FX Daily: Renminbi performs strongly

The world remains transfixed by war in Europe. Financial markets will today look at the ramifications of new sanctions on Russia and their impact on Russia's place in the global financial system. The dollar has understandably been favoured this week, but the one currency outperforming the dollar over the last 48 hours has been the Chinese renminbi

USD: Dollar liquidity will remain favoured

FX markets are slightly calmer this morning as the world tries to come to terms with war in Europe. The dollar strengthed through the day yesterday amidst signs of some stress in dollar funding markets. Here we look, for example at the three-month EUR cross-currency basis swap, where banks were prepared to lend out euros at 23bp less than market rates to secure USD funding. Typically, this kind of stress is associated with dollar strength in the spot market.

The fallout from the Russian sanctions for global financial markets may take some time to percolate through - e.g. given the size and prominence of the sanctions on Russian banks and the size of their FX deposits, does that create any tightness for hard currency money markets? Given the uncertainty, we suspect investors will want to hold on tight to their dollars. Also helping the dollar seems to be the Federal Reserve story, where FOMC members still seem happy to speculate over a 25bp or 50bp rate hike at the 16 March meeting. Here, the pricing of the Fed terminal rate (in two years) is just 5bp off its recent highs. That compares to the 15bp and 25bp adjustment lower in the terminal rate pricing for the European Central Bank and the Bank of England, respectively.

The only currency to outperform the dollar over the last 48 hours has been the Chinese renminbi. Implied yields on the offshore renminbi (CNH) are an attractive 3%, but more to the point is that the renminbi is still seen as a managed currency. And as a bone fide world reserve currency (being one of the five currencies in the IMF's Special Drawing Right (SDR) basket), the renminbi now seems to be taking on safe-haven properties - a trend no doubt welcomed by Chinese authorities. Unlike the dollar, the renminbi is backed by a massive trade surplus. The trade-weighted renminbi continues to push higher and notably, Chinese authorities have yet to express any resistance. USD/CNH sub 6.30 would be a notable development for global FX markets and be quite supportive for currencies like the South African rand.

Away from Ukraine, the US macro data will focus on personal income and inflation data. Here, the core PCE deflator is expected to rise to 5.2% year-on-year in January - probably keeping the debate going over whether the Fed hikes 25bp or 50bp next month. We continue to favour the dollar over Europe and favour the DXY returning to yesterday's spike high near 97.70.

EUR: Official selling?

We may not know for a day or two, but we suspect the size of Central Bank of Russia (CBR) FX intervention yesterday was very large - perhaps in the region of US$5-10bn, This intervention would have been to supply FX, mainly USD, to the local market and to prevent the rouble from collapsing any further. As it was, USD/RUB traded to 90. We suspect the intervention was conducted in dollars - yet dollars only make up a small proportion of the CBR's reserves. That activity will leave the FX composition of reserves overly balanced to euros, meaning it would now be a surprise to hear of the CBR selling EUR/USD in the spot market to rebalance reserves. Typically, this activity can occur a little later and is sometimes conducted by a different department, e.g. the portfolio management team, while intervention is conducted by the markets desk.

This sizable re-balancing could add to pressure on EUR/USD. We now favour this trading in a broad 1.11-1.13 range and will look out for any further ECB commentary on whether events in Ukraine will delay the central bank's exit from stimulus. Here, look out for a speech from ECB President Christine Lagarde at 15CET following a Eurogroup meeting.

GBP: Holding its own

GBP has actually performed quite well given the heavy sell-off in European equities yesterday. UK equities are heavily exposed to the Oil and Gas sector, which understandably has come under a lot of pressure given links to Russia.

The surge in European gas prices probably means that UK CPI peaks closer to 8% than 7% and will stay higher for longer. That should keep the BoE wary and should market conditions calm - and the focus return to macro-tightening - EUR/GBP should be able to return to the 0.8280/8300 area.

CE3: FX intervention threat to limit the downside

The CE4 central banks of Poland, Hungary, the Czech Republic and Romania have been some of the most FX interventionist over recent years. Naturally, the geography of these countries saw their FX rates hit hard yesterday - all being briefly 1-2% lower against the dollar. Yet all these central banks are currently in aggressive tightening cycles and will have more incentive than usual to prevent weaker currencies triggering an unwelcome easing of monetary conditions.

It would be no surprise for investors to start assuming that the local central banks could start offering EUR near levels such as 4.70 in EUR/PLN, 25.00 in EUR/CZK, 370 in EUR/HUF and 4.95 in EUR/RON. We'll provide more updates on this subject over coming days.

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