FX Daily: The Teflon pound

The chances of UK PM Johnson resigning are rising, but the pound appears immune to political noise and might not suffer from a change of leadership in the country. If anything, new Brexit negotiations bear bigger risks. Elsewhere, the dollar might have a more balanced positioning now after a large long-squeeze, which couild help keep EUR/USD below 1.1500.

USD: Looking for a breather after major position-squaring

A well-telegraphed jump in US inflation to 7% was taken as a “sell the fact” opportunity for FX investors, with a substantial unwinding of dollar longs triggering widespread dollar weakness. The technical break higher in EUR/USD likely put some extra pressure on the dollar in other crosses: whether the 1.1500 resistance holds is key for dollar bulls at the moment.

We still think the dollar counter trend does not have long legs, and we see scope for a recovery by the end of this week, as imminent Fed tightening and room to cement views around a fourth Fed hike in 2022 (the Fed’s Bullard sees this as the base case scenario) still offer the greenback – which should now have a less skewed net-long positioning - some appeal on dips.

Today, the US calendar includes December PPI and initial jobless claims, plus a number of Fed speakers. Leal Brainard will attend the Senate hearing for her Vice-Chair nomination, while Barking and Evans (both non-voters in 2022) are set to participate in two conferences.

Any recovery in the dollar may mostly emerge against the low-yielders for now, as rallying oil prices and stabilising sentiment continue to offer good support to the pro-cyclical segment. USD/CAD is currently attempting a break below the key 1.2500 support - the loonie is looking a very attractive currency at the moment despite the worsening domestic outlook due to lockdowns in Canada.

EUR: A break above 1.1500 is not our base case

EUR/USD extended its run after breaking above the top of its December-January range, and is now eyeing 1.1500. Still, another leg higher in the pair is not our base case, as along with our view for the dollar to recover, the euro seems to be lacking a clear bullish driver at the moment.

The data calendar in the eurozone does not include market-moving releases. After having heard from two ECB hawks this week (Schnabel and Nagel), markets will weigh the remarks of the more neutral Luis de Guindos today.

GBP: Potential Johnson resignation may not bother the pound

The pound only marginally lagged other G10 currencies yesterday as UK Prime Minister Boris Johnson started to face calls for his resignation from within the Conservative party following an admission before Parliament that he attended a party when gatherings were not allowed in England.

Most Tory MPs still appear determined to wait for the results of a formal investigation before taking any action: a vote of confidence on the Prime Minister would require the support of 54 Tories. That said, the chances that Johnson will resign are clearly rising.

The pound is not embedding any political risk at the moment, which would in theory make it vulnerable to the downside if markets start to see the recent developments as a net-negative factor for the currency. We doubt, however, this will be the case, and a new Prime Minister (Chancellor Rishi Sunak appears to be the front runner) may not automatically have any negative implications for the GBP outlook.

If anything, there may be a bigger risk for sterling associated with post-Brexit trade negotiations with the EU. UK Foreign Secretary Liz Truss (another name that has circulated to succeed Johnson) will meet EU officials today to discuss the still unsolved Northern Ireland dispute. The EU has already signalled that a suspension of the NI protocol would trigger a trade retaliation. This is surely one important theme to follow, but we note that the pound did not suffer from the resurgence of Brexit-related headlines last year: unless trade tensions escalate quickly, EUR/GBP should remain on track for a move to (or brake below) 0.8300 in the near term.

On the BoE side, we'll hear from Catherine Mann this morning. The market is currently pricing in an 85% probability of a 25bp rate hike at the 3 February meeting.

AUD: Back at 0.73, but downside risks loom

The Aussie dollar has followed the bullish wave in commodity currencies, and is now pressing the

0.7300 level. The current benign environment for pro-cyclical currencies means that another leg higher is not off the cards, although we doubt the sustainability of an AUD/USD rally in a longer-term perspective. First, because we expect the USD to find fresh support, and second because some soft data out of China may spill over on the overly exposed AUD.

Incidentally, markets have moved too aggressively in pricing in RBA tightening, in our view. The current expectations for 90bp of tightening in 2022 should be gradually scaled back, which poses some additional downside risks to the AUD outlook.

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