FX Daily

(07:02 CET) **18 October 2021**

EUR: the best of both worlds

Asia overnight

Rising oil prices continue to feed investor concerns about inflation and soft China data added to investor nerves, which led to some risk-off trading during the Asian session. China's GDP, IP and FAI data surprised to the downside and retail sales data surprised to the upside. Electricity rationing and Covid lockdowns weighed on growth, according to our China economist. Most Asian bourses were trading lower and S&P futures close to flat at the time of writing. The NZD and USD were the strongest performers in the G10 in the Asian session. The former was given a boost by strong NZ inflation data, but held back by soft China data as well as the extension of Covid restrictions in Auckland. The AUD was weighed down by weak China data as well as AUD/NZD selling.

AUD & NZD: NZ inflation & the divergence between the RBA & RBNZ

NZ inflation came out well above market and RBNZ expectations rising to 4.9% YoY from 3.3% YoY with the cost of building houses the largest contributor to inflation. Excluding a jump in inflation due to a GST increase in 2010, this was the largest quarterly rise in prices since 1987. The RBNZ's sectoral-factor model of inflation (its core measure) jumped from 2.3% to 2.7%, which is not far below the top of its 1-3% target band. The NZ rates market is now pricing in modestly less than a 50% chance of a 50bp rate hike in November. While we expect the RBNZ to continue hiking rates, we are a bit sceptical it would raise rates by 50bp at one meeting. After all, NZ's largest city, Auckland, remains in lockdown and the central bank has said it would proceed cautiously in raising rates given the evolving virus situation. The NZ government has relinquished its zero-Covid strategy and is moving towards a living with the virus strategy as vaccination rates increase. The share of eligible people fully vaccinated in NZ is at 66% and modestly short of the 70-80% considered to be needed for herd immunity. We are short AUD/NZD and expect the cross to take another look at parity in the coming quarters. The RBA Minutes released on Tuesday will confirm the RBA's dovishness and especially its abrogation of responsibility for dealing with Australia's rising house prices. The central bank is leaving it to APRA and its macroprudential measures to cool the housing market, which, among many other things, is in contrast to the RBNZ.

EUR: the best of both worlds

For most of this year, the EUR price action has been driven by two seemingly conflicting factors. The first driver is the role of the EUR as a funding currency for FX carry trades while the second is its appeal as a stable and liquid investment currency that underpins the attractiveness of the Eurozone stock markets and the higher-yielding EGBs. Both EUR features are a function of the policy outlook of the ECB, which keeps the Eurozone rates deeply negative while also maintaining very favourable financial conditions that boost the appeal of stocks and (peripheral) bonds. The latest inflation surge in the Eurozone seems to have precipitated the end of the ECB's ultra-accommodative 'crisis mode' and has recently fuelled concerns about unwarranted tightening of the Eurozone financial conditions and sent the EUR lower. We think that the transition to a less accommodative policy in the Eurozone can be positive for the EUR, if the ECB transforms some of its monetary easing tools (eg, PEPP) into credit easing tools – eg, similar to the OMT or the SMP backstop facilities that were used to fight the Eurozone sovereign debt crisis. In this way, the Governing Council could be able to reduce its monetary stimulus without triggering an unwarranted tightening of the Eurozone financial conditions. In turn, this could make the EUR a less appealing funding and more attractive investment currency.

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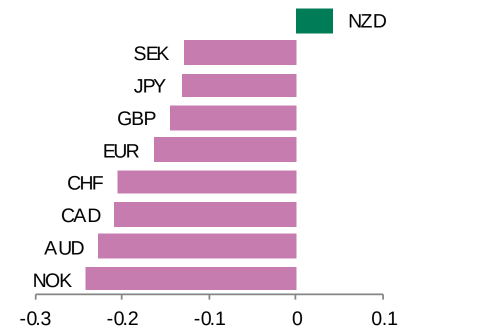
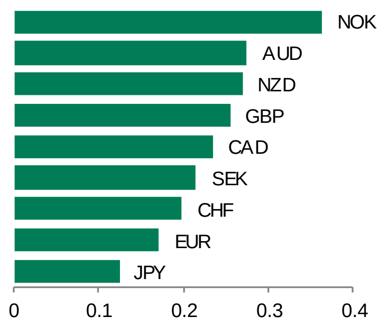
Overnight returns (%, vs USD)



Source: Bloomberg, Crédit Agricole CIB

1M implied volatility daily change (net, vs USD)



Source: Bloomberg, Crédit Agricole CIB

USD: FX position-squaring to remain the dominant driver

The USD lost some ground against most of the G10 FX last week, with the notable exception of the JPY. Given that our positioning indicator still suggests that the USD is the most overbought G10 currency, fresh USD buyers may need some convincing to join the party. In the meantime, the recent USD-longs position squaring could have further to go in the very near term. The latest US macro releases failed to give the USD an extra fillip, as upbeat retail sales for September were largely offset by an underwhelming University of Michigan survey. Today's US IP figures are expected to show that the recovery in production has retained solid traction going into Q421 despite the impact of hurricanes and restrained supply chains. With most of the good news already in the price, the bar seems quite high for the USD to rally on any frothier data, while attention could soon shift to the release of the Fed Beige Book on Wednesday.

CAD: focus on BoC survey as markets assess prospects for earlier hikes

USD/CAD has recently fallen below 1.24 for the first time since early July, thanks to continuing improvement of the Canadian terms of trade as well as resilient market sentiment and relatively steady US rates. October's price action appears reminiscent of Q221 when the pair tested 1.20, with the notable difference that our positioning indicator is still suggesting that the CAD is the second biggest short position in G10 FX. A short-squeeze could thus accelerate a potential further retracement in FX spot. Today, the latest BoC business outlook survey will be closely watched for further evidence that inflation expectations have shot higher while the Canadian companies continue to face difficulties filling up jobs vacancies. Such a combination can subsequently be hard to ignore for the BoC, especially if the Canadian inflation data surprises to the upside later this week. Indeed, with a further QE slowdown to conclude the programme at the end of the year almost a given now, the key upside risk for the CAD is that the BoC front-loads its first expected rate hike to the middle or even H122.