FX Daily: Glimmer of diplomatic hope?

Asset prices have moved to price in some degree of military intervention in Ukraine, but are far from embedding a full-fledged Russian invasion. Let's see whether today's Scholz-Putin meeting paves the way for a diplomatic solution: this could hold the dollar back and help pro-cyclicals recover. Elsewhere, a drop in iron ore bodes ill for AUD's outlook

Russian rubles and US dollars

USD: Scholz-Putin meeting holds key to today's market mood

The dollar started the week on a strong footing, thanks to a combination of geopolitical events triggering risk aversion and rising speculation on a 50bp Federal Reserve rate hike in March.

On the first theme – geopolitics – markets will follow very closely today's meeting between German Chancellor Scholz and Russian President Putin, largely seen as one last chance for the West to mediate a diplomatic solution. Meanwhile, the US has pledged to provide substantial financial help to Ukraine in case of invasion. We think global assets are pricing in some degree of military intervention in Ukraine, mostly confined to the Donbas region. Yesterday's support at the 115.00 level in USD/JPY is, in our view, a clear indication that the market is far from pricing in a black swan scenario – i.e. a full-fledged invasion of Ukraine. There is therefore a considerable amount of downside risk for high-beta currencies, and in particular, the European ones, should tensions escalate further. Oil's rally can offer some shield to Canada's dollar and Norway's krone.

On the second theme – Fed rate expectations – today's FOMC minutes from the January meeting will shed some light on how much consensus there was about front-loading rate hikes. Yesterday, James Bullard reiterated he's backing aggressive tightening before the summer.

While indications that the Ukrainian situation may be heading to a diplomatic solution could help pro-cyclical currencies recover and lift some support from safe-havens (including the dollar), we expect the narrative around frontloading of tightening by the Federal Reserve to put a floor under the dollar in the near term even if the geopolitical risk is priced out. Data should play second fiddle today, with some focus on PPI and Empire Manufacturing in the US.

EUR: 1.1300 could hold for now

EUR/USD seemed to find some buyers around the 1.1300 support, which is a level that prices in some geopolitical risk (although no tail risk, as discussed above) but still benefits from bets around European Central Bank tightening this summer.

Unless the Ukrainian situation deteriorates, a decisive break below 1.1300 likely requires some re-pricing of ECB rate expectations. Today, we'll hear from ECB member François Villeroy, while the data calendar includes the German ZEW index (set to rebound as Omicron impact fades) and the second read of eurozone 4Q GDP.

GBP: Jobs data helps case for front-loaded hikes

The pound has shown some resilience despite USD appreciation, with cable finding some good support at 1.3500. We think the underlying positive narrative of front-loaded Bank of England tightening is limiting the downside for the pound despite the adverse risk environment.

This morning's jobs data for January continued to underpin tightening prospects, as the jobless rate held at 4.1% while average weekly earnings accelerated in December.

AUD: China's stance against iron ore speculation clouds the outlook

The Aussie dollar has been the worst performing G10 currency in today's Asian session as iron ore prices dropped by more than 10%. The move was triggered by a statement from China's regulators aimed at warning Chinese companies against speculation and hoarding when it comes to iron ore trading.

Iron ore had been on an appreciating run (moving back above 150$/t) since late last year as Beijing put in place pro-growth measures to counter the impact of Covid and regulatory restrictions. Today's signal from Chinese authorities is clear: a recovery in activity will not be accompanied by another big rally in commodity prices. This limits the upside potential from iron ore despite an expected rise in steel production, with direct and indirect intervention against price speculation from Beijing likely to be the new normal.

Our commodities team continues to favour a gradual contraction in iron ore prices, and warns of the material possibility of seeing sub-100$/t levels by year-end. This should limit any sustained rally in the Aussie dollar for most of 2022, in our view. For today, AUD/USD may hold above 0.7100 unless the Ukrainian situation deteriorates.

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