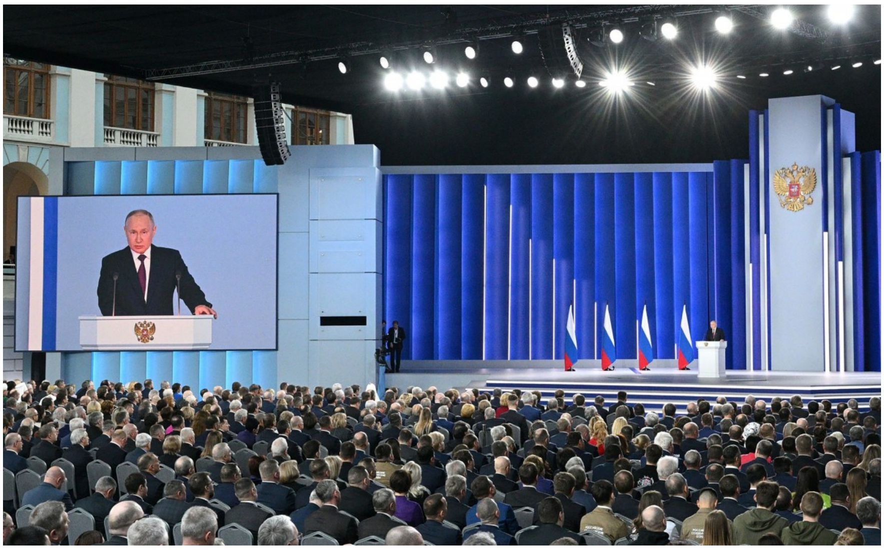
FX Daily: Geopolitical risk strikes back

We remain doubtful that the dollar has further to run on the Fed story, and today's FOMC minutes may struggle to match the recent hawkish Fedspeak. However, a resurgence in geopolitical risk means that defensive USD positions may linger. Elsewhere, the RBNZ 50bp hike was paired with a hawkish tone, but the risk of undershooting rate projections is high



In a speech on Tuesday, Putin said Russia would pull out of its last remaining nuclear treaty with the US

USD: Helped by geopolitical uncertainty

We recently argued that the dollar rally would run out of steam, as the hawkish repricing of Federal Reserve rate hikes has likely peaked, and that external factors would be a more likely cause of further USD appreciation. This has indeed been the case since market action resumed after Monday's US holiday, as a return of geopolitical risk weighed on global risk assets and buoyed the safe-haven dollar.

The focus is now on Russia's next moves on the Ukraine front ahead of a potentially turbulent anniversary of the invasion, at a time when China – a key ally for Russia – has seen a rapid deterioration in its relationship with the US. An important point is that geopolitical themes had a clear channel with assets through energy prices, and the drop in gas prices observed over the winter has broken that link. This means both that there is room for more geopolitical risk to be priced in, but also that impact should not be as direct and forceful as last year unless energy prices materially bounce back.

On other fronts, markets will watch with great interest the content of the FOMC minutes today. We must remember that the 1 February meeting was held before the strong jobs and inflation figures, and crucially before the hawkish repricing in Fed expectations. With markets pricing in close to a 5.50% peak rate, we would essentially need to see evidence that multiple members voiced the desire to hike by 50bp at the start of February. That would back the cause for a 50bp move in March, and likely lift the dollar. However, the bar is set quite high after the recent hawkish comments, and we don't see a very high chance of a hawkish surprise today.

The current instability in the geopolitical picture warrants caution and a bit more support to the dollar may be on the cards, even though we see a good chance that the USD upside correction has peaked.

Francesco Pesole

EUR: Rebound delayed?

Yesterday's PMIs clearly pointed to an improving picture in the eurozone, and we had previously signalled how the data could have encouraged some to re-enter strategic medium-term euro longs. However, the resurgence of geopolitical risk in Russia/Ukraine is inevitably curbing appetite in the common currency: markets may need to get some reassurance on that before jumping back into EUR/USD longs.

We think that, at this stage, support around 1.0640-1.0660 is enough of an encouraging sign for EUR/USD given the strength of the dollar against other pro-cyclical currencies. A hawkish surprise in the FOMC minutes and/or more geopolitical risk being priced in would likely put the 1.0600 support at risk. But unless those two risks materialise, a good Ifo reading in Germany today and stabilisation in sentiment may actually start to favour a move back to 1.0700-1.0750 before the weekend.

Francesco Pesole

GBP: Enjoying good momentum

The pound has continued to display very good resilience despite a re-strengthening in the dollar, this time thanks to very strong PMI readings yesterday. A big (and unexpected) jump from 48.5 into expansionary territory (53.0) in the composite gauge is favouring a re-rating of growth expectations in the UK, which is ultimately translating into rising bets on Bank of England tightening – the biggest driver of GBP performance of late.

The OIS pricing for the BoE peak rate has jumped by around 15bp since Monday, and now falls around the 4.55% area - i.e. fully factoring in at least two more hikes. There's another factor that may play a role here: government borrowing figures for January surprisingly came in £22bn short of the Office for Budget Responsibility's forecasts. This essentially gives Chancellor Jeremy Hunt plenty more ammunition to deploy fiscal support. The initial impact on the pound from those figures was not positive, but there are reasons to believe this could prove beneficial for GBP further down the road.

We are not convinced the BoE will ultimately deliver more than one hike, and given the pound's high sensitivity to the BoE story, we are struggling to see a sustainable outperformance of sterling against the euro in the coming months. But we have to admit that a break below 0.8800 in

EUR/GBP is a tangible possibility in the very near term, and a recovery from those levels (which is our base case) may only be gradual.

Francesco Pesole

NZD: RBNZ stays hawkish

The Reserve Bank of New Zealand's decision overnight was fully in line with our expectations: a 50bp rate hike to 4.75%, a hawkish tone, and unchanged rate projections. The New Zealand dollar is trading stronger after the announcement and press conference by Governor Adrien Orr, but it still seems like the instability in global risk sentiment is putting a cap on NZD/USD gains at the moment.

The acknowledgement of slower inflation and a subdued economic outlook were included in the statement, as well as an analysis of the potential impact on growth (negative) and inflation (positive) of cyclone Gabrielle. Ultimately, the reiteration that the monetary policy strategy has a medium-term horizon was clearly aimed at detaching market rate expectations from such short-term events.

Interestingly, the new RBNZ projections included an even larger (and longer-lasting) slump in the housing market. This seems to us another attempt to sound hawkish and to re-link the market pricing with the 5.50% projected peak rate, as the housing correction appeared to many – including us – as the main reason to stop hiking earlier.

We still think there is a high risk that the 5.50% peak rate will not be reached unless the impact of the cyclone effectively stops the deflationary process. Markets are pricing in 35bp for the 5 April meeting: it's important to note that there are no key data releases except 4Q GDP before that date. A 25bp increase looks more likely, but we wouldn't exclude one last 50bp move before data deteriorate in the second quarter. This means that the RBNZ could offer support to NZD into the start of 2Q, but we then think that a worsening in data and slower inflation should leave further NZD/USD upside heavily dependent on a favourable external environment. We still target 0.67 by the third quarter.

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