

FX Daily: Liquidity headaches

Another spike in the USD OIS-FRA spread is signalling that liquidity/USD funding conditions have continued to deteriorate. While still far from alarming levels seen in spring 2020, this may translate into more strength in the dollar, which could receive some extra help from solid payrolls today. European currencies may remain the weakest segment in G10



USD: Most factors keep pointing to stronger dollar

The market environment continues to favour a strong dollar as we head into a weekend where the battle for Ukraine's major cities looks set to intensify further. The market's liquidity conditions have weakened this week, and were exacerbated overnight after reports of shelling to Europe's largest nuclear plant in Ukraine. A measure of money-market risk and USD funding conditions – the 3m USD OIS-FRA spread, has spiked to 29bp, the highest since May 2020. Still, the spread is far from the levels seen at the height of the spring 2020 market crisis (it neared 80bp then). This suggests that USD funding conditions are not too alarming at the moment, but the deterioration in the past week naturally argues in favour of a stronger dollar.

Domestic factors are also offering support to the greenback, as markets have priced back in some Fed tightening after a speech earlier this week by Fed Chair Jay Powell removed some doubt about the Bank's policy plans and all but confirmed a 25bp rate hike in March. Fed fund futures are close to pricing back in six hikes by the end of 2022, and a solid US payroll number today could help cement tightening expectations further – ultimately adding to USD good momentum. Consensus is centred around another 400k+ headline nonfarm payroll figure today, with a lot of focus set to be on wage growth, which may have accelerated further from the 5.7% January reading.

While we expect it to be dollar-positive, the NFP impact should be reduced compared to previous instances, as the focus remains on the Russia-Ukraine situation. Today, G7 leaders will meet, and we may hear about more sanctions against Russia. Investors will keep an eye on any hints of a coordinated effort to limit dependency on Russian commodities, which could put more upside pressure on energy prices.

In the current environment, we could see the dollar remain bid along with those pro-cyclical currencies that are not geographically exposed to the conflict in Ukraine (CAD, AUD, NZD). EUR/CAD, for example, is a pair that mirrors such dynamics and may be looking at a decisive move below 1.4000 in the coming days as energy prices push higher. AUD and NZD remain a market favourite in the G10, and may benefit from a pro-growth announcement at China's Two Sessions (today and tomorrow).

↓ EUR: Gearing up for a break below 1.10?

Pressure has continued to build around a break below 1.1000 in EUR/USD. Divergence in policy expectations and equity performance (European equities have weakened more than the US) have driven the pair's short-term fair value lower: we currently estimate it at 1.0980.

This suggests that we may not have to wait for a specific trigger-event to force a decisive move below 1.1000, although a strong NFP reading, more sanctions against Russia or further spikes in energy prices could all contribute to breaking the support today. There are no market-moving data releases in the eurozone today.

→ GBP: More resilience compared to European peers

The pound has come under some pressure this week but is definitely showing much better resilience compared to other European currencies like the euro and Swedish krona. This is partly due to the fact that the market continues to price in five 25bp rate hikes by the Bank of England in 2022, which has prevented the kind of re-pricing seen in EUR markets.

A decisive break below 1.1000 in EUR/USD could favour another drop in EUR/GBP, which could explore the 0.8200-0.8250 area in the coming days. There are no UK releases or events to watch today.

↓ SEK: 11.00 in EUR/SEK is not out of reach

EUR/SEK has reached the 10.80 mark, a level last seen during the financial turmoil in April 2020 and we estimate the pair is currently embedding a 2.0% short-term risk premium related to the conflict in Ukraine. It must be noted that such a level of EUR/SEK overvaluation is not too wide compared to recent history, which leaves some room for further appreciation in the pair – even though it is USD/SEK which is likely facing even bigger upside risks.

The krona remains the worst-positioned currency to the Russia-Ukraine conflict and its market implications, as it combines a high beta to risk sentiment with geographical vicinity, negative exposure to energy prices (incidentally, Sweden imports large amounts of Russian oil) and also lacks a supportive domestic monetary tightening story. We think this means that SEK will have to wait for a decisive de-escalation in tensions before being able to recover recent losses, and we cannot exclude a move to 10.90-11.00 in EUR/SEK, especially if Europe takes steps to curb imports of Russian commodities.

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