

FX Daily: Monetary brakes vs. China expansion = volatility

Realised volatility in FX is picking up to levels last seen in November 2020. The Federal Reserve looks set to stamp hard on the monetary brakes just at a time when China seems to be encouraging stronger investment. FX markets are caught between these two themes and of the two, we would prefer to back the former and selective strength in the dollar



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📈 USD: CPI at 7.5% YoY lets Fed expectations run wild

Yesterday's release of [US January CPI](#) has uncorked a rare vintage of Fed expectations. Arch-hawk James Bullard hit the wires late yesterday with the suggestion of 100bp increments in tightening and perhaps even some inter-meeting tightening. The market now prices 47bp of tightening for the 16 March FOMC meeting and fully 167bp of tightening by December. Listening to business reports on the radio this morning, comparisons were made to the early 1980s, when Paul Volcker took Fed rates to 15-20%. The Fed's actions at that time sent the economy into recession and the dollar soared.

And this is probably the key question for markets now - i.e. whether we see some orderly tightening from the Fed which can prolong the growth cycle or whether stamping out inflation needs to send the economy into recession? The market is nowhere near the latter conclusion yet, where US long-dated yields are still rising.

But Fed tightening is not the only story in town. Yesterday saw some [very strong Chinese new loan growth figures for January](#). This provided a strong boost to the commodity complex and seemed one of the few explanations for why the dollar briefly turned offered across the board after the US CPI release. These two opposing forces are leading to some sharp increases in realised FX volatility - e.g. 3-month EUR/USD realised volatility is back to levels last seen in November 2020.

If the Fed is to step hard on the monetary brakes, we would certainly favour the dollar against the low yielders backed by central bankers who have firmly placed themselves in the dovish camp. The Japanese yen and the Swedish krona stand out currently after dovish actions yesterday. And overnight comments from European Central Bank President Christine Lagarde have also poured a little cold water on the ECB tightening story. Commodity currencies are another matter - but to withstand dollar strength they will certainly need to be backed by hawkish central banks. And that is certainly not the case for Australia yet.

For today, we will probably focus on how risk assets cope with the fallout from higher US rates, and defensive FX positions look warranted. DXY could be headed back to 96.50. The only data of note is Michigan consumer sentiment for February. Let's see whether higher prices are causing a further deterioration in sentiment.

⬇ EUR: Backpedalling from the ECB?

EUR/USD has seen a wild ride over the last 24 hours driven by the themes discussed above. In addition, early Asia saw a Christine Lagarde interview hit the wires, where she warned against the ECB acting too quickly on rates and hitting activity and jobs. Clearly, a firmly hawkish tilt at the 10 March ECB meeting (announcing an end to APP) is far from a done deal. Those comments, plus earlier remarks from Bullard seem to be behind the complete reversal of yesterday's EUR/USD rally. And one could argue that the ECB is a lot closer to the Riksbank camp (inflation is purely supply-related, unlike that seen in the US and the UK).

Continued EUR/USD volatility within ranges looks likely - we could see 1.12-1.15 for quite a while. A tough day for risk assets marginally favours a further correction in EUR/USD today to 1.1350 and potentially 1.1310.

Elsewhere, the Riksbank was happy to [defy expectations](#) of less dovish positioning. This has left the krona quite vulnerable. EUR/SEK is currently pressing big resistance at 10.65/66, with a break opening up 10.84. USD/SEK could make a push back to the 9.48 high.

⬆ GBP: Better positioned than some

GBP has been holding up quite well and EUR/GBP looks set to break below 0.8400. Helping GBP is undoubtedly a hawkish central bank, which will stay hawkish to ride out the inflation hump into April/May. At the same time, UK equity benchmarks have a much higher weighting to the Materials sector than some (FTSE 100 has 12% weighting to Materials compared to 2% in the S&P 500), helping UK equities to outperform this year on the stronger commodity sector.

UK 4Q/Dec data released today was mixed and was perhaps quite soft were it not for spending on health. Yet the Bank of England had assumed this already and it looks unlikely to detract from the BoE tightening story - where nearly a 40bp hike is priced for 17 March.

In politics, it sounds like there is some greater momentum towards seeking a resolution on the Northern Ireland protocol (post-Brexit trading arrangements). One longer-term story is the access of UK financial institutions to EU clearing - or 'equivalence'. This access has recently been extended to 2025, but the EU seems to want it to end then. This could turn into a big GBP negative in 2024.

For today, though, we favour EUR/GBP correcting lower to 0.8380.

➔ RUB: 100bp rate hike looks discounted

There will be a lot of focus today on the Central Bank of Russia's (CBR) monetary policy decision. Please see Dmitry Dolgin's full meeting preview [here](#) - views which were also supported by this [week's release of January CPI](#). He expects a 100bp rate hike today, upward revisions to CPI and hawkish guidance which could leave open the door for another 50-100bp rate hike.

On another day, this could all be very positive for the rouble as the CBR continues to display hawkish credentials and Russia runs a large current account surplus, energy prices are high and the CBR's FX buying programme for the budget rule is currently suspended. However, tensions surrounding Russia's military ambitions will probably leave investors reluctant to hold long RUB positions over the weekend - a weekend where Russia has just started joint military exercises with Belarus. Some are also arguing that the CBR could today announce a resumption of the FX buying programme for the budget rule.

However, a bull case could develop for the rouble into next week should the CBR choose to delay the FX buying programme until a much clearer geopolitical picture has emerged. And it would not be a surprise for the rouble to strengthen next week as some speculated over the departure of Russian forces from Belarus were military exercises to end on schedule 20 Feb.

Barring any major new developments this weekend, USD/RUB could make a run at 73.25 next week.

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