FX Daily: GBP risks skewed to the upside

Disappointing UK data this week could cement market expectations of a Bank of England rate cut this month. But we still think the pound is more likely to rise than fall this week

USD: Oil producing FX to outperform

While oil prices jumped in response to the supply disruption in Libya and Iraq, risk assets have not been hit as hard as they were at the height of the US-Iran dispute this year, as the geopolitical and wider global risk implications are materially lower. This suggests (a) cyclical G10 currencies and emerging market FX should remain supported (USD/CNY hit a new multi-month low); and (b) oil-producing currencies such as the Norwegian krone, Canadian dollar and Russian rouble should outperform. As we wrote in our latest edition of FX Talking: #FeelGoodInc, we see the risk environment as encouraging for the near future and we like higher beta currencies.

EUR: Uneventful ECB meeting, EUR/USD in tight range

The January ECB meeting this Thursday should be a non-event. No new economic projections are published and the board is unlikely to change its risk assessment. As for the January eurozone PMI (Friday), our economists look for a modest improvement, though the Manufacturing PMI should remain in contractionary territory. With no ECB policy normalisation coming any time soon, any euro upside appears off the table. EUR/USD to remain in a tight range.

GBP: Asymmetric reaction function to the UK data

Both November UK labour data (Tuesday) and January PMIs (Friday) will be closely watched this week after a stream of disappointing UK data last week. A downside surprise or data which shows no improvement would likely cement the market expectations of a Bank of England rate cut this month. However, the market is already pencilling in a January rate cut with a 70% probability. This suggests that negative GBP reaction following potentially softer UK data may be limited. If anything, the risks are skewed to more pronounced GBP upside (than downside) this week should we see a rebound in PMIs - which would reverse the imminent monetary policy easing expectations. Hence, we view the GBP/USD range for this week as asymmetric and skewed to the upside. Still, the risks to GBP for coming months are tilted to weaker sterling due in part to Chancellor Sajid Javid's interview about the UK government's intention to diverge from EU rules. Concern about the outlook for the UK economy should keep GBP contained, while GBP/USD speculative positioning no longer suggests scope for a short squeeze - if anything, GBP net longs have risen further, currently at 16% of open interest.

NOK: Higher oil price and stable risk environment

The Norwegian krone is likely to be the main G10 FX beneficiary from the mix of higher oil prices and a stable risk environment. Compared to the Canadian dollar (also oil exporting), the NOK valuation is more appealing while January tends to be the seasonally strongest month for the krone. EUR/NOK to converge towards the 9.80 level.