FX Daily: Pricing out what's left of geopolitical risk

The dollar came under pressure yesterday on the back of optimism around Russia-Ukraine peace talks. Still, we suspect there is not much geopolitical risk premium left in the FX market and a re-connection with rate dynamics could mean a rebound in the dollar in the coming weeks. Still, for today, Germany's CPI might help the euro hold on to gains

USD: Soft momentum should not last long

Yesterday, we saw some big moves in FX as some advancement in peace negotiations between Russia and Ukraine prompted markets to unwind some of their defensive long dollar positions, mostly to the benefit of those currencies that had been hit the hardest during the conflict (SEK, JPY, EUR). The yen, in particular, has received some extra help from the large market intervention by the Bank of Japan to keep 10Y JGB yields below the upper bound of its yield curve control tolerance band (0.25%), with USD/JPY now trading back around the 122.00 area.

At this stage, we doubt there is much geopolitical risk premium left in most assets, as markets appear to have taken an optimistic stance well before peace talks have yielded any result. In FX, a key gauge of Ukraine-related sentiment – the Swedish krona – is currently trading above the levels it was at in the week before the Russian invasion started. EUR/USD is some 1.5% weaker, which is however fully explainable by the sharp widening of Federal Reserve-European Central Bank policy divergence and short-term rate differential.

In fact, the dollar remains cheap against most G10 currencies in the short-term when short-term rate differentials – normally a key driver of FX moves – are considered. This, in our view, means that once the dust has settled, the dollar remains in a position to emerge as an outperformer beyond the very near term, mostly thanks to the Fed accelerating the pace of tightening: we currently expect a 50bp hike in both May and June. We think that this Friday's jobs data will endorse our call. On this topic, ADP payrolls (a 450k increase is expected) today will help shape the market's expectations ahead of the nonfarm payrolls on Friday.

Incidentally, the inversion of the US yield curve on the back of rising hawkish Fed bets may not be widely read as an indication of a forthcoming recession just yet, but should prove a dollar-positive, all things equal.

On the Russia-Ukraine side, markets will monitor whether Russian pledges to de-escalate military operations around Kyiv will be fulfilled and whether this will pave the way to a ceasefire. So far, US officials have voiced some caution on the possibility of a rapid de-escalation. Still – as discussed above – the upside potential from geopolitical risk being priced out now appears more limited. We still suspect this means that the FX market may be increasingly detached from trading the Russia-Ukraine situation and start to catch up with the wide moves in rate and growth differentials, all of which point to a stronger dollar. DXY holding above 98.00 today may be an early sign of this dynamic playing out.

EUR: German CPI to help euro hold on to gains

EUR/USD rallied by more than 1% yesterday on the back of optimism around a peaceful resolution of the Ukraine war. Everything we discuss in the USD section is fully applicable to EUR/USD: geopolitical risk now appears almost fully priced out, while rate differentials and other fundamentals point to a weakening in the pair.

At the same time, the euro might get some support today from the March inflation readings in Germany and France (the eurozone aggregate figures are published on Friday). German inflation looks set to have broken above 6.0%, once again driven by higher energy prices, which should keep alive the market's expectations on ECB tightening in 2022. We'll also hear from ECB President Christine Lagarde this morning.

That said, with markets currently pricing in around 60bp worth of ECB hikes by the end of the year, it seems that any significant narrowing in the USD-EUR short-term rate differential would primarily be driven by a dovish re-rating of Fed expectations, if anything.

We think EUR/USD can hold around 1.1100 today, but we continue to see sizeable downside risks in the coming weeks.

GBP: The big underperformer

The recent re-pricing of the Bank of England tightening expectations seems to have left the pound in quite a vulnerable position in the crosses, and unable to truly benefit from the improvement in Ukraine-related risk sentiment. EUR/GBP is now trading at the highest since December 2021, and may well test the 0.8500 resistance by the end of the week.

We doubt, however, there is enough fundamental justification for EUR/GBP to trade consistently above 0.85, as the BoE-ECB policy divergence remains wide, and the Ukraine war looks likely to have hit the eurozone harder than the UK. In our view, a gradual return to the 0.83-0.84 region looks more likely into the summer.

The only highlight in the UK today is a speech by the BoE Deputy Governor Ben Broadbent.

CEE FX: Still a bumpy ride ahead

The progress in negotiations between Ukraine and Russia and the prospect of de-escalation helped the Central and Eastern Europe region to make new gains and move to its strongest levels since the start of the conflict. The forint benefited the most from the situation with a gain of 1.85%, breaking below 370 per euro. The zloty gained roughly 0.6% and the koruna 0.4%.

On the other hand, all three currencies lost ground in our view due to the decline in the interest rate differential. As tensions eased, rates fell across the region by 15-25bp across the curve.

Although we expect all three currencies in the region to strengthen, as we have previously warned, it will be a bumpy ride. As such, yesterday's gains may not be sustained by the currencies for long and further developments will continue to be driven by global headlines.

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