

FX Daily: Waiting for the Fed, with an eye on Ukraine

A week dominated by Wednesday's FOMC announcement - an event that bears downside risk for the dollar in our view - starts with a very mixed picture in global equities as Russia-Ukraine tensions remain in focus. PMIs should signal a further slowdown in the eurozone, but political developments in Ukraine and Italy should matter more for the euro



➔ USD: Fed balance sheet discussion could halt the dollar recovery

The week starts with a mixed picture for global equities, with Asian stocks and European futures following the drop in US equities on Friday, while Dow Jones futures point to a rebound. The US calendar today only includes the non-market-moving PMIs, and global risk sentiment/geopolitics should be the main drivers.

As discussed in our [G10 FX Week Ahead](#), political developments in Ukraine are set to remain centre stage in a week also dominated by Wednesday's Fed meeting. Over the weekend, the UK released intelligence that claimed Moscow was planning to install a pro-Russian leader in Kyiv, and the US

asked its diplomats to leave Ukraine as tensions continue to escalate. With sanctions from NATO countries to Russia set to pile up, the question is whether the already complicated gas supply situation in Europe could be further exacerbated. The short-term fate of high-beta commodity currencies appears very much tied to political developments in the region.

Turning to the Fed meeting, [our economics team expects](#) the QE programme to be terminated. This may be interpreted by markets as an indication that the Fed's balance sheet will do the heavy lifting in the policy normalisation process, which could pour some cold water on current expectations for four rate hikes by the end of the year. Ultimately, this should cause the dollar recovery to stall or marginally reverse, although an escalation in geopolitical tensions in Ukraine would have the exact opposite effect on the greenback.

The Bank of Canada will also announce monetary policy on Wednesday, and we expect a 25bp rate hike, which would be fully warranted by the tightness of the labour market as well as rising inflation. We expect Canada's dollar to be a major outperformer this week on the back of that.

➔ EUR: Ukraine and Italy's politics matter more than PMIs

The week starts with the release of January PMIs in the eurozone. Both the service and manufacturing indices should decline due to the combination of Omicron restrictions and high energy prices, although the FX impact of PMIs has been quite contained in the past few months.

Arguably, geopolitical tensions with Russia may end up having important implications for the eurozone if the gas supply starts to be used as a means of retaliation against sanctions. The euro seems to be pricing in little to no geopolitical risk, so the downside risks for the common currency are non-negligible if tensions with Russia flare up. Barring such a scenario, we think some dollar softness after the FOMC can help EUR/USD climb back to the 1.1415/20 area this week.

One side theme to keep an eye on is Italian politics, as the process to elect the new president of the republic starts today. Former Prime Minister Silvio Berlusconi (a worst-case scenario for markets, [in our analysis](#)) has pulled out of the race, which leaves two options on the table: current PM Mario Draghi can either remain at his current role or he can be elected as president. Either way, we doubt the process will generate a meltdown in the Italian bond markets, although EUR/CHF is embedding very little risk of a considerable widening in the BTP-Bund spread, which means that the balance of risks is still skewed to the downside for the pair.

⬆ GBP: Not data to further direct BoE expectations

The January PMIs will also be released in the UK today, although – unlike the eurozone – we may see a marginal increase in both indices driven by the easing of Covid restrictions in the country. This week, markets will not take much input from the data calendar to further assess the likelihood of a Bank of England rate hike next week, which is now almost fully priced in.

Some focus will instead be on EU-UK post-Brexit negotiations and on the British political picture, as PM Boris Johnson appears close to being forced out of his role. The market's reluctance to price in either Brexit-related or political risk premium into the pound has been quite evident, and should this continue to be the case this week, the pound could stabilise against both the EUR and the USD.

AUD: Tick-up in inflation to provide some help

The 4Q inflation report published tonight in Australia should see a mild acceleration in the headline rate from the latest 3.0% read. While not screamingly high when compared to similar markets (we could see 6% inflation in New Zealand later in the week), this could keep hawkish expectations on the Reserve Bank of Australia alive and help build a floor under the Aussie dollar.

That said, the current pricing for RBA tightening (more than 100bp of tightening in the next year) seems unrealistic, which poses downside risks further down the road for AUD. Until some sort of reality check from the RBA forces some re-pricing of rate expectations, the very oversold AUD could find some support in periods of stable risk sentiment, although the exposure to China and its zero-covid policy should continue to put a curb on any sustained rally.

This week, we could see AUD/USD consolidate in the 0.7200/0.7250 area.

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