FX Daily: USD/JPY in the driving seat

An on-consensus US December CPI release has allowed the FX markets to revert back to the main event – a potential sea-change in Bank of Japan (BoJ) policy and perhaps plenty of downside in USD/JPY. That is the hottest story in town right now. Soft US consumer sentiment and softening inflation expectations should also keep the dollar bias bearish today

USD: Slip sliding away

An on-consensus US CPI release yesterday did not interrupt this year's narrative of the US Federal Reserve being able to cut rates later in the year and the dollar being able to fall. As our US economist James Knightley wrote in his review of the release, it seems that it is mainly the shelter component holding the core month-on-month reading up here and shelter should start to come sharply lower in the second quarter.

Consensus is now behind consecutive 25bp Fed hikes in February and March, followed by a Fed turning dovish over the summer and starting to deliver rate cuts later in the third quarter. The Fed taking rates back towards less restrictive territory remains a tailwind to risk assets – especially to emerging risk assets buoyed by China rebound expectations. Fund flow data show good momentum in Chinese equity ETFs, which is normally very supportive of the renminbi.

It is a quiet day for US data, and a soft University of Michigan consumer sentiment plus declining inflation expectations can keep the dollar on the back foot.

With USD/JPY expected to stay under pressure into next Wednesday's Bank of Japan meeting, the DXY can stay biased to the 102.00 area near term.

Chris Turner

EUR: ECB will be happy with the stronger euro

The ECB's trade-weighted euro has now returned to levels seen last February. And actually, the year-on-year change in EUR/USD is now mildly positive. This will be welcome news to the ECB, where last summer's 6% YoY EUR/USD decline was contributing to the inflation problem.

With short-dated (two-year) USD swaps drifting to new lows for the move, EUR/USD swap differentials continue to move in favour of EUR/USD. And this is a theme which we suspect will play a greater role in EUR/USD pricing over the next 12 months.

For today, the eurozone data calendar sees the release of November industrial production and the trade balance. We will also find out how much European banks have repaid of their targeted longer-term refinancing operations (TLTROs) drawings in January. The expectation is around €200bn, with the range being around €50bn-450bn. Any higher-than-expected repayment might be positive for two reasons: i) it would reduce excess euro liquidity and would be supportive of eurozone rates and ii) it might be seen as a sign of confidence as precautionary borrowing is paid back. Let's see.

EUR/USD remains on course for 1.0900 and possibly 1.0950. Weekend profit-taking may pose the biggest risk to EUR/USD, but 1.0750 should now be a good near-term base.

Chris Turner

JPY: Off to the races

Looking at the FX options market, USD/JPY remains the stand-out interest. One-week implied volatility remains at a very high 20% and volatility for the Bank of Japan (BoJ) meeting next Wednesday is priced as high as 40% or a near 1.7% move in spot USD/JPY. As events showed yesterday with the 2% USD/JPY fall, even at these levels the FX options market may still be under-pricing volatility.

This huge interest in USD/JPY is understandable. The BoJ may be on the verge of its biggest policy change in decades. Even short-dated JPY Interest Rate Swaps have started to move and are at the highest levels (near 30bp) since 2008!

Clearly, USD/JPY has come a long way very fast, but some of the longer-term skews in the FX options market point to a structural shift in the market's view in USD/JPY. We suspect few will want to stand in the way of the USD/JPY downside. 126.50 looks like the clear near-term target for USD/JPY.

Chris Turner

CEE: Higher EUR/USD is a small boost for region

All the important numbers have already been published this morning. Romania's December inflation fell from 16.8% to 16.4% YoY, more or less in line with market expectations. In Hungary, on the other hand, inflation rose from 22.5% to 24.8 % YoY, less than the market expected.

Later today, we will see the final December inflation number in Poland, which surprised in a flash estimate to the downside to 16.6% YoY. We'll also have some secondary data such as the current account in Poland, Czech Republic and Romania, and today, after the end of trading, Fitch will publish a rating review of Poland. The country is currently rated A- with a stable outlook and we do not expect any changes today. Also in Poland, the lower house of parliament will vote on a bill that should help unlock EU money and get access to €35.4bn.

On the FX market, we found the CEE currencies almost unchanged after yesterday's US inflation number. However, higher EUR/USD today will give them a chance to erase this week's losses. But still, it shouldn't change much in the picture of a flat week. For the Polish zloty we see a return below 4.680 EUR/PLN and for the Czech koruna levels below 24.00 EUR/CZK. Hungarian inflation numbers should be good news for forint and we can go back below 396 EUR/HUF.

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