FX Daily: Stress testing the dollar bulls

Softer US data this week will be a key test for whether dollar bulls are comfortable with their positioning. We think they probably are. Elsewhere, some temporary calm in Eastern Europe and the Chinese Lunar New Year holidays could make for some better conditions for risk assets, allowing some FX recovery stories to come through - such as the Australian $.

USD: Bracing for softer US data

The dollar starts the week gently offered - though holding onto last week's bullish break-out. The widely-followed DXY is so far holding above 97.00. One of the key stories this week will be whether the dollar can hold onto last week's bullish break in the face of softer US data. Here James Knightley sees most of this week's US data surprising on the downside - including the ISM business surveys and the ADP and NFP jobs releases.

We tend to think the Omicron-inspired US weakness in January is well-understood by the market and instead investors are more influenced by the very hawkish comments made by FOMC Chair Powell at last week's press conference. Assuming the US economy starts to bounce back over the next month or so - and that there are no major downside surprises on inflation - then the narrative of front-loaded Fed tightening and a stronger dollar should continue as a dominant theme.

In terms of the international environment, it tentatively seems that diplomatic paths are being pursued and that the US written response to Russia's security demands could lead to another round of high-level meetings. Equally, the Normandy group (Germany, France, Ukraine and Russia) looks to be meeting again in a couple of weeks in an attempt to breathe fresh life into the Minsk peace accord. A possibly quieter week in terms of geopolitical risk (and US 10 year Treasury yields perhaps more contained) could provide a breather to risk assets and allow some currencies such as the Australian dollar to recover ahead of big event risks such as tomorrow's RBA meeting.

Mild consolidation could see DXY briefly break under 97.05 to the 96.85 area - that should hold, however.

EUR: Focus on growth, inflation and politics

Today sees 4Q21 Eurozone growth (expected at 0.4% QoQ), German January inflation (seen at 4.4% versus 5.3% in December) and scrutiny over the re-election of Sergio Mattarella as the Italian President. Downside risks to the Eurozone GDP number are possible, given Germany's poor reading, but our team still expects a rebound in the spring or summer. That should be a key theme in helping EUR/USD to build a floor in the 1.08/1.10 area later this year.

In the shorter term, though, the biggest input to EUR this week will be Thursday's ECB meeting. This looks unlikely to provide EUR/USD with much support. And we think today's correction in EUR/USD should be relatively shallow and stall ahead of 1.1200.

GBP: Staying supported into BoE

On Friday James Smith published his BoE preview in the form of four scenarios. We contributed the GBP levels, meaning a baseline view of EUR/GBP dropping to the 0.8300 area as the BoE hikes 25bp. The market will also want to hear what the BoE plans to do with its balance sheet. We suspect, to start with at least, the balance sheet run-off will be very passive and, like the Fed, interest rate hikes will be the preferred choice for tighter policy.

As we have been highlighting recently, we suspect the BoE welcomes GBP strength as a means to fight higher energy prices. And a slightly calmer equity environment could also be supportive to the higher beta GBP.

AUD: Short squeeze pre RBA?

AUD/USD broke heavily below major support at 0.70 on Friday - but has since bounced back. Speculators were already heavily short the AUD before Friday's break lower - and we think now the risk is greater of a short squeeze in the run-up to the RBA's event risk tomorrow.

Credit data released overnight in Australia showed some very healthy 7% YoY credit growth (albeit business rather than consumer-led) and a change in RBA language and a potential end to QE could send AUD/USD back towards the 0.7080/7100 area.

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