FX Daily: Higher bund yields don't mean higher euro

Bund yields edged meaningfully higher yesterday but the move was driven by supply rather than rate expectations so we don't expect this to push the euro higher

USD: De-escalating trade situation vs the bond sell-off

Risk assets remain supported as we approach the 'phase one' agreement, with the US taking further steps to de-escalate the trade situation by removing China from its currency manipulator list. Although positive for pro-cyclical and emerging market currencies, the accompanying decline in bond markets (a function of higher supply and improving global growth outlook) is limiting the spillover in higher yielding FX as local bonds are under pressure. However, given the weak prospect for monetary policy tightening from major central banks, the scope for a tantrum-like bond sell-off is limited, in our view.

As for US data points, December CPI is expected to accelerate further above the 2.0% level today. Coupled with the upcoming US-China 'phase one' deal, the case for an imminent and meaningful easing cycle from the Federal Reserve is decreasing. This should be supportive of the US dollar, particularly vs its low yielding G10 FX alternatives such as the euro or yen - as the dollar should retain a meaningful carry advantage.

EUR: Higher bund yields don't necessarily mean higher euro

While bund yields edged meaningfully higher yesterday, any repeat of the 2017 euro rally (whereby rising bund yields led to euro strength) is unlikely as the current move is supply driven, rather than caused by expectations of European Central Bank policy normalisation. EUR/USD to remain below the 1.1180 level today.

GBP: Building downside risks

Sterling's decline accelerated as disappointing UK data (November industrial production and GDP) brought the Bank of England closer to an interest rate cut – the market is currently pricing in more than a 50% probability of a cut at the January meeting. With GBP/USD speculative positioning turning sharply over recent months - from net shorts (close to 40% of open interest) in mid-September 2019 to net longs (8% of open interest) currently - the downside risk to GBP is building. Bar a possible rate cut, the uncertainty about the EU-UK trade deal (to be reached this year) should also limit GBP upside throughout the first half of the year.

HUF: Rising CPI to add to the forint downside

In Hungary, and in line with the broader central and eastern Europe trend, our economists expect headline December CPI to jump to 3.9% year-on-year driven by the significant acceleration in energy prices. The core CPI is expected to rise to 3.9% YoY. And a further increase in prices is expected in January. However, as the National Bank of Hungary is unlikely to change its on-hold stance, we expect EUR/HUF to continue moving higher, as the Hungarian real rate continues to fall, and is actually the lowest / most negative in the EM space. We expect EUR/HUF to reach 340 this quarter.

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