolitical isolationism relative to the US. We'd be careful picking a bottom in the pair just yet, and a move to 0.820 is not out of scope. In the longer run, we deem at least 25bp worth of dovish repricing is due in the GBP curve, which should offer some support to EUR/GBP.

Francesco Pesole

NZD: Rallying on unchanged rate projections

The Reserve Bank of New Zealand (RBNZ) cut rates by 50bp to 3.75%, in line with our call and the broader market consensus. The Kiwi dollar is trading on the strong side as the Bank did not revise its terminal rate projections lower (still at 3.10%), despite retaining an optimistic view that inflation will remain within the target band and flagging growing downside risks to the economy.

The indications are that this was the last 50bp reduction, and NZD is benefitting from seeing the end of the easing cycle sooner than previously thought. Early aggressive easing by the RBNZ suggests New Zealand can be better prepared to face trade headwinds than Australia, and we still expect a gradual depreciation in AUD/NZD in the medium run.

For now, we don't think the impact on NZD/USD from a slightly less dovish than expected RBNZ will be long-lasting. As we expect a return of US trade policy as a central market theme in the coming weeks, we think the Kiwi dollar remains vulnerable. And the RBNZ's increased concerns about the growth outlook may allow some dovish repricing in the NZD curve despite the unchanged rate projections.

We expect a return to 0.56 by the end of this quarter in NZD/USD, and a move to 0.55 in the second quarter as US protectionism risk intensifies.

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