FX Daily: Two tier rouble market emerges

The introduction of sanctions against many Russian banks has seen bifurcation emerge in the rouble FX spot market, where the rouble yesterday was briefly trading 10-15% weaker in the offshore than the onshore market. Expect this two-tier market to continue and European currencies to remain under pressure

USD: Powell testimony could drive a further wedge between the dollar and European FX

In a development we highlighted in our initial market reaction article, the counter-party limitations and risks posed by aggressive sanctions against Russian institutions have seen the emergence of a two-tier rouble market. Onshore names will trade with onshore names and offshore with offshore. Last night the onshore USD/RUB rate closed around 101 at a time that the offshore rate was being quoted at 115. It is hard to see that gap being closed anytime soon, although there is a chance that the offshore USD/RUB is dragged a little lower as Russian exporters are forced to sell their accumulated FX earnings over coming days - these flows may go through the onshore market as we understand it.

For broader FX markets, European FX understandably remains under pressure. In an article we published on Friday, our CEE team gave their views on the tolerance of CEE central banks to local currency weakness. That tolerance was tested yesterday when the likes of EUR/PLN and EUR/HUF traded to highs of 4.80 and 380 respectively - to which both Polish and Hungarian central banks responded with threats of FX intervention. Expect this friction to continue.

Even though the USD funding markets have calmed down a little, the dollar remains very much in demand. Liquidity considerations are one thing, but the macro dent from Putin's war will clearly cost Europe far more heavily than the US. Indeed, pressure is building for European leaders to bite the bullet and start curtailing Russia's oil and gas imports in spite of the economic cost. The relative insulation of the US economy is allowing the Fed to remain in hawkish mood and probably have the most cause of any to stick to tightening plans.

On that subject, FOMC Chair Powell delivers semi-annual testimony to the Senate today at 16CET. As long as he continues to focus on the inflationary threats - as Joe Biden did last night - expect Fed tightening expectations to remain broadly intact and the dollar supported. Today also sees the February ADP report ahead of Friday's jobs data.

The DXY trade-weighted measure of the dollar - heavily-weighted to European FX - has this week pushed up to new cyclical highs. Expect war in Europe to keep the dollar bid and DXY pressing the next layer of resistance at 97.70/98.00.

EUR: ECB swings to support mode

EUR/USD is edging below 1.1100, helped yesterday by the ECB seeming to hold the door open for continued stimulus. That is a far cry from the sequencing narrative in play only a month ago, where the market was debating the timing of the end of its APP bond-buying scheme and its first rate hike. This story was nowhere clearer yesterday than in the European government bond markets where Italian BTPs enjoyed a huge 32bp rally on the view that ECB support would be available for longer.

With eurozone growth potentially taking a 0.7%-1.0% hit this year from events in Ukraine, it is no surprise to see EUR/USD breaking to new lows. For today look out for: i) Eurozone February CPI (expected at 5.6% YoY versus 5.1%) and ii) ECB speakers in the form of Guindos (12CET) and more importantly/dovishly Lane (17CET).

As our FX options team have been saying recently, the EUR/USD FX option market may remain one of the last liquid venues to hedge European FX risk. The 2% volatility skew for 3m Risk Reversals (investors are prepared to pay 2% more to own a EUR downside than EUR upside protection) is the widest since March 2020 (when EUR/USD briefly traded down to 1.07). Unless we hear any heartening news of a ceasefire in Ukraine, expect EUR/USD to drift down to 1.10 - and maybe lower.

GBP: Massive re-pricing of the BoE cycle

Despite the surge in European natural gas prices and what that means for UK inflation (we have that peaking near 8% now not 7%), the Bank of England tightening cycle has suffered one of the largest repricings lower. For example, the terminal rate for BoE rates has been downscaled by 70bp over recent weeks, while the Fed cycle is -50bp and the ECB cycle -35bp.

This should leave GBP a little vulnerable, as should its status as a currency that is more sensitive to financial risks/equities, given the size of the financial sector in the UK economy. With European equities remaining vulnerable as the world re-prices European growth, EUR/GBP can bounce around in a 0.8300-0.8400 range - but could break higher if equities take another large leg lower.

EUR/CHF continues to decline and has now briefly traded under 1.02. The SNB has commented in the local press that it will continue intervening, though has again made reference to the trade-weighted CHF and not just EUR/CHF. Based on comments made last December - that the SNB was more interested in the real, trade-weighted CHF - we doubt the SNB is prepared to throw the kitchen sink at EUR/CHF until 1.00.

CAD: Bank of Canada to hike by 25bp

As discussed in our BoC meeting preview, we expect to see a 25bp rate hike in Canada today. This is in line with what Governor Macklem has been signalling in recent remarks and fully warranted by a tight labour market and high inflation. The global re-pricing of tightening expectations has seen markets price out the possibility of a 50bp move today, although 25bp is fully embedded into CAD and should not be enough to send the loonie higher. The focus will be on forward-looking language and on the assessment of the impact from the Russia-Ukraine conflict on policy plans. The BoC will likely highlight some higher degree of uncertainty, but should not have much interest in turning materially less hawkish just yet.

After all, the spike in oil and gas prices is set to further underpin Canada's economic momentum, while geographical distance and strong links to strong US domestic demand are likely insulating the country from any economic spillover from the Ukraine turmoil. All this means that CAD could continue to perform relatively well, especially in the crosses, with external factors (oil dynamics above all) set to out-shadow post-BoC moves, which may prove quite contained. While some USD demand could keep USD/CAD around 1.2700 for now, EUR/CAD may soon test the 1.4000 support.

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.