

FX Daily: Gradual tightening continues in New Zealand

Powell's second nomination as Fed Chair gave a lift to the dollar as markets priced out the risk of the more dovish Brainard taking over the role. Ahead of tomorrow's FOMC minutes, we may see some consolidation in USD-crosses today. In New Zealand, the RBNZ should hike by 25bp and may signal 125bp of extra tightening in 2022. We expect a neutral NZD impact.



➔ USD: Positives keep piling up

The [nomination of Jerome Powell](#) for a second term as Fed Chair was the major driver for markets yesterday. In FX, it generated another round of USD buying, as the risk of the more dovish Lael Brainard taking over was priced out (she was, however, named Vice Chair) and markets reinforced their views around a first Fed hike by mid-2022. As of this morning, the OIS market is fully pricing in a 25bp raise at the June 2022 meeting.

The DXY index has continued to break higher and is now trading at levels last seen in July 2020. Nevertheless, CFTC data did not show any signs that speculative investors have started to build back USD longs, as discussed in "[FX Positioning: Where are the dollar longs?](#)". This may be mostly

due to a lag between positioning and market moves, although it could also signal that some currencies (like the EUR) may not be particularly oversold just yet.

Today, we might see most USD crosses stabilise around current levels. A wait-and-see approach might prevail ahead of tomorrow's FOMC minutes and the US calendar includes only the rarely market-moving Markit PMIs and Richmond Fed surveys.

Elsewhere, some focus should remain on the currencies of Russia and Ukraine. These started to see some independent weakness on Monday, on reports of Russia massing troops at the Ukraine border. The 5-year sovereign CDSs of both countries were hit hard (Russia +11bp, Ukraine +46bp) as investors looked to hedge against escalating tensions. Foreign positioning in Russian local currency OFZ debt markets is not extreme (at 21% of outstanding issuance versus 35% pre-pandemic). The Rouble has been a very popular carry trade this year on the back of front-loaded Central Bank of Russia tightening – and it could now prove vulnerable as liquidity conditions start to deteriorate into year-end.

➔ EUR: Pausing for a breather, but still vulnerable

EUR/USD continued its fall, now trading in the lower-half of the 1.12/1.13 range. While widespread dollar strength was mostly behind yesterday's leg lower in the pair, the common currency is also dealing with a worsening of the Covid situation in Europe. Yesterday, German Chancellor Merkel said the current virus wave is "worse than anything we've seen" and encouraged German States to apply stricter containment measures. While it is true that Germany and Austria (which announced a lockdown last week) have lower vaccination rates (below 70%) than other EU countries like Italy, France and Spain, concerns that even highly-immunised countries will have to step in with more Christmas restrictions have risen significantly in the past week.

All this is naturally paving the way for some re-rating of European growth expectations, ultimately leaving the EUR quite vulnerable. The data-flow is also looking unlikely to come to the rescue of the EUR, as eurozone PMIs today should inch lower in both the manufacturing and services sectors.

A potential pause in the dollar's appreciation today may give EUR/USD some rest, but the risks remain skewed to the downside and the recent break below 1.1250 may have paved the way for another leg lower to the 1.1170 support in the coming days.

➔ GBP: Untouched by Covid risk, for now

The vicinity of the UK to the EU, where cases are rising dangerously and new restrictions are being discussed, may be keeping a floor on EUR/GBP. Markets could be reluctant to speculate that the UK will be able to dodge another serious Covid wave. That said, GBP is clearly looking less vulnerable than the EUR at this moment.

Today's focus in the UK will be on November PMIs, which are expected to decrease only marginally. We think the surveys should not particularly affect the market's conviction that the Bank of England will hike rates in December, particularly given the strong jobs and inflation reports last week.

➔ NZD: Another RBNZ hike, but only 25bp

The RBNZ will announce policy at 0100 AM (GMT) tomorrow and, despite a portion of the market

speculating on a 50bp move, we think the well-telegraphed second hike of the cycle will be only of 25bp, bringing the policy rate (OCR) to 0.75%, the highest in G10. Back in September, RBNZ vice-Governor Hawkesby signalled that policymakers were more in favour of a gradual approach to tightening, and we think this approach should hold this week despite the quite elevated 3Q inflation reading (4.9%). After all, the RBNZ still has to see the impact on growth of the 3Q Covid restrictions and will by February 2022 (the month of the next policy meeting) have a clearer picture on inflation and employment/wage growth dynamics.

We think that the market will mostly focus on the content of the Monetary Policy Statement tomorrow, which includes economic and policy rate projections. The latest rate forecasts – updated in August – saw the OCR rise to 1.60% by end-2022 and to 2.0% by end-2023. The market is pricing in around 200bp of tightening in the next year, and while we think this is overly hawkish, we expect the OCR projections for end-2022 to be raised to 2.0% or more. This, and the generally hawkish tone of RBNZ statement, should ultimately avert a dovish re-pricing of rate expectations in New Zealand, and we think the impact on NZD should be broadly neutral.

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