FX Daily: Looking for a way out

Financial markets seem calmer this Wednesday despite the continuing tragedy in Ukraine. There seems more focus on diplomacy ahead of a meeting between Ukraine and Russian foreign ministers in Turkey tomorrow. Yet energy prices look set to stay high as the West weans itself off Russian exports. Expect the commodity export/import story to dominate FX

USD: Consolidation comes through, but dollar to stay bid on dips

Equity futures seem a little more supported today as the markets (perhaps optimistically) hope that some kind of ceasefire can emerge in Ukraine. Fanning those hopes seem to be comments from President Zelenskiy that Ukraine no longer seeks NATO membership. At the same time, it seems that Russia may no longer be seeking regime change in Kyiv. This seems to be building expectations that some kind of deal can be achieved when Ukraine and Russian foreign ministers meet in Turkey tomorrow.

Even if a deal were thankfully achieved, what is clear is that sanctions against Russia would not be reversed immediately and that Putin's war in Ukraine has accelerated the West's transition away from Russian energy supplies. The big news yesterday was the US and UK banning Russian fossil fuel imports, while the EU announced a plan to wean itself off Russian natural gas supplies. Naturally, fossil fuel prices remain elevated and there are even suggestions that more coal can be burnt in the process.

Apart from the human tragedy of this war, one of the legacies will be higher fossil fuel prices while this energy transition is underway. Of the many implications here, we think two stand out for the FX market: i) ever-greater focus on terms of trade gains/losses - or positive/negative income shocks. ii) higher and longer-lasting inflation and more hawkish central bank policy.

In practice, this should mean that the currencies of commodity exporters continue to perform well - Indonesia and Australia are the biggest exporters of coal, for example. As a fossil fuel importing bloc, European and Asian FX should underperform - where currencies are free-floating. USD/CNY's remarkable stability through this crisis suggests that the renminbi is a managed reserve currency - and its 3% trade-weighted appreciation since Putin's invasion shows that Chinese authorities are clearly not averse to a strong currency.

Suffering less of a growth shock than Europe, the US focus will remain on inflation. Tomorrow sees the release of US February CPI - potentially near 8%. Expectations for the Federal Reserve tightening cycle have remained quite robust and we would continue to back the dollar over coming months, where not only energy independence and liquidity support it - but also widening interest rate differentials.

DXY looks to be consolidating before making a push to 100 over the coming days/weeks. If peace does have a chance over coming days, USD/JPY could start to break to the upside as the market focuses on: i) cleaner Fed tightening and ii) Japan's dependency on more expensive imported fossil fuels.

EUR: Will European banks take up dollar swap lines?

Of many financial developments in the current crisis, one has been the issue of dollar funding. Asset freezes on a large chunk of the Russian financial system have raised fears over access to dollar funding. We are interested to see today whether any European banks have felt the need to use the European Central Bank's 7-day dollar swap line. Auctions take place every Wednesday and last week $270mn was drawn down. Any bigger dollar uptake today could rekindle market nervousness about the free-low of dollar funding.

EUR/USD can consolidate into tomorrow's meeting in Turkey and US CPI - though we suspect that it will be hard to sustain any gains over 1.10 in the current climate. There has also been some focus on a report that the EU could undertake a 'massive' new round of joint debt issuance to finance energy transition and defence spending. European assets enjoyed a brief rally on the report, although EU members such as Germany might be reluctant to support it - having been told that last year's EU joint debt issuance for the Recovery Fund was a one-off.

Elsewhere, Poland and Hungary tightened rates sharply yesterday as a means to support their currencies. Look out for a press conference from National Bank of Poland Governor Adam Glapinksi at 11CET today. Our team had been looking for the policy rate (now 3.50%) to head to 4.50%. But it seems that rates could be heading much higher and the FRA market seems to be pricing rates closer to 5.50%. We doubt the Polish zloty or the Hungarian forint can enjoy a sustained rally until events to the East are a lot clearer. Selling pressure in local currency bond markets will also restrain zloty and forint gains.

GBP: Recession risks growing

High energy prices are increasing the risks that the UK goes into a technical recession in the third and fourth quarters of this year. While these fears may be negative for GBP over the longer term (and we do favour EUR/GBP higher next year), a hawkish Bank of England and a flatter or even inverted yield curve would probably keep GBP bid. EUR/GBP can probably head back below 0.8300 again near term.

Cable is clinging onto support above 1.3100, but failure to move through the 1.3150/3180 area leaves it vulnerable to 1.2850 on renewed dollar strength.

RUB: Onshore reopens

After a two-day public holiday, onshore USD/RUB trading has reopened and is being quoted at 117. The offshore is being quoted at 128 (having been quoted at 150/170 earlier in the week). We suspect that the two rates continue to trade wide apart - a function of sanctioned counterparty risk. And we suspect the rouble will trade stronger in the onshore market, where Russian exporters are forced to offload their FX export earnings.

In terms of other Russian asset markets, the focus is on whether there is a technical default on Russian sovereign debt. What was the liquid 2047 Russian sovereign Eurobond now trades at 22 cents on the dollar and investors will be watching whether Russia meets its $117mn coupon payment on the sovereign Eurobond on 16 March.

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