FX Daily: Focus will be on Japan, China and the UK this week

FX markets open the week on a quiet footing, but with core 2023 trends intact. Emerging market currencies remain bid on the China reopening story, plus the Japanese yen remains very much in demand ahead of Wednesday's BoJ decision. Softer China data this week will test the conviction of renminbi bulls, plus UK inflation and labour data will be key for GBP

USD: Dollar to remain gently offered

The week starts with DXY bouncing from a marginal new low at 101.80 in Asia overnight. Today marks a partial US market holiday to respect Martin Luther King day and could mean that trading conditions, which seemed quite illiquid last week, remain so. The US data calendar is relatively light this week but as our US economist, James Knightley, writes in our economic preview, retail sales, industrial production and existing home sales should all fall on the soft side. In theory, then, this should not impact too much the market expectations of two 25bp Federal Reserve hikes in February and March, both of which are expected to be reversed by year-end.

The benign Fed story and the China reopening trade have kept emerging market currencies on the front foot. What seems a conviction call in the market now is that the dollar has turned, pressure to defend emerging market currencies with rate hikes has reversed and 2023 will mark the virtuous cycle of flows into emerging markets, currency gains, rate cuts and local currency bond markets performing well. Indeed, one of the benchmark EM local currency bond market indices is already up 4.2% this year and has retraced more than two-thirds of last year's decline. The further success of this story clearly relies both on a benign Fed and more positive news on China.

On the issue of China, we are now starting to see local authorities admitting the rising death toll after abandoning the zero-Covid policy last November. Clearly, any renewed shut-down would dent this year's optimism. Equally, tomorrow sees the release of China's fourth-quarter GDP data, which is expected to have contracted on the quarter with an exceptionally low reading of 1.5% year-on-year. We presume that investors are looking through the fourth quarter and probably through the first quarter Chinese data and are positioning for the reopening benefits to appear from the second quarter onwards. So let's see how long Asian FX positioning copes with some softer Chinese data tomorrow.

Also very much in focus this week is the Bank of Japan (BoJ) meeting on Wednesday. Further adjustments to its JGB targets are in focus and investors are positioning for this with higher longer-dated swap rates. 10-year Japanese swap rates have pushed another 5bp higher overnight to the highest levels in a decade. We suspect USD/JPY can trade down to 126.50 before Wednesday.

The factors that have pressured DXY below 102 remain in place, but DXY may find support in the 101.30/50 region this week.

Chris Turner

EUR: 1.0900/1.0950 may be best EUR/USD levels of the week

EUR/USD continues to trade comfortably above 1.09. The focus in Europe this week may be some key speakers at the World Economic Forum in Davos, where European Central Bank President Christine Lagarde speaks on Friday. We will also see some German data in final CPI and the ZEW investor expectations survey - which is expected to have improved. As above, EUR/USD will probably be driven by events in Asia this week. However, we suspect that 1.0900/1.0950 levels may be the best of the week.

Elsewhere this week we have a Norges Bank policy meeting. A final 25bp rate hike is expected to 3.00%. The oil market remains bid on the back of the foreseen pick-up in Chinese demand. And with investors taking a glass-half-full approach to risk assets this year, the EUR/NOK bias is probably lower this week.

Chris Turner

GBP: UK data will be key this week

Sterling has taken rather a back seat so far this year. However, the UK data calendar picks up in the form of both labour market data and December CPI this week. Last week had seen the conviction of a further 100bp hiking cycle from the Bank of England (BoE) start to soften. 95bp of tightening is now priced in by August this year. It is not clear that this week's data will add to those softer expectations - wages and inflation could remain high- but we do see those BoE tightening expectations coming under pressure over coming months. That could see EUR/GBP continue to nudge up towards 0.89, which is our target for the end of this first quarter.

Chris Turner

CEE: Light calendar means stronger FX

This week we are looking at a lighter calendar in the CEE region with rather secondary data prints. Today, we will see the release of the Czech Republic's PPI, Poland's state budget result for last year, and Poland's core inflation for December. The core CPI rose from 11.4% to 11.7% YoY, according to our estimates, despite a drop in the headline number. Romania's industrial production for November will be released on Wednesday. On Friday, we will see data from the Polish labour market, and after the close of trading Fitch will publish a rating review of Hungary. Given the drop in gas prices and the compromise found between the Hungarian government and the European Commission, we do not expect any changes. On the political front, we will follow the EU story and the government's efforts to unlock access to EU funds. Last week the lower house passed a law on judicial reform and now it is the turn of the opposition-controlled Senate.

On the FX market, given the lack of regional momentum, CEE FX will be driven mainly by the global story. In general, we expect higher EUR/USD and good sentiment in Europe to keep CEE supported. Moreover, gas prices are testing lower levels again, which could be positive for the Czech koruna and Hungarian forint.

In addition, the forint should still benefit from lower-than-expected inflation and could test lower levels below 394 EUR/HUF this week. On the other hand, we think the koruna has the strongest long positioning in the region at the moment and further gains will be difficult. Thus, we expect levels around 24.00 EUR/CZK for this week. The Polish zloty, which has lagged behind the region so far, should also see slightly stronger levels and could benefit from the regional optimism and move a bit lower below to 4.68 EUR/PLN.

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