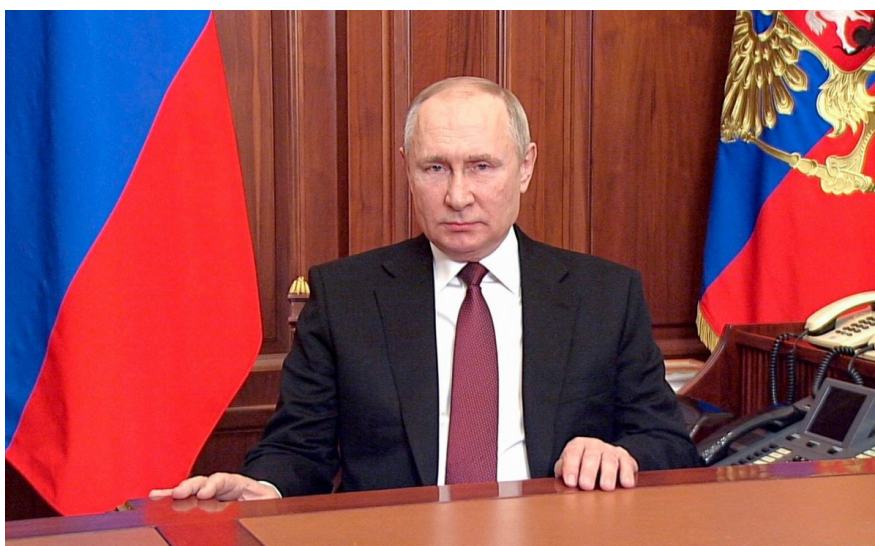


FX Daily: Spheres of influence

The world is shocked as Russia launches a major military offensive against Ukraine. Financial markets are predictably witnessing a flight to safety and may have to price in slower growth on the further spike in energy prices. In FX, European currencies will remain under pressure and the dollar should continue to be favoured



Russian President
Vladimir Putin

USD: Dollar gets the flight to safety bid

News early this morning that Russia has launched a major military offensive across Ukraine has shocked the world. As we discussed in our [market review](#) yesterday, FX markets had shifted to a benign interpretation of events - perhaps that the Russian incursion would stop purely in the rebel-held areas. That thesis has been blown away by developments overnight and FX traded volatility prices have understandably jumped.

The cross-market reaction is understandable too. Brent prices have surged through \$100 and European natural gas prices should surge too - with no sufficient alternative for Russian gas for Europe. Equities are off around 3% in Asia and European equities and corporate credit are likely to come under heavy pressure today. In bond markets, we have seen a bullish flattening of yield curves consistent with investors pricing lower growth. A key question will be whether investors price lower terminal rates for tightening cycles or whether the energy price shock firms up stagflationary fears and rates at the short end of the yield curve hold up well.

A key focus for today will be the Western response to Russia's aggression. In the US, watch carefully for the progress of the [Menendez Bill](#) in Congress. This has been dubbed the 'mother of all sanctions bills' and given events overnight it seems its progress is highly likely. The question will then be which Russian financial institutions are targeted for severe financial sanctions. Russia has closed local markets today, but USD/RUB has traded to 90 and as we discussed in yesterday's report it would not be a surprise to see a two-tier market develop again - i.e. an onshore and an offshore rouble swap market - even though the rouble is a deliverable currency.

Given the uncertainty, expect FX markets to trade along the lines we discussed in yesterday's report. Namely, those geographically closest to the crisis and exposed to the imported energy story - CE3 currencies in particular - to stay under pressure. The Czech koruna and Hungarian forint have already fallen 1-1.5% today. The Swedish krona also looks exposed - a dovish central bank and a small open economy exposed to what will be lower European growth prospects.

While the Federal Reserve tightening cycle may be re-priced lower, we would still favour the dollar to outperform Europe right now. Trade and energy links to Russia are tiny compared to Europe. And dollar liquidity will be in demand at very uncertain times like this. As discussed yesterday, we still like DXY (heavily weighted against European currencies) rising to 97.00.

And in terms of spheres of influence, the Chinese renminbi remains strong and is establishing its credentials as a safe haven, reserve currency. Those commodity currencies that trade off the renminbi - e.g. the South Africa rand and Brazilian real, plus those formally managed against the renminbi - e.g. the Singapore dollar - should continue to perform well.

⬇️ EUR: Under pressure

EUR/USD briefly traded down to 1.1200 overnight and one week traded volatility jumped to 8.2% from 6.7% on the Russian news. EUR/USD has remained remarkably supported through this crisis so far, but given the uncertainty, we would still say that risks are skewed to the 1.1200 area or even a retest of the 1.1120 lows.

EUR/JPY has broken sharply lower too - as equities take the strain - but unless we see another 10-15% equity correction, a break of good support at 127.50 is far from clear.

➡️ GBP: Natural gas will keep BoE awake at night

Early reports suggest Dutch natural gas prices have jumped 40% this morning. Surging natural gas prices will keep the Bank of England in a hawkish mood meaning that the pricing of the BoE tightening cycle may hold up better than some.

GBP does have a higher correlation with risk, but so far, it is holding up quite well and EUR/GBP can continue to trade a 0.8300-0.8350 range.

⬆️ CHF: EUR/CHF trades to a new low

Events in Ukraine have sent EUR/CHF to a new low. Investors could speculate that Russian money will be heading to Switzerland and out of dollars ahead of likely more aggressive sanctions. In terms of the Swiss National Bank's tolerance for franc strength, comments made in December suggest the SNB may not step in aggressively until closer to 1.00. Switzerland's low inflation means that its real exchange rate is not as high as its nominal rate - perhaps there is a 3-5% difference

here.

Until Ukraine tension is resolved, expect EUR/CHF to stay offered and we cannot rule out a test of 1.00 if the situation deteriorates further.

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