

FX Daily: The big short (squeeze)

The generally oversold commodity FX segment is likely experiencing a big short-squeeze as the market's fears on Omicron are abating. AUD stands out as an outperformer, boosted by an upbeat tone by the central bank overnight. With no data releases today, the dollar should still stand between underperforming low-yielders and recovering pro-cyclicals



➔ USD: Stuck in the middle

A slow start to the week in terms of data releases saw markets turning more optimistic on the Omicron variant story and – while still waiting for more details on the vaccine efficacy – pro-cyclical FX has recovered some ground. We are likely witnessing some short-covering among commodity FX: [as the latest CFTC data showed](#), there is a general overstretched net-short positioning in that segment. This would also help explain why the New Zealand dollar is struggling to follow the recovery path of its closest peers: despite the recent underperformance, NZD remains quite overbought by speculators.

China seems pretty much at the centre of the global focus at the start of this week. [The People's Bank of China cut](#) its reserve requirement ratio by 50bp yesterday, continuing to buck the global central bank tightening plans, to support the economy. More crucially, the Politburo signalled that

some real estate curbs will be eased, just as Evergrande approaches a long-awaited debt restructuring. With the Omicron risk looming, we are wary about making any strong calls on pro-cyclical currencies, but the latest developments in China are most surely a positive for the currencies which have a high beta to the region.

Today, we may get a bit of the same as yesterday: there are no major data releases in the US and no Fed speakers given the pre-FOMC blackout period. The dollar may simply remain the tip of the balance between currently underperforming low-yielders (JPY, CHF) and recovering pro-cyclicals, with sentiment on the Omicron variant still set to drive most market moves. Investors will also keep an eye on developments on the US-Russia diplomatic tensions, as Biden is reportedly considering sanctions on Russian banks if Russia invades Ukraine.

➔ EUR: Limited upside potential

It appears that the euro's role as a funding currency is curbing the EUR/USD upside in the current market environment, as investors jump back into risk-on bets. With the eurozone growth outlook already partly compromised by restrictions in Germany and other eurozone countries, and the European Central Bank sticking to a broadly dovish tone, the euro may be facing more pressure regardless of Omicron-related sentiment. We could see EUR/USD re-test 1.1200 this week.

➔ GBP: Held back by BoE Omicron concerns

We've seen a stark divergence in how central bank officials have addressed the Omicron risk in the UK and US. While the Federal Reserve sent some hawkish signals and still sounded quite focused on spiking inflation, the Bank of England saw even some of its more hawkish voices like Michael Saunders take a more cautious tone. Yesterday, MPC member Ben Broadbent (more of a dove than Saunders) declined to say whether a rate hike will be needed and acknowledged the Omicron-variant impact will take time to be assessed. The market is currently pricing in 7 out of 15bp of tightening at the 16 December meeting.

This divergence in policy expectations may keep a lid on cable's upside in the run-up to the BoE meeting despite the upbeat risk sentiment.

⬆ AUD: Boosted by RBA's optimism

The Australian dollar has experienced a very strong start to the week, rising by more than 1% vs the USD. Being the most oversold currency in G10, we are likely seeing some substantial squeezing of AUD shorts, triggered by the more upbeat mood of markets about the Omicron variant, positive signs from the Chinese economy (RRR cut and eased real estate curbs) and, overnight, a quite optimistic tone by the Reserve Bank of Australia.

The rate announcement saw no changes to the main policy tools, with rates and the pace of asset purchases left unchanged at A\$ 4b per month. However, policymakers characterised the Omicron variant as a "source of uncertainty" that "is not expected to derail the recovery", and stressed instead a strong recovery in the jobs market. This is ultimately allowing markets to speculate that the RBA may follow the example of the Bank of Canada and abruptly end asset purchases (rather than simply tapering again) at the February meeting. The three factors the RBA will consider for its decision in February will be: the behaviour of other central banks (an acceleration of Fed tapering would be crucial), the functioning of the AUD bond market and – most importantly – progress towards the inflation and employment goals.

Needless to say, the impact of Omicron ultimately holds the key to the policy direction in the near term, but the RBA has clearly positioned itself among those central banks (like the Fed) that do not currently see the new variant as likely to truly dampen the recovery and policy plans. With still a lot of short positions to be unwound, this is a notion that can continue to offer support to the Aussie dollar in the coming weeks.

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