FX Daily: Life outside the dollar bull story

Explaining dollar weakness this week looks less a story of any re-assessment of Fed tightening and more a re-appraisal of growth and currency returns outside of the dollar. This story - and dollar correction - might have some further room to run. But we are not in the camp saying that the dollar has peaked.

USD: Soft Dec retail sales could see the dollar correct further

The dollar has broken lower this week and on a trade-weighted basis is about 2.0/2.5% off its late November highs. The hawkish re-pricing of the Fed cycle has stalled/gone far enough for the time being - where US money market rates in 2023 are 8-10 ticks off recent highs. Extended positioning has probably made the dollar vulnerable early this year and it has weakened on any hints of softer inflation - e.g. yesterday's US December PPI reading.

But the environment looks one of greater attractiveness of overseas assets and the need to put money to work - rather than any negative re-assessment of the US growth and Fed cycle per se. After all, the IMF predicts the US to have the largest positive output gap this year (3.3% of GDP) - suggesting that if inflationary second-round effects will be evident anywhere, it will be in the US.

The Achilles Heel for the dollar will be on the external side. The US ran a 3.7% of GDP current account deficit in 3Q21 (that's big) and China overnight has just reported that its monthly trade surplus was close to $100bn - yes, close to $100bn! Our view this year, however, is that the US can fund its external deficit with high growth and interest rates, and unlike some fund managers, we do not think the dollar has peaked.

For today, a soft US December US retail sales figure (as US citizens struggled to find cars to buy) may provide an excuse for the dollar to correct a little further. DXY broke below strong support earlier this week (resistance now 95.15/20) and looks as though it can fall another 0.5% to the 94.10 area. But we would view this move as corrective and expect the dollar to start finding support ahead of the Jan 26th FOMC meeting.

EUR: Short squeeze may have a little further to run

Wednesday saw a decisive break-higher in EUR/USD, surging out of a six-month bearish trend channel - and it is not clear the correction is over. Support will now be found at 1.1430. To the upside, 1.1500 resistance looks vulnerable - with outside risk to 1.16. We would, however, see any move to the 1.15/16 region as a correction and retain targets in the 1.08/1.10 region this spring/summer as the Fed tightening cycle starts and US yields rise as the Fed clarifies how quickly it wants to shrink its balance sheet.

The adjustment in EUR/USD looks very much a dollar story - including international fund managers putting money to work outside of dollar assets (EM equity and debt markets have seen some $10bn in inflows over the last three weeks) - rather than any bullish re-assessment of the EUR per se. That is why we continue to favour the EUR/commodity cross rates lower - such as EUR/CAD and EUR/NOK. The European calendar is quiet, but ECB's Lagarde speaks at 1430CET.

Elsewhere in Europe, the glass half-full approach should be helping the likes of the SEK. The SEK had been one of the big underperformers last year - undermined by a central bank as positioning itself as one of the last to hike. Look out for December Swedish CPI today. Any upside surprise could add to Riksbank unease and it will be interesting to see whether super-dovish Riksbank Governor Ingves has any change of tone when he speaks at 1310CET today.

GBP: Better November UK activity numbers

The UK has just released some better UK activity numbers for November, including monthly GDP, industrial production and services indices. Even the trade deficit narrowed. This suggests the UK economy might have had a little insulation heading into the Covid-restricted December period. A 25bp BoE rate hike is still priced with an 80% probability for the February 3rd meeting - which will likely keep GBP supported over the coming weeks.

We feel that Cable surging through 1.3600 helped the whole $/Europe correction this week. A move above 1.3750 resistance would target the 1.3840 area over coming sessions.

RUB: For the brave

Russian and Ukraine assets took a lurch lower yesterday on comments from the Russian Deputy Foreign Minister that talks with the US/NATO had reached a 'dead-end'. The impact on Ukraine assets was particularly large - with the 5 year sovereign CDS widening a huge 116bp and the two-year USD bond jumping 200bp.

It seems, however, that more talks are scheduled for next week and comments from Russian foreign minister Lavrov suggested that replies to Russia's proposals could be received next week. Given oil and gas prices where they are, we presume Russian energy exporters are sitting on a lot of FX proceeds and considering when to sell. Russian exporters holding onto FX receipts was one factor exacerbating the RUB collapse during the Ukraine crisis back in late 2014.

Of course Russian and Ukraine assets will remain very vulnerable to newsflow over coming weeks, but any signs of compromise - or at least commitment to talks at a future date - could see an outsized rally in the RUB - and a reversal of this week's sell-off in Ukraine fixed-income assets.

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