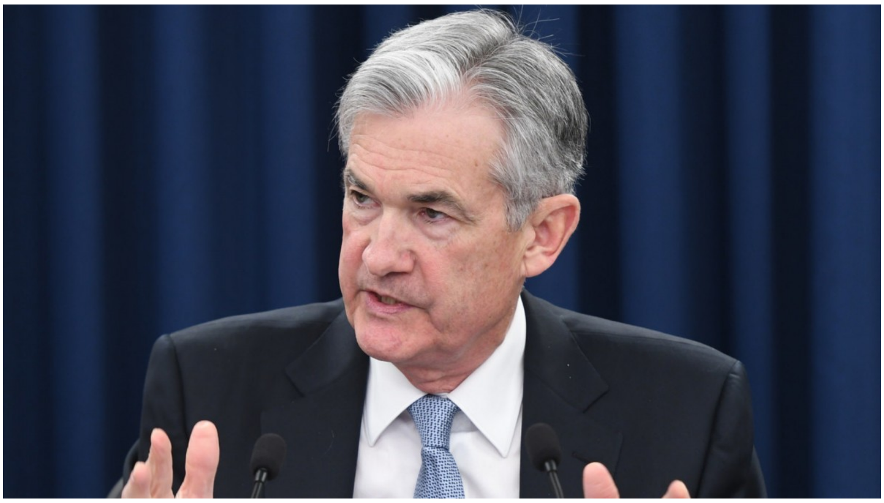
USD: New year, New Fed

The Fed's new dovish tone suggests the dollar will fall against high yielding currencies and emerging markets while the euro and yen will probably lag



Source: Federal Reserve

USD: Fed surprisingly drops forward guidance of further tightening

In a surprisingly dovish move, last night's FOMC statement saw the Fed drop its forward guidance on the need for 'further gradual increases' in the policy rate and instead switch to a data-dependent approach. The global economy (presumably trade wars, China & Brexit) and financial developments (presumably the S&P sell-off in December) were used to justify the switch to a patient and seemingly symmetric bias in policy rates. We had thought that the dollar would top out this year once it became clear that Fed rates had peaked and the dovish shift in the Fed will support that view. Certainly, the bar for further tightening looks a lot higher now, even though our team thinks there is still scope for one to two more Fed hikes this summer. How will FX markets react? High yield activity/commodity currencies have been the top performers in both the G10 and emerging market spaces so far this year – benefiting from the reprieve from Fed tightening and the truce in the China trade war. The renminbi has also recovered about of a third of last year's losses against a basket of currencies. Given overweight positions in the US late last year and under-invested positions of the buy-side currently, we suspect investors will continue to cautiously put money to work in undervalued high yield currencies. They will do this until they see clear signs of a re-escalation in trade tensions (US tariffs on auto imports could be a story mid-February) or there are other signs of a hard landing. This then should mainly be a story of US dollar weakness versus high yield/EM, while the euro and yen will probably lag. However, this Fed story is a big deal and thus DXY support at 95.00 looks vulnerable.

EUR: GDP will be soft, but even EUR/USD gets dragged higher by soft USD

The local focus today will be on 4Q18 eurozone GDP data, which we and the consensus expect at 0.2% quarter-on-quarter. While France & Belgium delivered slightly better than expected readings of 0.3% QoQ yesterday, it looks like Germany and Italy will drag the eurozone number lower – including Italy moving into a technical recession. For today, however, we think the Fed story will dominate proceedings and EUR/USD will test resistance at 1.1570/1620, with upside risks.

GBP: Sticking to the script

EU leaders have a new script that developments in London make a disorderly Brexit more likely. However this should be seen as positioning and even if Prime Minister Theresa May returns from Brussels empty-handed, the prospect of a fresh set of amendments being debated in London on 13/14 February can keep sterling supported.

TRY: Inverted curve helps the lira right now

This is a bond market-friendly environment right now. While aware of risks around local Turkish elections in March, risk-seeking investors will be attracted to the Turkish lira and TRY debt right now, with the Central Bank of Turkey committed to tight policy.

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