FX Daily: Omicron dovishness

Risk assets are back under pressure this morning, with markets still awaiting updates on the vaccine coverage against Omicron. The discussion is now shifting towards monetary policy as markets have priced out the Fed's (and other central banks) tightening, ahead of today's Senate testimony by Powell. This leaves USD and pro-cyclical FX, vulnerable

USD: Fed rate expectations under pressure

The rebound in equities yesterday was relatively contained, and Asian equities (as well as Western stock futures) are back in the red this morning. This is clearly an indication that markets are awaiting some solid confirmation that the current vaccines offer enough protection against the Omicron variant before jumping back on risk-on trades. For now, the US administration is not running on the assumption that new vaccine formulas will be needed and is simply planning to roll out booster doses faster (like in most other developed countries).

In FX, low yielders are finding fresh support this morning, and a contraction in oil prices after yesterday's tentative rebound is back to putting pressure on commodity currencies. In the pro-cyclical space, SEK emerged as a major outperformer yesterday, likely benefitting from a sizeable short-squeezing, as some market sentiment stabilisation allowed a delayed positive impact from last week's hawkish Riksbank meeting.

Another factor that seems to be offering support to the likes of the low-yielding JPY, EUR and CHF against both pro-cyclical currencies and the dollar, is the process of repricing of rate expectations in light of the potential danger caused by the new variant. After all, the three low yielders are inherently those with the smallest room for a dovish repricing when it comes to 2022 rate expectations.

Tonight's Senate Testimony by Fed Chair Powell will be the focus of much attention, as prepared remarks showed that he will flag significant downside risks stemming from the Omicron variant to both employment and economic activity. Markets have now pushed back the first rate hike by the Fed, to September 2022.

With this in mind, a recovery in the dollar remains strictly tied to some positive news on the vaccine coverage against the omicron variant. The greenback should continue to stand in the middle between the group of low-yielders and pro-cyclical currencies - which like the dollar have the largest room for dovish repricing of rate expectations. Things tend to change rapidly as virus-related news hit the market, but for now, indications of markets plunging into risk-off suggest we could still see USD capped and commodity currencies staying offered on oil underperformance.

EUR: Keeping an eye on inflation amid Omicron-related support

November estimates published yesterday showed that inflation broke the 6% mark in Germany, and our economist expects more upward pressure on prices before a gradual retreat in 2022. We'll see the French and EZ-wide inflation numbers today, but the impact on the EUR should be secondary to the swings in sentiment related to the Omicron variant.

A popular funding currency before the Omicron-induced correction, it is likely that we need to see some confidence being re-built into risk trades to see the EUR depreciate across the board. A return to 1.1200 in EUR/USD appears strictly linked to an improvement in the general sentiment about the implications of the new strain. Early signs this morning seem to point in the opposite direction.

GBP: Double threat to the pound

The UK will start offering booster doses to all adults, a move that follows fresh restrictions on international travel imposed by the Government to contain the spread of the Omicron variant. With the 16 December BoE rate decision drawing closer, a worsening of the virus situation globally and specifically in the UK, may not only put upward pressure on EUR/GBP due to the pound's higher sensitivity to risk sentiment but may also mean markets could increasingly price out a December rate hike by the BoE.

It is too early to draw any conclusions on that, but for today, a choppy risk environment may send EUR/GBP above 0.8500. The UK data calendar is quite empty: markets will only keep an eye on remarks by BoE's policymaker Catherine Mann, who voted to cap QE at the November MPC meeting.

CAD: Growth data to play second fiddle

The loonie was a major victim of both the Friday risk sell-off and its exposure to oil prices and its overbought condition. Despite possibly having a more balanced positioning now, a hit to sentiment, oil prices and the potential pricing out of BoC rate expectations due to the Omicron variant spread, still signal sizeable downside risks for CAD.

Today, we'll see Canada's growth numbers for 3Q, and the consensus for the annualised figure is around 3.0% YoY. Barring a major miss, we think the Bank of Canada's tightening plans should not be impacted. After all, the economy is running quite hot in Canada and a tight jobs market is fuelling concerns of persistent inflation.

We'll see whether the Omicron variant dramatically changes the economic outlook in Canada, which as of now, looks set to be a CAD-positive in the medium run. News on the variant will set the tone for global sentiment in the coming days and will drive all moves in CAD, likely out-shadowing any post-GDP reaction.

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