G10 FX Week Ahead: From Washington to Rome

Developments in the US capital will likely drive the dollar next week. Signs that Biden's fiscal bill will struggle in the Senate may pour cold water on risk sentiment despite an FOMC message that is likely to remain dovish. Meanwhile, Italy's political turmoil is far from over and some key parliament votes may pressure EUR/CHF

Joe Biden, President of the United States of America

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USD: Fed to keep the taps open

	Spot	Week ahead bias	Range next week	1 month target
DXY	90.2660	Neutral	90.0000 - 91.0000	90.0000

- Policy makers in Washington could drag the dollar in both directions next week. On the one hand, focus will return to the Senate and whether Biden's $1.9trn stimulus plan can progress in its current form – or has to be dismantled. With cash holdings at the lowest levels since 2013, a stuttering stimulus plan may be risk negative/dollar positive. On the other hand, Wednesday's FOMC meeting should see the Federal Reserve retain its dovish outlook and recommit to buying $120bn of assets per month until substantial progress has been made towards its goals. This is a dollar negative.
- There's also lots of US data next week. The highlight will probably be the first look at 4Q20 GDP – expected at 4%+ (quarter-on-quarter annualised). We'll also see two readings of January consumer confidence and personal income and spending data for December. In addition to US data, the IMF will release an update of its World Economic Outlook (WEO) on Tuesday. In its October update it projected world output at 5.2% this year after a 4.4% contraction in 2020. It will probably revise 2021 US growth higher and eurozone and perhaps Chinese growth a little lower. Overall, these adjustments can probably add to the consolidatory mood in FX markets.

EUR: Surprisingly resilient in spite of broadening lockdowns

	Spot	Week ahead bias	Range next week	1 month target
EUR/USD	1.2163	Neutral	1.2050 - 1.2250	1.2200

- EUR/USD has held up surprisingly well over the last week, with the European Central Bank backing away from its full use of the Pandemic Emergency Purchase Programme 'envelope,' perhaps giving it a lift. The external environment does not look right for a strong EUR/USD advance though, where the dollar/Asia bear trend has stalled and Italian politics could yet deliver a sting in its tail. For the week ahead, we'll be looking to see what impact broadening lockdowns are having on the continent and whether ECB President Christine Lagarde and Chief Economist Philip Lane will try to address the modest sell-off in eurozone debt markets with more dovish commentary – they speak on Monday and Wednesday, respectively,
- We will also hear from German Chancellor Angela Merkel and French President Emmanuel Macron at the virtual Davos – also joined by Chinese President Xi Jinping. Presumably, Covid and climate change will top the agenda. On balance, we continue to see EUR/USD trading in a 1.20-1.23/25 trading range this quarter and then making a push higher when economies reopen in the second quarter.

JPY: Investors stay vigilant

	Spot	Week ahead bias	Range next week	1 month target
USD/JPY	103.86	Mildly Bearish	103.50 - 104.50	102.00

- Even though USD/JPY isn't going anywhere (one-month realised volatility has dropped to 4.6% from close to 7% in November), investors are still prepared to pay 6.30% for one-month implied volatility. In effect, they're not buying into this idea of a sustained drop in volatility. One can understand why. Equities seem stretched and the Japanese yen is still probably seen as one of the best defensive currencies in the event of a market correction.
- Tight USD/JPY ranges would seem in order for the week ahead, although the JPY could get more interesting over coming weeks. The Bank of Japan is expected to unveil a monetary policy strategy review at its 18/19 March meeting. The question is whether it will be a tweak to its current rather complex tool kit or something more drastic – especially if Covid trends continue in the wrong direction.

GBP: A week of calm

	Spot	Week ahead bias	Range next week	1 month target
GBP/USD	1.3646	Neutral	1.3460 - 1.3800	1.3900

- We have a neutral view on GBP/USD for next week. A fair amount of good news is now in the price of sterling (ie, the reduced odds of negative rates, faster vaccination). Coupled with our neutral view on the risk environment next week, there are limited catalysts for sterling to move decisively in either direction next week.
- On the data front, the material miss in the UK Services PMI reversed the prior GBP gains. While the majority of manufactures reported a worse supplier performance (linked to Brexit) the PMI miss does not tell us much about the GDP figures (as the relationship between PMIs and GDP is now weak), suggesting there's no long-lasting negative impact on GBP. The focus next week will be on the UK employment numbers. The jobless rate is set to increase further (towards 6% in November), but the impact on GBP should be limited, reiterating a rather neutral view on sterling next week.

AUD: Left without a solid floor as inflation may slow

	Spot	Week ahead bias	Range next week	1 month target
AUD/USD	0.7718	Mildly Bearish ↘	0.7620 - 0.7760	0.7900

- The Aussie dollar is bearing the brunt of today's risk-off environment and AUD/USD has wiped out all weekly gains – which were helped by signs of resilience in the Australian labour market – and is back to the 0.7700 gauge. Also contributing to AUD's loss of momentum was the dramatic fall in December retail sales, which contracted by 4.2% after the jump (+7.1%) seen in November.
- Next week, the key data release to monitor is the 4Q inflation report. Consensus appears centred around a flattening in the year-on-year reading at 0.7%, but we see the impact of domestic and external virus-related factors as having pushed the figure to 0.5%. This may put some short-term pressure on the AUD next week as it would fuel expectations of an even longer period of low rates in Australia. However, we doubt that would be enough to trigger speculation of more easing by the central bank, which appears to be out of firepower, considering negative rates have been ruled out. Some cooling off in the risk rally may leave AUD without a solid floor and we could see AUD/USD retract into the 0.76 area next week.

NZD: Looking better than AUD

	Spot	Week ahead bias	Range next week	1 month target
NZD/USD	0.7174	Mildly Bearish ↘	0.7100 - 0.7200	0.7300

- The Kiwi dollar may outperform AUD next week as there are no data releases in New Zealand that are likely to have a material FX impact. The only data point to watch will be the trade numbers for December, which look set to show an increase in exports, and in the overall trade position of New Zealand. Still, NZD/USD may come under some pressure on the back of choppier risk sentiment and could move back into the lower half of the 0.71-0.72 range.
- The inflation report published overnight in NZ showed headline CPI surprisingly holding at 1.4% in the 4Q. With no central bank events/speeches scheduled (for now) until the 24 February meeting and only the labour data on 02 Feb likely to have a material impact, market expectations around more easing by the Reserve Bank of New Zealand (through more quantitative easing, as negative rates have been fully priced out) are likely to stay muted after the inflation reading. This could limit NZD downside in the near term.

CAD: Pipeline issues not a short-term risk for the loonie

	Spot	Week ahead bias	Range next week	1 month target
USD/CAD	1.2701	Neutral	1.2620 - 1.2780	1.2500

- The Canadian dollar has shown some good resilience this week despite the bad news for Canadian oil producers of the Biden administration revoking the permit on the Keystone XL pipeline. The project was a fundamental part (it would have carried 800k/bbl a day to the US) of the plan to solve the long-standing issue of insufficient pipeline capacity in Canada. This is a topic that may remain in the background as long as crude demand stays low (hence, the relatively low impact on CAD so far), but may well be an obstacle to Canada's longer-term economic outlook in the post-pandemic period.
- What did help CAD this week was the Bank of Canada policy announcement (here is our reaction piece). While keeping all policy measures unchanged, the economic projections showed a more upbeat tone on the medium/ long-term outlook and Governor Tiff Macklem downplayed any need for extra stimulus. He also commented on CAD, signalling more appreciation could hinder the recovery, although he acknowledged this has been largely caused by broad-based USD weakness, and fell short of signalling that CAD levels will be taken into consideration at the next policy decision. Next week, two data releases will be in focus: November retail sales and November GDP. We expect CAD to remain mostly driven by external factors, and especially market sentiment when it comes to US fiscal stimulus plans.

CHF: Perceived risk of early elections in Italy on the rise

	Spot	Week ahead bias	Range next week	1 month target
EUR/CHF	1.0778	Mildly Bearish ↘	1.0720 - 1.0800	1.0800

- Italy's political turmoil is set to remain centre stage for longer after Prime Minister Giuseppe Conte managed to survive two confidence votes earlier this week but failed to secure an absolute majority. In the next few days, he will attempt to bring some MPs and Senators on board to back his government but chances are that he may not secure a majority before Wednesday's votes on some motions put forward by the Justice Minister.
- Markets are sensing a higher risk of early elections, as evident from a rise in the 10Y BTP-Bund spread to 125bps and the drop in Italian equities today. Further fuelling such fears was a media report that Conte is considering going to elections as he struggles to secure a stable majority and some recent polls suggested a party led by him would obtain 15% of the vote. In practice, early elections are still the most unlikely option, in our view, as the parties involved in the ruling coalition would have no clear political advantage in heading to the polls right now. Plus, a vote while virus-containment measures are in place would prove logistically complicated. There is indeed a chance that Conte may resign as PM, but that would not automatically trigger elections: we rather expect the President of the Republic to encourage a new coalition and possibly a national unity government under a new technocratic PM. Still, as the perceived risk of elections has risen and may rise again next week if Conte loses (or possibly postpones) the parliament votes, there is a risk of a further widening in the BTP-Bund spread, possibly to 150bps, as the ECB communication about not using the full PEPP envelope could also play a role. In FX, this could push EUR/CHF below the 1.07368 December low.

NOK: Slowing pace of appreciation

	Spot	Week ahead bias	Range next week	1 month target
EUR/NOK	10.3090	Neutral	10.2000 - 10.4300	10.2000

- The Norges Bank meeting had a limited impact on the krone this week, with the currency remaining primarily driven by global risk sentiment. Still, the fact that the NB did not alter its stance and continues to subscribe to its forecast from the December meeting (signalling the first hike will be delivered in the first half of 2022) makes the NOK outlook constructive, with the currency set to benefit from the mix of a global growth recovery and the most hike-prone central bank in the G10 space. However, next week should be more about range-bound trading than NOK gains, given our neutral outlook on risk sentiment (see above). Moreover, with NOK already recording meaningful gains in the early part of January (and January being seasonally the strongest month for NOK) its pace of appreciation should slow in coming months, in our view.
- It will be a calmer week on the Norwegian data front in contrast to this week. The unemployment readings (Thursday and Friday) and December retail sales (Thursday) should have a limited impact on the krone. EUR/NOK is set trade in the 10.20-10.43 range next week.

SEK: Stuck in a very tight range

	Spot	Week ahead bias	Range next week	1 month target
EUR/SEK	10.0780	Neutral	10.0200 - 10.1700	10.0000

- EUR/SEK price action remains well-behaved and the cross is stuck in a tight range around the EUR/SEK 10.10 gravity line. Next week should see no change and we look for another week of range-bound trading. With USD consolidating and the two-way risk to sentiment next week, there's little to suggest that EUR/SEK should break out of the tight trading range of 10.02-10.17. The effect on the krona from the Riksbank's announcement of a change in the way FX reserves are accumulated (a marginal SEK negative on the announcement day) has now fully faded.
- It is a busy week on the Swedish data front. The main focus will be on the Prospera Inflation expectation (Wednesday), January Economic Tendency Survey (Thursday) and December retail sales (Thursday). Given the near-term Covid induced uncertainty and the Riksbank signalling no change in interest rates over the forecast horizon (in sharp contrast to the Norges Bank), the domestic data next week should have a negligible impact on SEK.

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

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