

## FX Daily: Temporary calm, but European currencies remain vulnerable

Global financial markets have taken the first tranche of Russian sanctions in their stride. And so far recent events in Ukraine have not prevented central banks in Hungary and New Zealand from pushing ahead with tightening cycles. Yet the situation remains fragile and European currencies should continue to under-perform



Overnight the Reserve Bank of New Zealand delivered a widely expected 25bp rate hike

### USD: Favour the dollar for liquidity and energy independence

The escalation of the crisis in Ukraine has so far had only a limited further fall-out in global financial markets. Global equity markets have held in reasonably well over the last 24 hours, while in the foreign exchange (FX) space, commodity and selected emerging market currency pairs have continued to perform well and there is no clear sense of 'risk off' trading.

Clearly, the situation in Ukraine is incredibly fragile and investors remain nervous that Russian authorities lay claim to broader areas of the Donbas than those currently held by rebels and potentially now by the Russian military. The market reaction to the first tranche of Russian sanctions has been relatively sanguine so far – perhaps because the tiering of these sanctions has been well-flagged. Of note, many Western financial institutions will now be prohibited from trading Russian sovereign debt in the secondary market – for debt issued after 1 March. Previously June 2021 had seen only seen participation in Russian primary debt trading restricted. Russian markets are closed for a public holiday today, but we suspect the moves could add an extra 100bp to

Russian sovereign borrowing costs. The rouble is now 3% off its lows too.

Perhaps the surprise from yesterday's raft of sanctions was the early German announcement that the certification of Nordstream II will be halted. European natural gas prices are going to remain exceptionally volatile over the coming weeks – bounced around by the threat to European gas supplies from Russia and the lack of alternatives (both Qatar and Azerbaijan have said they will struggle to make up for any shortfall in Russian supplies).

Given the very uncertain picture in Ukraine, we suspect that investors will still prefer the liquidity and energy independence of the dollar – at least against the European currencies. Additionally, as central banks in both [Hungary](#) and New Zealand (see below) have shown over the last 24 hours, geopolitics have not prevented 50bp and 25bp rate hikes respectively. It therefore seems unlikely that the Fed will be knocked off course from the start of an aggressive tightening cycle.

The US data calendar is light today and events in Ukraine will continue to dominate. But with the US dollar index (DXY) heavily weighted towards European FX, we would certainly back the dollar right now and would favour DXY returning to the 97.00 area over coming days.

### ➔ EUR: In harm's way

The euro (EUR) has held up reasonably well this week. This probably owes to a risk environment that is far from 'averse'. Indeed, some Latam currencies exposed to the commodity cycle and the Renmimbi are performing well.

Similar to the Fed, events in Ukraine have knocked about 10bp off the pricing of the terminal European Central Bank (ECB) rate (roughly in the two-year horizon), but we suspect expectations of the Fed cycle will bounce back quicker. Ahead of the crucial March 10th ECB meeting, look out for ECB speakers today in the form of François Villeroy de Galhau, Luis de Guindos and Pablo Hernández de Cos. These are all at the dovish end of the spectrum and may be keen to emphasise the negative demand effects of higher energy prices.

EUR/USD could break below 1.1280 to the 1.1220 area – or lower – should Russian lines move further West in Ukraine or natural gas prices spike further.

### ➔ GBP: Watch out for Bank of England speakers at 1030CET

After a brief spike to 0.8380 yesterday, EUR/GBP is again dropping back to the low 0.83s. We favour this direction of travel, where at least GBP is being buoyed by a more materials-weighted local equity benchmark and the UK government's more aggressive re-opening schedule.

At 1030CET today we will see Bank of England (BoE) heavy-hitters Andrew Bailey and Ben Broadbent testify to a parliamentary committee. We doubt they will want to push back (yet) on aggressive pricing of the BoE cycle, which is providing support to GBP and helping to insulate against higher energy prices. We continue to favour a move to the 0.8280/8300 area for EUR/GBP.

### ➔ NZD: RBNZ delivers a hawkish hike

Overnight, the Reserve Bank of New Zealand (RBNZ) delivered a widely-expected 25bp rate hike but surprised on the hawkish side by revising its rate-path projections significantly higher. The policy rate is now expected to rise from the current 1.0% to 2.5% over the next 12 months and is set to peak at 3.25% in 2023. Incidentally, the bank announced the start of quantitative tightening

through both bond maturities and managed sales of its holdings under the Large Scale Asset Purchase (LSAP) programme.

All this confirms how the RBNZ is set to remain the most hawkish central bank in the G10 space, a factor that in our view will offer New Zealand dollar (NZD) some good support in the medium term. In the short-run, external factors (geopolitics, unstable risk sentiment in the run-in to Fed tightening) continue to pose downside risks to NZD and may soon offset the modestly positive post-RBNZ reaction in the currency. NZD/USD may slip back below 0.6700 in the coming days.

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