

## FX Daily: Nothing but the dollar

The dollar has continued to strengthen as global liquidity conditions deteriorate and energy prices have spiked again. All focus now is on the magnitude of the projected shock to oil and gas supply from Russia, either from Russia itself or from self-imposed curbs by Western countries. European currencies may remain the weakest segment in the coming days



### **USD: Safe-haven inflows unlikely to stop soon**

It's mostly a dollar story in FX right now. A combination of elevated upside volatility in energy prices, equity underperformance and liquidity concerns continue to push investors seeking safety towards the greenback. The 3-month FRA-OIS spread has continued to widen, reaching around half of the spike we saw in the spring of 2020 (now at 38bp), signalling a further deterioration in liquidity and USD funding conditions. The fact that we are still a far cry from those 2020 levels is in a way reassuring, but we must remember how much more accommodative global and USD financial conditions are now, which does highlight the deep mark that the Russia-Ukraine conflict is leaving on market confidence and liquidity. We'll get a chance to gauge the degree of concern about USD funding conditions among financial institutions once data on usage of the Fed FX swap lines are published later this week.

As the Ukraine conflict shows no sign of imminent de-escalation (more Russia-Ukraine talks yesterday yielded no tangible result) markets remain firmly focused on the implications for the energy market. The US is reportedly looking for consensus among allies to stop or curb the import of Russian oil, and might move autonomously should European countries continue to resist such a fully-fledged ban. Meanwhile, Russia has threatened to cut gas supply to Europe. This is an environment where markets are quite freely speculating on the magnitude of the supply shock to the commodity market, which is translating into big intra-day fluctuations in many commodity prices – even outside of the energy spectrum.

Along with the geographical vicinity and different correlation with risk sentiment, the disorderly rise in energy prices is what is generating a big divergence between the dollar (the US is largely energy-independent) and most European currencies (the region is largely dependent on Russian oil and gas). This looks unlikely to change soon, and we see no reason why this divergence in the FX market should be inverted for now. A move to 100.00 in DXY seems plausible in the coming days.

The highlight in the US calendar today is the NFIB Small Business Optimism index, hardly a market-moving release, especially in the current market environment.

## 📉 EUR: The fall does not look overstretched

We estimate that the risk premium embedded into EUR/USD is currently around 0.5%, with the pair's short-term fair value at around 1.0930. This suggests that most of the recent drop in EUR/USD has been warranted by diverging Fed-ECB policy expectations, US equities relative outperformance (in the last month: S&P500 is off 7%, Eurostoxx 50 is off 15%) and swings in global risk sentiment.

We read this as an indication that downside risks for the pair remain sizeable, with markets that may price in more of the adverse impact on the eurozone's economy of a potential reduction of energy flows from Russia. With Russia currently threatening to cut the gas supply to Europe through Nord Stream 1, upside risks to gas prices remain very significant, and so does the downside risk for EUR and the rest of European currencies, with only the gas-exporting NOK and safe-haven CHF being shielded.

Later this week, we expect the European Central Bank to [pause its hawkish transition](#), which looks unlikely to give the euro any lifeline. Still, markets will be on the lookout for any currency-related comments. We think EUR/USD may remain under pressure until finding support around the 1.0640, 2020 lows.

## 📉 GBP: Approaching 1.30?

Dollar strength continues to put pressure on cable, which saw an important technical break below the 1.3160 December 2021 lows yesterday, is currently pressing 1.3100 and could soon be testing the psychological 1.3000 support, a level last seen in November 2020.

The technical break in GBP/USD may have partly spilt over into EUR/GBP, which bounced back yesterday and briefly traded above 0.8300. Still, EUR's biggest exposure to the conflict and potential Russia retaliation on the energy supply could soon force EUR/GBP to re-test the 0.8200 support in the coming days.

## ➔ AUD: The correction may not have long legs

AUD and NZD are the worst performing G10 currencies in early trading today, following a correction from short-term overvaluation territory that began yesterday. Nevertheless, the two currencies are up approximately 2% against USD in the past month, having harboured a good deal of pro-cyclical bets recently thanks to their reduced exposure to the Ukraine conflict, positive sensitivity to rising commodity prices and an upbeat re-pricing of China's growth outlook.

Tonight, a speech by Reserve Bank of Australia Governor Philip Lowe will be in focus, as markets try to gauge whether the recent global developments are prompting a change in the Bank's patient stance on monetary tightening. This does not seem very likely given the RBA's explicit focus on wage growth dynamics (the next wage data will be released in May), but it is also hard to ignore positive external inputs, and above all the sharp rebound in iron ore prices.

The global commodity rally and fresh hopes of strong Chinese demand have more than offset the iron ore losses seen in February as Beijing announced measures to curb price speculation. The question remains whether China will take more direct steps to curb the rise in prices, although a strong yuan and the generalised strength in commodity prices may have widened the country's tolerance band.

AUD/USD has erased its overvaluation, according to our short-term fair value model, while NZD/USD is still around 2% overvalued. We expect some relative outperformance of AUD over NZD in the coming days, and AUD/USD might even find its way back above the 0.7320 200-day moving average soon.

### Authors

#### Francesco Pesole

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

#### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

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