

FX Daily: Taking advantage of EUR/USD stability

FX markets have started the New Year backing those currencies with front-loaded tightening cycles. Here Sterling and some of the CE4 currencies have been the strongest performers and been joined by some of the commodity exporters. The next major leg higher in the dollar may have to wait until investors are ready to price Fed Funds rates above 1.50/1.75%.



➔ USD: Look out for ADP and FOMC minutes today

The New Year starts with investors taking a glass-half-full view of the global economy. Equity markets remain close to their highs, industrial commodity prices are moving gently higher and yield curves are undergoing some bearish-steepening - all moves typically associated with growth. The [decision of OPEC+ to resume supply increases from February](#) also looks like a vote of confidence in the demand story, even though Asia and its [zero-tolerance stance to Covid-19](#) create pockets of pessimism (as it did last year).

Fortunately, the US economy looks in [a good position](#), which is keeping the Fed normalisation story and the strong dollar story alive. We'll see more updates on this later today when the minutes of

the December FOMC meeting are released. This meeting was about as hawkish as it could get, suggesting accelerated tapering of the Fed's QE activity and a median expectation for two rate hikes in 2022. It was notable yesterday that the Fed's arch-dove, Neel Kashkari, said he favoured two Fed rate hikes this year.

Perhaps for some dollar bulls the performance of the dollar since that FOMC meeting has been disappointing. Yes, USD/JPY has broken to a new high (higher energy prices have probably played a role here), but broader trade-weighted measures of the dollar are still one percent off the highs seen in late November. Notably, the market has struggled to price the Fed Funds rate cycle above the 1.50/1.60% area over the next two to three years - begging the question of whether everything has been priced for the Fed tightening story?

We think it too early to declare that the dollar bull trend is over, but do acknowledge that some consolidation at higher levels can allow other stories to play out. That seems to be the case with the strong performance of Sterling and some of the CE4 currencies of recent weeks after the BoE pulled the trigger in December and central banks in the Czech Republic (see below), Hungary and Poland have all accelerated their tightening cycles. These trends look set to continue for the near term.

For today we would expect DXY to remain supported in the middle of its 95.50-97.00 range and take its cue from the December ADP jobs figure released at 1415CET and then the FOMC minutes released tonight.

➔ EUR: Stability allows CEE strength to win through

EUR/USD has been trading in a 1.1180-1.1380 range since late November. Our preference is still for the range to be broken to the downside, but this may have to wait until US data is strong enough to convince investors of three Fed rate hikes this year (our house view) and a bigger multi-year tightening cycle. We favour the break lower coming in the early part of the year since through 2H22 the market will start to shift its focus to the first ECB hike, probably coming in March 23. In short, 1H22 may be the window for EUR/USD to break a new low (e.g. 1.08/1.10) before recovery is seen towards the end of the year.

Current consolidation in EUR/USD has allowed some strong performance of the CEE currencies (ex RUB) over recent weeks. Policymakers in Hungary and Poland have embraced the hawkishness long shown in the Czech Republic and are now employing some forceful monetary policy tightening. [Poland hiked rates 50bp yesterday](#), for example. These very attractive implied yields - e.g. 3 month implied yields are now 4% p.a. for HUF and 2.8% for PLN - look set to provide continuing support over coming weeks - while EUR/USD continues to trade its range.

⬆ GBP: Europe's favourite currency

Sterling has had a good Christmas period. On a trade-weighted basis, it has broken to the strongest levels since early 2020. The UK government's decision to power through the Omicron surge with relatively few restrictions seems to have been rewarded by investors. Here the rationale seems to be that an open economy and continued high energy prices will keep the risk of a further BoE tightening in February in play. And remember that UK inflation may not peak until the 6% area in April - compared to Eurozone inflation which may be peaking around now as German VAT adjustments fall out in the base effects.

We had never really backed the idea of a policy error hitting GBP last year and feel that we have a window - probably in 1H22 - for EUR/GBP to test the 0.8275/85 early 20 lows and potentially trade closer to 0.8200.

📈 CZK: High quality, high yield

One of the strongest EMFX performances over recent weeks has come from the much-backed Czech Koruna. Once again the Czech National Bank (CNB) surprised hawkishly, hiking rates 100bp to 3.75% at its late December meeting. Notes from the press conference suggested that the policy rate would be taken well through 4.00% over coming meetings and interest rate derivatives markets price the top of the cycle at around 4.75% this summer.

4.75% would be an exceptionally high yield for one of Europe's highest quality currencies, where sovereign debt is rated AA- and the five year sovereign Credit Default Swap trades at just 40bp - similar to the emerging world's other favourite safe haven, Israel.

Interestingly the topic of the CNB's large FX reserves (US\$171bn) arose at the December press conference. There has been some suggestion that the CNB could start selling its FX reserves to drive EUR/CZK lower and tighten monetary conditions without policy rate increases having to do all the heavy lifting. So far the CNB has said that it will not be using the exchange rate as a monetary policy tool. Yet this month the CNB will start to sell part of the annual income from its FX reserves (it probably made around EUR4-5bn last year) and the topic of the exchange rate playing a role in tightening monetary policy looks unlikely to go away soon.

The 2011 lows near 24.00 beckon for EUR/CZK.

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