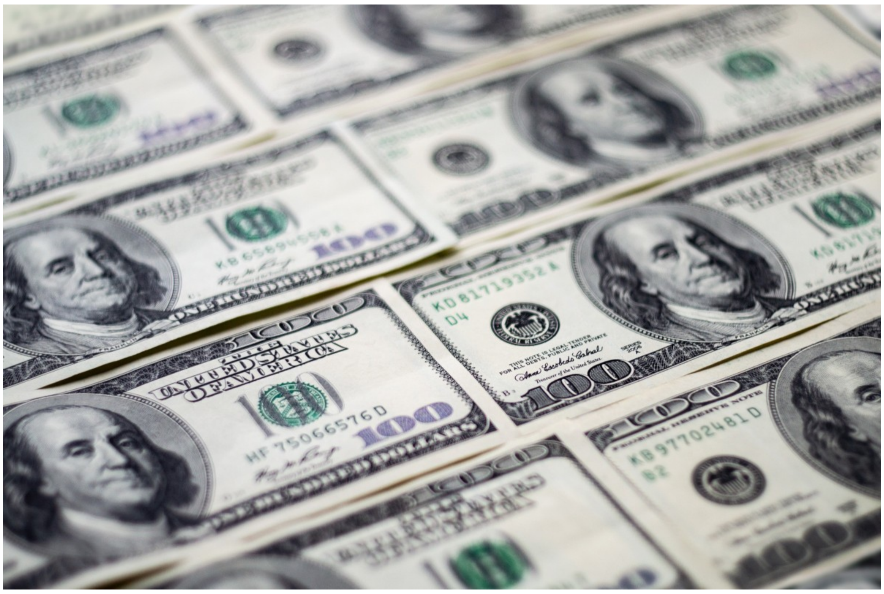
G10 FX Week Ahead: Pausing for a breath

We expect the dollar bear trend to take a breather in a week packed with risk events. Biden's inauguration may be accompanied by civil unrest and Trump's impeachment trial, the EUR may edge below 1.20 with the ECB meeting, EU summit and Italy's political crisis in focus, while the BoJ, BoC and Norges Bank meetings should have limited FX impact



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USD: A peaceful transition of power?

	Spot	Week ahead bias	Range next week	1 month target
DXY	90.4740	Mildly Bullish	90.0000 - 91.0000	90.0000

- Washington will very much be the focus of the world's attention this coming week as Joe Biden is inaugurated as the 46th US President on Wednesday. It would seem unlikely that we see a repeat of the civil unrest witnessed on Capitol Hill, but progress on impeachment proceedings may pre-occupy the Senate at a time when the US economy looks like it needs more support. Washington on Tuesday will also see Janet Yellen's confirmation hearing as US Treasury Secretary. She may well be asked what she thinks about the dollar. Our best guess would be that she would reply along the lines of believing in a strong dollar policy, but exchange rates should be best set by the market. We doubt the dollar needs to rally much on these remarks. US data this week will focus on housing (doing well) and whether US initial claims show another unwelcome spike.
- In the background, we suspect the dollar bear trend needs some consolidation. The USD/Asia drop has slowed (helped partially by a weaker CNY fixing) and also by emerging complaints around the world over the pace of the dollar decline. Given flows into emerging markets have been a key driver of this benign dollar decline, China 4Q GDP (released early Monday) will also set the tone, as will any further signs of tighter monetary policy after a small liquidity drain by the People's Bank of China on Friday.

EUR: ECB and EU summit in focus

	Spot	Week ahead bias	Range next week	1 month target
EUR/USD	1.2120	Mildly Bearish	1.1980 - 1.2170	1.2200

- European policymakers will take centre stage this week – a week which sees meetings of both the ECB and EU leaders. On the former, little is expected of the ECB after December's easing measures. However, we would expect President Lagarde to say that the ECB is 'monitoring the exchange rate carefully', wary of the euro's impact on an already subdued inflation rate. The EU summit on Wednesday looks set to focus on the co-ordination of the vaccination roll-out and also the implementation of the EU Recovery Fund. On the subject of politics, Monday will also see the market review the results of the CDU leadership contest in Germany.
- We're also interested to see any conclusions reached by the European Commission in its report, released Wednesday, on improving the international role of the euro, e.g., on the subject of pricing energy in euros. This is a structural issue, will take some time, but will likely have strong support from those countries trying to find ways to extricate themselves from dollar dominance. Wrapping up, ongoing Italian political uncertainty and a steadier dollar could briefly see EUR/$ trade 1.1980.

JPY: BoJ set to stay dovish

	Spot	Week ahead bias	Range next week	1 month target
USD/JPY	103.70	Mildly Bearish	103.30 - 104.40	102.00

- USD/JPY has recently been one of the major beneficiaries of the steeper US yield curve. It's not clear that the US curve needs to steepen more next week – e.g., does the proposed $1.9 fiscal stimulus plan get pulled apart? – suggesting USD/JPY does not need to trade up through the 104.50 area. Our rates strategy team think that dovish Fed commentary and lighter supply may be sufficient to keep US Treasury yields stable around current levels.
- In Japan, the highlight of the week will be Friday's BoJ meeting. The worsening Covid situation in Japan will no doubt be weighing on the BoJ minds, as will deflation (which may get worse when the December CPI figure is released on Friday). No fresh easing is expected from the BoJ and instead speculation is growing that the BoJ will scale back its ETF stock buying programme – given the strength in equities and the BoJ's substantial ownership of this ETF sector.

GBP: Consolidating after its recent outperformance

	Spot	Week ahead bias	Range next week	1 month target
GBP/USD	1.3621	Neutral	1.3420 - 1.3800	1.3900

- GBP has been the best performing G10 currency this week, benefiting from the mix of (a) the market re-pricing the odds of the Bank of England moving into the negative rate territory after Governor Bailey's comments earlier in the week; (b) faster roll-out of vaccination in the UK vs other major economies (EZ, US). While the former is now in the price, the latter should continue to provide a marginal support to GBP. Despite its recent outperformance, sterling does not show signs of short-term overvaluation (it at currently trading at the level of its short-term fair value). This limits a scope for a short-term pull back.
- On the UK data front, the focus will be on the Dec CPI (Wed) which is expected to increase modestly, yet staying well below the 2% target, Dec retail sales (Friday) and Jan PMIs (Friday). The latter two should improve vs the prior reading, but any effect on GBP should be limited. The speech from Gov Bailey (Mon) and the BoE Chief Economist Haldane (Tue) are unlikely to affect GBP much, as the market already adjusted the probability of negative rates lower.

AUD: Inevitable slowdown in jobs recovery

	Spot	Week ahead bias	Range next week	1 month target
AUD/USD	0.7723	Mildly Bearish ↘	0.7630 - 0.7790	0.7900

- Despite a week of good USD performance, AUD/USD has managed to hold above 0.7700 (and briefly touched 0.78 yesterday) thanks to a lingering strength in iron ore prices, some positive spill-over from US stimulus hopes and signs of China possibly re-allowing some Australian coal shipments at its ports.
- Next week, the main data point to watch is the December jobs report. As per our economist's preview of the release, Australian labour growth to slow we expect a slowdown in the employment recovery, with the December increase in hiring at 67k vs 90k last month. While we are still less pessimistic than consensus (centred at 50k), we think almost half of the increase will be attributable to part-time hiring. This should simply confirm expectations for the RBA's lower for longer approach, and have a short-lived impact on AUD. With no other key drivers data-wise for AUD next week – except some spill-over from China's growth data on Monday – and the USD that may continue to inch higher (see USD section above), we could see AUD/USD come under some mild pressure next week.

NZD: Are speculators unwinding Kiwi longs?

	Spot	Week ahead bias	Range next week	1 month target
NZD/USD	0.7167	Mildly Bearish ↘	0.7080 - 0.7240	0.7300

- The Kiwi dollar appears in a more fragile state compared to its peers AUD and CAD, as it dropped 1% this last week. As highlighted in our previous week-ahead article, NZD is lacking a buffer (like the iron ore rally for AUD) when the risk environment becomes choppier. Another factor contributing to NZD underperformance is the possible unwinding of some speculative long positions that (according to CFTC data) were at +26% of open interest on 5 January, the highest in G10.
- Next week will see the release of 4Q CPI numbers, which may have dropped closer to 1.00% (YoY) as economic activity struggled due to virus containment measures. This should be largely expected, and with the vaccine roll-out gaining pace worldwide we would be surprised to see the Reserve Bank of New Zealand putting excessive focus on inflation right now. At the same time, there is no more upside room for RBNZ rate expectations after negative rates have been fully priced out, so a grim read may prompt some investors to reconsider some bets on more monetary stimulus (although most likely through more QE, rather than cuts).

CAD: BoC's "lower for longer" not under discussion

	Spot	Week ahead bias	Range next week	1 month target
USD/CAD	1.2722	Mildly Bullish	1.2660 - 1.2820	1.2500

- The Canadian dollar has confirmed its ability to weather moments of unsupportive risk environment better than most pro-cyclical currencies. Also contributing to CAD's resilience in spite of USD momentum was the positive spill-over from the larger-than-expected fiscal plan announced by President-elect Biden. The exposure of CAD to the US-related sentiment might put the loonie at risk in case of any political/social turmoil around Joe Biden's inauguration next week, although there is a chance that the market will simply overlook any events in this regard as it did with Trump's impeachment process and previously the Capitol Hill riots.
- Looking at domestic drivers, the Bank of Canada will announce monetary policy on Wednesday, one-and-a-half hour after the release of the December inflation report. Core CPI may linger around 1.00%, but this should not have any clear implications for the BoC policy decision. In fact, we don't expect the BoC to announce any new measures on Wednesday. The vaccine-related hopes have fuelled the prospects of a quicker economic recovery, but the contagion picture in Canada has worsened of late and in general there would be no reasons at this stage for Governor Tiff Macklem to sound any hawkish. In line with what we heard from Fed Chair Powell yesterday, the BoC may simply reiterate its lower-for-longer pledge. Accordingly, we expect CAD to be only marginally touched by the policy meeting and more dependent on external factors in the week ahead.

CHF: The impact of Italian politics may stay contained

	Spot	Week ahead bias	Range next week	1 month target
EUR/CHF	1.0761	Mildly Bearish	1.0690 - 1.0800	1.0800

- Italy plunged into another political crisis this week after a junior partner of the ruling coalition (former PM Renzi's party "Italia Viva") withdrew its support. We discuss our view on the topic in detail in this article. Markets have so far had a very muted reaction to the government crisis, with the 10Y BTP-Bund spread staying at check around 110-120bp and no clear risk-premium emerging in EUR/USD or EUR/CHF, according to our short-term fair value model.
- We are not surprised markets have remained calm in front of the Italian political developments so far: unless we see the worst-case scenario of early elections materialise (we think this is unlikely), the other scenarios (cabinet reshuffle, change in PM, technocrat-led national unity government) would hardly cause enough of a change in the eurozone and Italian outlook to generate a sell off in Italian bonds considering the ECB's heavy buying of Italian assets. We will know more whether PM Conte will have to resign or not on Tuesday, when he faces a key confidence vote in the Senate: his hope is to bring some centre-right MPs on board. Should he fail, resignations would be inevitable, but that would not automatically exclude he will be given another mandate, although some alternative names for the role will start circulating. The Italian political crisis may not be solved quickly, and may put some mild pressure on EUR/CHF (CHF is the most common hedge to political risk in the EU). Still, as long as early elections are ruled out, we expect any market reaction to be contained, and we remain confident in our medium-term bullish view on EUR/CHF.

NOK: The krone to look through the NB meeting

	Spot	Week ahead bias	Range next week	1 month target
EUR/NOK	10.3150	Mildly Bullish	10.2500 - 10.4270	10.2000

- Norges Bank meets on Thursday but as it is an interim meeting, no new forecast will be presented. We don't expect the NB statement to deviate from the previous one and the NB should continue pointing to a policy normalisation next year (even if NOK has strengthened since the December meeting, so has oil prices, in turn suggesting no need to change thinking about the rate path). The effect on the currency should be thus limited.
- The external environment will be the key driver for NOK next week. With USD regaining some ground and consolidating, the near-term upside to cyclical currencies like NOK should be limited. As January is seasonally the strongest month for NOK (and a meaningful NOK appreciation was already observed in the first week of the month) we expect upside pressure on NOK to ease in coming weeks.

SEK: Riksbank FX purchases to have a limited impact on SEK

	Spot	Week ahead bias	Range next week	1 month target
EUR/SEK	10.1260	Neutral	10.0470 - 10.2000	10.0000

- As has been the case for other G10 cyclical currencies, the recent SEK appreciation trend reversed as the dollar consolidated. We expect EUR/SEK to consolidate in the 10.05-10.20 range next week with the external environment unlikely to put downside pressure on the cross. Equally, SEK should be less vulnerable to any possible bouts of risk aversion vs NOK, given its lower beta to risk.
- Riksbank announced that it was changing the way it builds FX reserves (moving from FX loans to direct purchases of foreign exchange). Given the need to replace SEK178bn worth of FX loans over the next three years, this means c.SEK 5bn worth of FX purchases per month. We don't see this as derailing the medium-term bullish SEK outlook as the size of monthly sales of SEK / purchases of FX reserves is rather small relative to daily turnover (an average of SEK160bn in EUR and SEK150bn in USD). We expect EUR/SEK to break below the 10.00 level this year and target EUR/SEK 9.75 by year-end.

Authors

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