

FX Daily: Key takeaways from a “hawkish” week

Despite the ECB sounding less dovish than expected (especially in its inflation projections), the policy divergence with the Fed remains sizeable and we expect EUR/USD to remain capped in 2022. The BoE's surprise hike may have put a floor under sterling ahead of a turbulent period, and Norges Bank is offering a bullish argument for the krone in the new year



USD: No reason to turn bearish

It's been a pivotal week for global markets, and while trading volumes are set to abate as we head into the Christmas break, we think global central banks have provided investors with an important toolkit to position for what lies ahead in 2022. If we were to find a common denominator of the G3 central bank messages this week it is the centrality of inflation in the policy discussion.

While surely more dovish in comparison to the other two, yesterday's decision by the European Central Bank to use a larger (but less flexible) Asset Purchase Programme to smooth the transition from the old APP – as well as the upward revision to inflation projections – was probably a victory

for the hawks. In practice, we saw three hawkish surprises (albeit at different degrees) this week: the fact that they all came at a time when the Omicron variant is rapidly spreading and new restrictions may lie ahead is even more indicative of how paramount the inflation theme has become. What is set to drive policy divergence now, however, is action more than words, and in this sense the Federal Reserve and Bank of England are clearly moving faster than the ECB in effectively fighting inflation.

In FX, we've seen the dollar weaken against all G10 currencies since Wednesday. In yesterday's note, we identified position squaring as a likely factor at play. It now appears that markets were partly relieved the Fed did not signal an even faster (or even abruptly ending) tapering. The change in Dot Plots was significant, but did not price more than what markets were already pricing in. In other words, there was no real (BoE-style) U-turn by the FOMC.

If this can explain the short-term underperformance of the dollar, it can equally serve as a bullish-USD argument for the longer run, as it signals more room for Fed rate expectations to turn more hawkish – both on the tapering side (i.e. pricing in an earlier end of purchases) and on the tightening side (i.e. a hike already in 1Q22). Despite the ECB sounding less dovish than expected yesterday, there is still a remarkable divergence between the Fed and ECB policy directions, and we remain of the view that this will cap EUR/USD in the coming months.

In the rest of G10, [Norges Bank tightened policy again](#) yesterday, and the small changes to the rate path projections signal there is more to come. We expect three rate hikes by NB next year, and we still judge that the market is underpricing the rate path by around 25bp. This should help NOK stabilise in an appreciation trend next year.

The two low-yielders, the Japanese yen and Swiss franc saw much less action at their respective central banks. The [Swiss National Bank merely reiterated](#) that the franc is highly valued, which indicates more FX intervention is on the way as CHF continues to face appreciating pressure from virus-related concerns. We discuss the Bank of Japan meeting in the JPY section below.

For today, markets will mostly re-assess weekly developments amid a very quiet US calendar. We think the risks are skewed towards the dollar recovering some ground as post-FOMC losses looked exaggerated given fundamentals.

EUR: Fed-ECB divergence is still significant

Our economics team [reviews yesterday's ECB decision day here](#). As discussed in the USD section above, the Bank's announcement and press release confirmed that the transition from words to action will be considerably more gradual at the ECB compared to the Fed and Bank of England.

The more moderate and less flexible increase in the APP was, in our view, not the biggest hawkish surprise as the ECB left the door open to re-assess the size and pace of tapering. More unexpected was the sharp increase in inflation projections. Yet, President Lagarde seems to have successfully conveyed the message that the ECB will continue to tolerate higher prices in 2022 without any tightening or significant acceleration in tapering. That is key to keeping peripheral spreads in check, but also suggests the ECB won't close the gap with the Fed in the foreseeable future, which should keep a lid on EUR/USD in the new year.

Today, the German Ifo for November is the main highlight in the eurozone, giving a chance for markets to assess how far business sentiment has deteriorated amid tough restrictions and

lingering supply strains. We see room for some recovery in the dollar in the coming days, and EUR/USD may edge back below 1.1300 before the Christmas holiday period depresses volatility.

➔ GBP: BoE offers some support amid grim virus news

The Bank of England surprised markets and consensus expectations by [delivering a 15bp rate hike](#) yesterday. The surprise was surely not due to the rationale behind the decision – we have long highlighted that high inflation and a resilient jobs market were good enough reasons to start tightening – but to the pre-meeting BoE communication, where multiple MPC members appeared to signal the intention to tread cautiously given the Omicron outbreak.

From an FX perspective, this is indeed a welcome development for the pound, as the BoE clearly sent the message that members are ready to act to curb inflation. With the UK fighting one of the worst Covid waves in the developed world, this is indeed set to support GBP as virus-related news will continue to offer a bearish argument in the coming weeks.

The risk in the longer run is that markets may have moved too quickly to price in hikes across the GBP curve – currently, nearly 100bp of tightening are expected for 2022. Our economist expects the BoE to pause in February, with two hikes in May and November. This means that the pound may suffer from some dovish repricing along the way, although that is a story for the new year: for now, virus developments (and in particular whether the UK government will impose new strict restrictions) are set to remain the primary GBP drivers.

➔ JPY: Some benefits from BoJ extending corporate funding

The Japanese yen has been well supported this morning after the Bank of Japan policy decision overnight. While announcing that the pandemic-related purchase of commercial papers and corporate bonds will be finalised in March 2022 and that holdings will be gradually unwound in 2022, the BoJ also extended its corporate funding scheme to September. Part of the market was likely expecting that the decision on corporate funding would be postponed, hence the positive reaction by the JPY.

In the last few days of trading before the Christmas period, the yen may stabilise around the 114.00 level, as some potential recovery in the dollar may still be offset by a choppy risk environment due to the Omicron spread.

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