FX Daily: Tight US labour market supports the dollar

Short-dated US yields and the dollar have received some support this week from data suggesting the US labour market remains tight. Further insights into this story come from today's US December jobs data, where decent jobs and average earnings figures should see the dollar hanging on to this year's gains. The CEE FX rally is running out of steam

The US dollar hit a four-week high yesterday on strong employment data

USD: The Fed still matters

It is a very familiar theme, but what the US Federal Reserve does with interest rates is still very relevant to FX markets. The dollar rallied around 1% yesterday on the strong December ADP jobs report which also pushed two-year US yields up 10-12bp. Signs of strength in the US labour market are understandably being read as prolonging both the Fed's concern with tight labour markets and its preoccupation with suppressing inflation.

Our colleague, James Knightley, has a marginally above consensus +225k forecast for today's US December jobs report, while he sees the unemployment rate ticking up to 3.8% (driven by a higher participation rate) and average hourly earnings growing at a still robust 5% year-on-year.

Such an outcome should probably see the dollar holding onto this week's gains, although the FX liquidity in the immediate aftermath of a payrolls report can sometimes be used as an opportunity to exit dollar cash deposits and put money to work overseas. We cannot rule that out, but our bias would be that a strong jobs report means a strong/stronger dollar.

As we noted earlier this week, the dollar typically does well in January and February and the uncertainty around next Thursday's US December CPI release may limit the dollar downside should today's US data disappoint.

105.80/106.10 could be the short-term DXY target on encouraging US jobs data.

Chris Turner

EUR: ECB pricing remains steady

Today's release of December eurozone inflation is expected to see the headline rate dropping to 9.5% year-on-year from 10.1% in November. A fall in the headline rate should be well telegraphed given the big decline in energy prices, but the core rate is expected to nudge up to 5.1% YoY. Core inflation will increasingly be the focus as 2023 progresses, where investors and central bankers remain wary that the inflation genie is out of the bottle and reluctant to be reincarcerated.

That concern over core inflation is probably one of the factors keeping the pricing for the European Central Bank cycle quite sticky at close to another 150bp of tightening this year – taking the ECB deposit rate to 3.50%. It seems unlikely that those expectations will crumble and undermine the euro.

In light of this and benign energy markets, we are a little wary of calling for big losses in EUR/USD. Indeed, yesterday's drop in spot seemed to have very little impact on FX option markets. A strong US nonfarm payrolls figure today could see EUR/USD losses extend to the 1.0450 area, but 1.03 feels a little too far in the otherwise benign environment for European FX.

Chris Turner

GBP: Staying soft

GBP/USD fell quite hard on the stronger dollar yesterday to dip back under 1.19. Yesterday we highlighted the Bank of England's Decision Maker Panel (DMP) survey and any insights it could provide on inflation expectations and wage growth. In the end, the survey hardly showed much improvement in inflation expectations and wage growth actually firmed up a little.

Yet our colleague, James Smith, pointed to the fact that the balance of firms finding it much harder to recruit had tumbled – which could be a leading indicator for softer wage growth. Nonetheless, BoE tightening expectations remain resolute as they have done for the last ten weeks. 100-125bp of hikes remain firmly priced in for late summer and we may need to see clear signs of inflation decelerating before these start to tumble.

On balance, we expect sterling to remain soft and any stronger US jobs data could be worth a move to 1.1780/1800. A more obvious target at 1.1650 feels a little too far.

Chris Turner

CEE: The current rally is running out of steam

Yesterday's CEE markets were dominated by Poland. December inflation dropped well below market expectations (from 17.5% to 16.6% YoY), while stability was expected. Although core inflation continued to rise according to our estimate, the headline number resulted in a massive rates and bond rally across the region. Moreover, National Bank of Poland Governor Adam Glapinski's press conference threw in the traditional dose of dovish rhetoric to complete this disinflationary story.

Today in Poland the markets are closed for the holiday and attention should turn to the rest of the region. In the Czech Republic, the traditional set of monthly data will be released: industrial production, construction and foreign trade. We expect industrial production to return to negative year-over-year figures, which has long been indicated by leading indicators.

In the FX market, we expect the current rally in the region to run out of steam today. Gas prices have stalled after a multi-day rally, while Polish inflation has sent interest rate differentials across the region to new record lows. Moreover, the lower EUR/USD and the outlook of strong US labour market data thus indicate a correction of previous gains in the CEE region. We saw some losses yesterday and we expect a continuation today. In our view, the most vulnerable at the moment are the leaders of the previous rally: the Czech koruna and the Hungarian forint with a move back to 24.100 EUR/CZK and 400 EUR/HUF, respectively.

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