FX Daily: The dollar comeback hinges on Powell, again

The current market enviornment resembles last week's pre-FOMC one: the dollar is regaining ground as markets position themselves for a hawkish tone from Powell. The difference is that, today, strong jobs gains give Powell an extra incentive to push back against lower rates. The dollar recovery may run a little longer. Expect ECB hawkish comments as well.

Source: Shutterstock

We have published our latest FX views and forecasts in the February edition of FX Talking: "Soft landing, hard landing, no landing?"

USD: Powell's second hawkish attempt can support the dollar

One week ago, we were observing how the dollar had regained the favour of the market as investors were positioning for a reiteration of the hawkish rhetoric by Fed Chair Powell after the FOMC meeting. As we now know, Powell actually conveyed the message of being relatively relaxed with loosening financial conditions last Wednesday.

Today, however, we are looking at a market environment that highly resembles last week's pre-FOMC one. Markets have been squaring short-dollar positions in the past two sessions as expectations have grown that Powell will deliver a hawkish speech at the Economic Club in Washington today. The key difference with last week is that Fed hawkish bets are now backed by a shockingly strong January jobs report (we recommend looking at our economics team's note on the US labour market published yesterday).

Let's assume that a goldilocks scenario where inflation declines without seriously harming employment is becoming a more central scenario for the Fed. Well, even so, it seems a rather appropriate time for Powell to deliver one last hawkish "hurrah" today. In a way, many are seeing at least some degree of protest against the market reaction to last week's FOMC as necessary. Yesterday, Atlanta Fed chief Raphael Bostic said that strong job gains could mean a higher peak rate.

Indeed, it looks like markets have already positioned themselves for some pushback against easing rate expectations, but the surprise strength of the US jobs report gives Powell ample room to sound more hawkish than expected. Ultimately, the ongoing upward correction may run a little longer before losing steam.

Incidentally, the overall environment is doing little to lure markets back into risk assets and away from the safe-haven dollar. US-China tensions are a source of concerns and likely weighing on global sentiment, and the eurozone cannot count on a supportive data flow to keep the growth re-rating process going. It looks like only another under-delivery (i.e. dovish surprise) by Powell can hurt the dollar today.

Francesco Pesole

EUR: ECB hawks to the rescue

EUR/USD has pressed lower and may re-test the 1.0700 support today. There isn't a whole lot driving the euro slump from the domestic side. In what is now becoming an increasingly common occurrence, ECB members appear to be rushing to the rescue in the week after the ECB meeting. The goal is simple: convince markets the hawkish bias is untouched, hoping to regain some of the market's trust that President Lagarde seems to have lost.

We'll hear from three ECB hawks - Schnabel, Knot and Kazimir – and one "dove" – Villeroy – who recently aligned its view with the broader ECB message on further tightening. All in all, a slew of hawkish comments and rate protests should be on the cards today. This could give some modest support to the euro, but we believe this evening's speech by Powell will have broader and longer-lasting implications for EUR/USD. A contraction to the 1.0600-1.0650 area by the end of this week is now looking increasingly likely.

A pushback against the dovish market reaction is also what we have seen from BoE officials so far, with Caroline Mann (a hawk) firmly ruling out the peak rate has been reached. Today, we'll hear from MPC members Ramsden, Pill and Cunliffe. With the rate protest coming from both the UK and the eurozone, EUR/GBP may hover around 0.8900-0.8950 for now.

Francesco Pesole

AUD: RBA deliver hawkish hike

The Reserve Bank of Australia raised rates by 25bp, in line with consensus, and signalled more rate increases are on their way. As we expected, sticky inflation has forced the RBA to sound more hawkish and to push rate expectations higher. Here is our economist's review of the meeting.

Markets are now pricing in a peak rate at 3.9% from around 3.6% before the announcement, but we think this is still underestimating how far the RBA will go. Our projections see rates hit 4.1% in the second quarter, and a potential first rate cut only in the fourth quarter.

We continue to see AUD as the most attractive currency in G10 in the months ahead. Indeed, recent deterioration in US-China relations are a concern, but Australia still seems on track to easing trade tensions with Beijing, and the room for further hawkish repricing in RBA rate expectations means that 0.75 in AUD/USD could be reached during a soft-USD environment in 2Q22.

Francesco Pesole

CEE: The US dollar brought pain to the region

The EUR/USD decline hit CEE FX hard yesterday. The US Dollar may cause pain to the region for a while longer and the local calendar has little to offer today. This morning's data showed Hungary's industrial production for December and the Czech Republic will release retail sales. Later today the Czech National Bank (CNB) will release FX reserve statistics including FX transactions for December. However, we don't suspect the CNB has intervened in this period. In our view, we may have last seen the central bank in the market in late September. However, we think the total intervention bill has reached CZK25.6bn since mid-May last year, roughly 16% of the CNB's FX reserves, and today's numbers won't change that.

On the FX front, the key will be which direction EUR/USD goes and regional factors won't do much about it. After yesterday's 1.9% depreciation, the main focus today will be on Hungarian forint. Yesterday's move has certainly eased the pressure on heavy long positioning, but that may not mean the end of the upward journey. In our view, the Hungarian forint has gone too far and our model linked to EUR/USD indicates levels more around 392 EUR/HUF. However, the US dollar move will be decisive factor today.

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