FX Daily: US recession fears and China pivot support risk rally

The dollar is broadly weaker after Friday's release of a sub-50 December ISM services reading added weight to the view that the US will enter a recession. At the same time, China's Covid pivot is sparking a re-assessment of activity currencies. We'll hear more from central bankers this week and the data highlight will be Thursday's December US CPI release

USD: ISM services knocks stuffing out of the dollar

The dollar starts the week under pressure and has seen some sizable losses over the last two trading sessions. Friday's price action proved instructive. The slightly lower-than-expected average hourly earnings data saw the dollar soften a little, but the sub-50 ISM services release really knocked the dollar hard. As our US economist, James Knightley, notes, ISM services readings under 50 are one of the most reliable indicators of a US economy headed into recession. This reading has not so much questioned whether the Fed will be taking rates close to 4.75/5.00% this spring, but rather added to the pricing of the subsequent Federal Reserve easing cycle.

Growing convictions that the Fed will have to ease later this year come at a time when China is dismantling its zero-Covid architecture and policy measures - especially in the property sector - are reorienting towards growth. This combination is proving a very benign one for emerging currencies and commodity currencies in general. As usual, we think the FX markets will take their cue from the US yield curve, where Friday's bullish disinversion of the curve (as short-dated yields crumble) point to a more reflationary setting and a weaker dollar. Were US two-year Treasury yields to drop below the 4.10/20% area this week, we would expect another decent leg lower in the dollar.

Whether those US short-end yields drop more this week will be determined largely by Thursday's US December CPI release. James Knightley is on consensus expecting core inflation at 0.3% month-on-month and 5.7% year-on-year. Downside surprises here were a big catalyst in the dollar reversing lower last year and this data point will remain one of the biggest FX triggers of the month. The week also sees Fed Chair Jerome Powell speaking at a Riksbank symposium on central bank independence. With concerns building around a US recession and price data easing, the tide seems to be turning against his hawkish rhetoric.

In all, we suspect investors will be looking to add to positions in EM FX and the commodity complex this week. The Chinese renminbi is enjoying strong gains and Asia's high beta Korean won is flying. It seems very hard to fight this trend - especially in the second week of the year when money is being put to work.

The recent DXY low at 103.45 looks vulnerable and 102.00 now looks to be the direction of travel as US recession fears build.

Chris Turner

EUR: Memories of 2007

EUR/USD has been participating in this dollar sell-off and the bias looks higher. Conditions here feel a little like the summer of 2007 when the slowdown in the US housing market saw the conviction build - especially from August 2007 onwards - that the Fed would have to ease. Having traded in a 4.50-5.00% range for the first half of 2007, US two-year yields crumbled to 2.70% by the end of 2007 and EUR/USD rallied around 10%. Of course, there are many differences between then and now, e.g. US sub-prime then, versus the US inflation battle now. But a surprisingly hawkish European Central Bank (both then and now) warns that EUR/USD could rally hard if the market is convinced the Fed will ease.

Low gas prices and China reopening are also supportive for EUR/USD and we would say that, despite the bearish seasonals for EUR/USD, pressure is building for further near-term gains. With money probably flowing into emerging market funds now - and out of dollar deposits - we can see EUR/USD heading up to 1.0735/85, with outside risk to the 1.09 area should US price data soften again this week.

Chris Turner

GBP: BoE Chief Economist speaks at 1630CET

Sterling has received some support from the better global risk environment. The highlight of today's session will be a 1630CET speech by Bank of England (BoE) Chief Economist, Huw Pill, with the title: 'The UK economic and Monetary Policy Outlook'. We have noted recently that the market has been locked onto expectations that the Bank rate will be taken to the 4.50% area (or +100bp from today's level) into the summer. This pricing has been resolute for several months. Recent job and wage data has yet to assuage the BoE's concerns over a tight UK labour market, thus we doubt Huw Pill will need to sound very dovish today.

With the dollar at risk of falling further, GBP/USD looks biased towards the 1.2350 area this week, while EUR/GBP should find support in the 0.8780 area.

Chris Turner

CEE: Inflation prints across the region

We have a heavy calendar this week led by inflation numbers across the region. Today we start with Hungarian industrial production and foreign trade and in the Czech Republic, we will see the final estimate of 3Q GDP and labour market numbers. Tomorrow, the Romanian central bank is scheduled to meet, and we think it will raise interest rates for the last time to 7.00%, but give a 30% probability that rates will remain unchanged. December inflation in the Czech Republic will be released on Wednesday. We expect a further increase from 16.2% to 16.4%, slightly above market expectations. Then on Friday, we will see December inflation in Hungary and Romania. In Hungary, we expect a further rise from 22.5% to 25.9% YoY, also slightly above market expectations. In Romania, we think inflation has already peaked and expect a small decline from 16.8% to 16.6% YoY.

The CEE markets experienced a massive rally in rates and bonds last week, but also in FX for most of the region. This week should show that inflation in the region is still a problem and this chapter is not over yet. Most interesting will be the Hungarian forint and another jump higher in inflation. Hungary is the only country in the region that has seen inflation surprise to the upside in each of the last three months. Thus, another surprise would likely push the forint back above 400 EUR/HUF.

Overall, higher EUR/USD after Friday's US jobs report is good news for the region. On the other hand, the fall in market rates is again undermining domestic conditions for FX. As we mentioned earlier, the drivers of the previous rally have been exhausted in our view and we should see a quieter week in the FX market.

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