FX Daily: Hawks on, risk off

The Fed minutes were even more hawkish than the December announcement, and led to USD appreciation across the board, which is extending due to unstable risk sentiment. Focus today will be on the services ISM in the US and German CPI in the eurozone. We expect the dollar to stay broadly supported, with pro-cyclical currencies possibly remaining pressured

Source: Shutterstock

USD: Fed minutes offer fresh support to the dollar

In yesterday's FX Daily, we flagged how the dollar's upside potential appeared very much tied to the market dropping its reluctance to price in the Fed funds rate above 1.50-1.60% in the next couple of years. While awaiting some hard data in the coming days to assess the Omicron impact – yesterday's ADP employment numbers were strong – more hawkish signals from the December FOMC minutes pushed tightening speculations higher. Fed members seemed to endorse quite a fast approach to rate hikes and also appeared open to the possibility of initiating balance-sheet reduction as early as this year.

The dollar jumped after the minutes were released, in a trading day that had previously seen low yielders outperform on weakening risk sentiment. We think the hawkish tone of the minutes can continue to offer some support to the dollar into today's session, although the fact that that the Omicron spread was not looking as severe around the December FOMC meeting as it does now may prevent further aggressive pricing of hikes – at least until data confirms the strong US growth story. Friday's nonfarm payrolls will be key, while today we'll take a look at the ISM services survey for December, largely expected to have shrunk (the question is by how much) due to Omicron.

In terms of Fed speakers, James Bullard (often the most hawkish voice in the FOMC) may double down on faster tightening today. The more moderate Mary Daly, who isn't a voter until 2024, is also expected to deliver remarks.

Stock futures point to a continuation of yesterday's slump in equities today, and while the hawkish Fed narrative – paired with good US data – would normally support the dollar against the low-yielders while leaving commodity currencies – and especially those backed by tightening cycles (like CAD and NOK) - insulated, the current fragile risk environment may keep the whole pro-cyclical bloc under some pressure into tomorrow's payrolls.

EUR: End of the run for German inflation?

A rally in EUR/USD was reversed after the hawkish Fed minutes, and the pair is back around the 1.1300 handle this morning. The EUR's consolidated role as an anti-cyclical currency is allowing it to resist the risk-off-induced USD strength for now, and another bad day for risk assets may put only minor pressure on the pair today.

Markets will focus on Germany's December CPI numbers today. Consensus is pointing at a slowdown in the headline figure from 5.2% to 5.1% YoY, which would endorse expectations that eurozone inflation has already peaked – with Omicron closures now starting to generate some drag. We doubt this will have any clear immediate impact on the EUR, given the European Central Bank's path appears pretty much set for now after the precise guidance provided at the December meeting. From a longer-term perspective, softening price pressures are something that should allow the ECB to hang on to a gradual approach to tightening, which should ultimately keep the Fed-ECB policy divergence a net-EUR/USD negative for most of 2022.

For now, EUR/USD may keep hovering around the 1.1300 mark heading into tomorrow's US jobs report.

GBP: Giving up some recent gains

A strong performer at the start of the new year, sterling is giving up some gains as risk sentiment deteriorates, with some dollar strength that may send cable back below 1.3500 today.

On the domestic side, the UK data calendar is very quiet and some focus remains of the government's actions against Omicron. Yesterday's decision to ease travel rules suggests that Boris Johnson's government is determined to push through the Omicron crisis without major restrictions. Once risk sentiment stabilises, this should allow the pound (which is backed by Bank of England tightening bets) to stay supported.

Scandies: NOK/SEK gap may not close soon

NOK/SEK is at the top of its 4Q22 range, now looking for a decisive break above 1.0300. Surging natural gas prices at the end of the year and the prospect of Norges Bank tightening allowed NOK to find good support around the holiday period. Looking ahead, as our commodities team expects energy prices to ease only after the peak winter months, and the market that is not pricing more than what Norges Bank is projecting in terms of 2022 tightening (75bp), we think that a risk sentiment stabilisation will see NOK emerge as an outperformer in the near term.

SEK's unattractive yield profile is not being matched by an ability to benefit from risk-off periods, with the krona having been hit as hard as NOK from the current slump in equities. Incidentally, we suspect that the Riksbank will offer no clues to support the current pricing for one rate hike by the end of 2022, which should keep the policy divergence between Norway and Sweden wide.

We think a significant recovery in European growth sentiment will be needed to for EUR/SEK to move back below 10.20, while tightening prospects and supported energy prices may keep EUR/NOK below 10.00 for most of 1Q22.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com