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Stronger USD & higher inflation remain in focus

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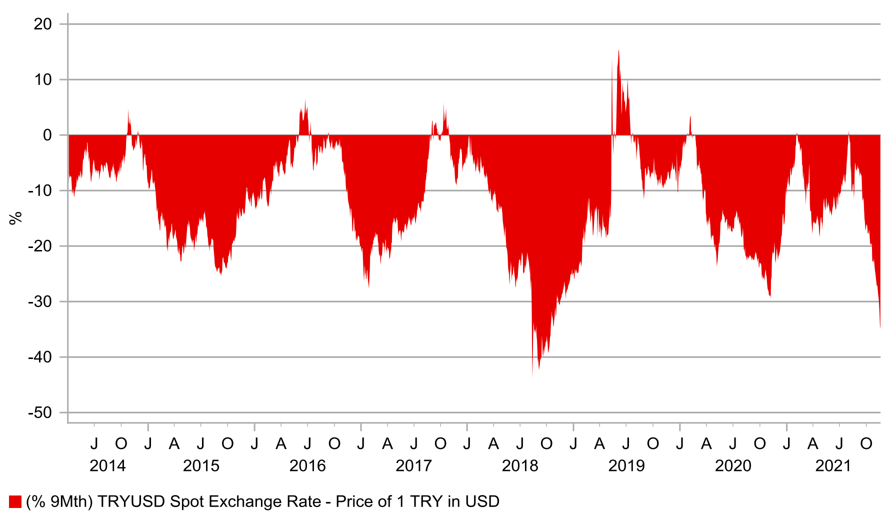
TRY: Sharp lira sell off brings back memories of 2018

The major foreign exchange rates have been relatively stable during the Asian trading session as the US dollar has given back some of its strong gains from earlier in the week when the dollar index hit a fresh year to date peak of 96.241. The main mover overnight amongst G10 currencies has been the New Zealand dollar. It has been boosted by a further hawkish repricing of RBNZ rate hike expectations. The implied yield on the December 2022 New Zealand 3-month bill futures contract has risen by 9 bps to a fresh high of 2.87%. Market participants have become even more confident that the RBNZ will be by far the most active G10 central bank to tighten policy in the year ahead. According to Bloomberg, the New Zealand rate market is pricing in just over 200bps of rate hikes by the end of next year. It would take the policy rate back to the highest level since 2015/2016. The trigger overnight for the further hawkish repricing of rate hike expectations in New Zealand has been the release of the RBNZ's measure of inflation expectations for 2 years ahead that rose more sharply than expected to 2.96% in Q4. It was the highest level since Q2 2011.

WORST TRY SELL-OFF SINCE 2018



Source: Bloomberg, Macrobond & MUFG GMR

Widening yield spreads are encouraging a stronger New Zealand dollar although a lot of tightening is already priced in helping to dampen further upside potential.

The other big mover overnight amongst emerging market currencies continues to be the Turkish lira ahead of today's CBRT policy meeting. Lira weakness has accelerated this week after USD/TRY broke above the 10.000-level. The lira has almost lost a quarter of its value against the US dollar since early September, and extended its losses from the peak in February to just over 35%. It has been the heaviest period of lira selling since the currency crisis in the summer 2018. On that occasion the CBRT helped to restore stability to the lira by raising the key policy rate by 16 percentage points to 24.00% which was set well above inflation that averaged just over 16% in 2018 but did temporarily hit a peak of as high as 25.2%. However, there has been no indication so far from policymakers in Turkey that they a willing to tighten policy this time around. Quite the opposite in fact, President Erdogan emphasized yesterday that he will fight against interest rates as long as he is here, and will not allow people to be crushed under higher interest rates. The comments support our forecast for the CBRT to deliver a further 100bps rate cut taking the policy rate to 15.00% at today's meeting, even if it would be an easy win for the CBRT to defy expectations and leave rates unchanged to provide more support for the lira. A rate cut today would take the policy rate further below inflation which reached almost 20% in October and is set to rise closer to the peak from back in 2018 exacerbated by the inflationary impact from acute lira weakness. So far this year inflation has already averaged 17.6% which was higher than back in 2018.

Recent market developments are making us more nervous over negative potential spill-over effects from Turkey. The most intense phase of the lira sell-off in the summer of 2018 did have a material impact on G10 FX performance. In August 2018, the EUR/USD rate temporarily dropped from around 1.1700 to a low of close to 1.1300 but quickly bounced back before weakening again later in the year. Euro-zone growth did slow in 2018 which was not helped by the sharper slowdown for the Turkish economy which recorded GDP growth of 3.1% in 2018 down sharply from 7.5% in 2017. On this occasion, the Turkish economy has been growing strongly as it bounces back from the COVID shock and is expected to expand by around 9% in 2021. However, there is a building risk of slower growth ahead. The developments could already be contributing to increasingly bearish euro sentiment in the near-term.

CAD: A temporary setback for the Canadian dollar

The other main development overnight has been the continued correction lower for the price of oil. Brent has fallen back below USD80/barrel for the first time since early in October and moved further below the recent peak of USD86.7/barrel from 25th October. It follows a report from Reuters overnight that China is releasing some oil from its strategic reserves. It is unclear if the Chinese authorities are doing so in response to Washington's invitation, or whether they already had plans to do so. It was reported earlier this week that Presidents Biden and Xi Jinping had discussed the merits of releasing oil from strategic reserves during their virtual summit. Washington has been lobbying Asian nations including China, India, Japan and south Korea to join their efforts to increase supply after OPEC+ members failed to speed up plans for production increases at their last meeting. Our oil analyst believes that whilst a coordinated move would be price bearish, such a stockpile releases will only be a temporary and a modest relief given SPRs are stocks not flows. We remain tactically neutral for the price of oil for the week ahead given the counterbalancing forces of (i) OPEC+ remaining resolute to not hike more than its pledged levels; (ii) potential coordinated SPR releases, and; (iii) the return of Iranian barrels. We view these forces will increase oil price volatility as trading liquidity recedes into year-end. Please see our latest Oil Market Weekly for more details (click here).