FX Daily: What to expect from “Super Thursday”

The Fed turned more hawkish in its Dot Plot projections yesterday, and we see the post-FOMC negative dollar reaction as short-lived. Today, we expect the EUR to weaken as the ECB may announce a new flexible purchase programme, the pound to face only limited downside as the BoE holds rates, and NOK to rally on a Norges Bank hike. Expect no surprises from the SNB

ECB President Christine Lagarde in Brussels

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Read all our FX previews for today's G10 central bank meetings in "G10 FX: What to expect from a week of intense central bank activity".

USD: Not trusting yesterday's weakness

As widely expected, the Federal Reserve doubled the pace of its tapering yesterday. The biggest news for markets was the substantial upgrade in the Dot Plot projections, that are now signalling three rate hikes next year, followed by an additional three in 2023 and two in 2024. This clearly marks a full shift in focus to inflation – incidentally, the "transitory" term was lifted – which is forcing the FOMC to turn a blind eye to Omicron-related risks to the outlook. In FX, all this reinforces our view of a strong dollar in 2022, especially as today's European Central Bank meeting (as discussed below) should mark a further widening in the monetary policy outlook between the US and the eurozone.

Yesterday's post-FOMC USD weakness appeared to be a function of both some position-squaring (the dollar was still overbought against G10 as of last week) and the (somewhat surprisingly) positive reaction in US equities. We think the ECB and Bank of England meetings today may be the catalyst for yesterday's dollar moves to be reversed, particularly to the detriment of the low-yielders.

Along with the four G10 central banks meeting today (Swiss National Bank, Norges Bank, BoE, ECB), we'll see rate announcements in Turkey and Mexico. While Banxico is expected to respond to higher inflation with another 25bp rate increase, the consensus view is that we'll see another rate cut in Turkey (by 100bp, to 14.00%). With inflation that touched 21.3% in November, the Turkish lira - which weakened past the 15.00 level this morning - may still struggle to recover.

EUR: Open for a correction as ECB stays dovish

As discussed in our preview, we expect a dovish message by the ECB today. The Omicron variant is postponing any discussion on monetary tightening to a much later stage, and the focus is instead set to be on the future of asset purchase programmes. An extension of the Pandemic Emergency Purchase Programme after March appears unlikely following recent comments bn President Christine Lagarde, and the question is whether the governing council will opt to smooth the transition to the much smaller Asset Purchase Programme (EUR 20bn per month) by increasing the size of the APP itself or by introducing a third programme. We see the latter as more likely, given it would allow greater flexibility than the APP, and expect it to amount to around EUR 300bn.

This should be read as a more dovish solution compared to a boost to the APP, and we expect the EUR reaction to be negative. As mentioned in the USD section, this week's meeting should further highlight the Fed-ECB divergence on inflation views (non-transitory vs transitory) and policy direction: we expect all this to keep EUR/USD capped in the medium term. For today, we expect the mix of the market reversing yesterday's losses in the dollar and idiosyncratic EUR weakness to put pressure on the 1.1200 support.

This morning, we'll also see a rate announcement by the SNB in Switzerland, although we think there is very little surprise potential as policymakers should keep all tools untouched while reiterating the franc is "highly valued". The combination of a dovish ECB and rising Omicron cases are likely to keep EUR/CHF vulnerable and SNB's FX interventions the norm.

GBP: Limited downside risks from BoE hold

As per our preview, we see only moderate downside risks for GBP from a "hold" decision by the Bank of England today, given that markets have now priced out the option of a hike and the pound is quite oversold. We think the more dovish outcome of a unanimous decision – Michael Saunders already signalled he could change his vote – is not off the cards, especially considering the deteriorating contagion situation in the UK. Still, our base case is either a 7-2 or an 8-1 split vote.

When it comes to forward-looking language, we think the MPC will highlight rising downside risks to the outlook but reiterate that rates will need to be raised next year. This would implicitly leave the door open to a February hike and should ultimately limit the pound's losses.

As we see greater downside risks for the euro today (the ECB announces policy 45 minutes after the BoE), a rally in EUR/GBP is not our base-case scenario. However, with the USD possibly recovering some of yesterday's losses and more potentially concerning news on the UK virus situation in the afternoon, we think the 1.3200 support in GBP/USD may come under heavy pressure.

NOK: One hike today, three more in 2022

We think Norges Bank will deliver a hawkish surprise today, by delivering a 25bp hike and keeping its rate projections unchanged – so still signalling three more hikes in 2022.

Markets have turned increasingly doubtful about the ability of Norges Bank to deliver on its December tightening plans given the spread of the Omicron variant and headwinds to the oil market. However, we think that high inflation and a strong economic outlook continue to support the case for more tightening.

If anything, we see Norges Bank taking a more cautious stance through some downgraded rate projections, but given lingering uncertainty about the severity of the Omicron impact on the global economy, we think the Bank will opt to keep the projections unchanged while awaiting more information.

We think the market is currently underpricing the Norges Bank's 2022 tightening cycle by approximately 25bp, and we therefore see considerable upside room for the krone, which is also receiving some tailwind from booming natural gas prices. We expect a significant fall in EUR/NOK today, possibly to the 10.00 level.

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