FX Daily: High beta currencies look vulnerable in the short-run

The Nvidia-led equity rally may now have to face the reality of higher rates, and we suspect high-beta currencies are at risk of corrections. Today, the focus will remain on Germany's struggling economy, with the release of the Ifo survey. The implications for ECB policy remain limited, so the euro's relative resilience is probably justified

A weak krona remains a concerns as the Riksbank prepares to cut rates

USD: FX feeling the Nvidia effect

Federal Reserve speakers have echoed the content of the FOMC minutes since those were published. Communication has been understandably cautious on the inflation outlook considering the recent higher-than-expected CPI, particularly stressing the risks of cutting too early or too fast. Risk-sensitive assets would normally suffer from an easing pushback, but the narrative in equity markets is strictly one of tech-driven outperformance after very strong results from Nvidia.

One argument that we think makes sense at this stage is that once the Nvidia effect has faded, equity markets are left with increasingly stretched valuations as USD rates continue to rise. Both 2-year and 10-year treasuries have pared around half of the late October to late December gains, trading around 50bp higher than their end-2023 levels. The S&P500 is up 6% year-to-date.

Our expectations are that the US data story won't be making a U-turn in the next couple of weeks. Indeed, we see a chance that February's data released in March starts to head in the right direction for Treasuries, but the 29 February PCE release should be strong and push rate cut expectations further away.

With all this in mind, we believe high-beta currencies are looking expensive in the very short run. The prospect of unstable risk sentiment and a dollar leg higher ahead of next week's PCE points to downside potential. Today, the US calendar includes the Conference Board's Consumer Confidence indicator, which is expected to have plateaued in February. We see room for a DXY stabilisation around 104.00 or a rebound already today as risk sentiment softens.

Francesco Pesole

EUR: German slump in focus

PMI releases have sent mixed messages. The eurozone's aggregate PMIs were better than expected, as discussed here, this probably means that recession concerns are easing and that the Red Sea disruptions have not had much dampening effect on activity. At the same time, Germany is consolidating its role as the black sheep in the region.

German manufacturing PMIs plummeted to 42.3 in February, overshadowing a modest tick-up in the service sector. This morning, the Ifo survey is published, and we should probably brace for a soft reading there too. Germany makes up a third of the eurozone's economic output and is the largest trading partner for most EU members: the question FX analysts like us are trying to answer now is whether the euro has already largely priced in the German slump or if other factors have prevented it from taking the hit.

We think the former explanation is more accurate, although it requires an additional key point. The FX market is trading on global risk dynamics (as discussed above) and short-term rate differentials. The key question is therefore whether mounting evidence of German economic weakness should be associated with prospects of faster and earlier rate cuts by the ECB. President Lagarde and many of her colleagues tried to send the message that no, it shouldn't. Inflation – and above all wages – are the real focus, so the relative resilience of the euro should not be surprising and the risks of a decline in EUR/USD in the short term mostly related to USD upside potential, in our view.

This morning, the ECB publishes CPI expectation figures for January, which had come in at 3.2% and 2.5% a month prior. Two ECB hawks, Joachim Nagel and Isabel Schnabel are also speaking today.

Francesco Pesole

GBP: Strengthening domestic story

The UK has continued to experience some repricing higher in growth expectations, as PMIs inched higher again in February. If the ECB had to convince markets that rate cut expectations were overly optimistic, the Bank of England has the "privilege" of letting data do the talking.

In fact, recent comments by MPC members have not leaned to the hawkish side. Earlier this week, Governor Andrew Bailey endorsed expectations of easing this year and reaffirmed that inflation does not need to fall back to target before the BoE can cut. The two most dovish MPC names, Ben Broadbent and Swati Dhingra said easing is likely and that there is a risk of overtightening.

The rebound in EUR/GBP from the excessively cheap 0.8500 low did not surprise us. But we have some doubts the pair can rally further in the near term, as markets may be more inclined to push 2024 ECB easing expectations back to 100bp (now 90bp) rather than pricing in three full cuts in the UK (now, 62bp). Still, our medium-term view remains bullish on the pair on the back of policy divergence.

Francesco Pesole

SEK: A strong week, but will it last?

EUR/SEK broke decisively through the 11.20 area this week, which had been a decent support throughout February. The stronger-than-expected headline CPIF in Sweden, some stickiness in long-term inflation expectations and the global equity rally have all contributed to a strong week for the krona.

Our short-term view on SEK is, however, not as rosy. We suspect the Riksbank turned dovish before the data really allowed it to, which is not a positive signal for SEK. The risk here is that policymakers are indeed feeling the pressure to relieve the economy from tight rate conditions and may start cutting before inflation has moved decisively lower, ultimately compressing the krona's real rate.

As discussed in the USD section, risk sentiment might struggle to keep fuelling rallies in high-beta currencies like SEK in the next couple of weeks. The end of FX sales means the downside could be rather slippery for the krona. We still see EUR/SEK rebound to the 11.30 area or higher before a longer-term decline can materialise.

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