Dollar Consolidates After Jumping in Line with Bond Yields

The dollar was marginally lower in early trade in Europe Wednesday, consolidating after being pulled higher by rising bond yields and a broad drop in risk appetite as the U.S. returned from a long holiday weekend on Tuesday.

The dollar index, which tracks the greenback against a basket of developed market currencies, was down after hitting its highest level in a week on Tuesday

The main driver for that upward move had been fears of inflation and expectations of aggressive action by the Federal Reserve to contain it. While talk of a 50-basis point hike in official interest rates at the Fed's March meeting is still confined to a small minority, short-term money market futures have implicitly started to price in that risk.

The yield on the 10-Year benchmark U.S. Treasury continued to grind higher in early dealings, however, rising two basis points to a new two-year high just under 1.90%.

The dollar has been boosted by U.S. Treasury yields rising further ahead of next week's Federal Reserve policy meeting.

Analysts expect the Fed to raise interest rates amid a "stable" labour market and rising inflation, said Moritz Paysen, FX trader at Berenberg.

"It is not a question of if, but how quickly and strongly interest rates will be raised," he said.

The sell-off in bonds has not been limited to the U.S. Germany's 10-Year benchmark bond traded above 0% for the first time since 2019, after German inflation was confirmed at 5.3% - the highest since the reunification boom over 30 years ago - in December. At a Eurogroup meeting on Tuesday, Germany's new finance minister Christian Lindner had warned of the need to rein in fiscal stimulus in the Eurozone and reintroduce some more effective limits on government borrowing, in a year when the European Central Bank is set to start winding down its support for Eurozone bond markets.

GBP Hurt by CPI

Sterling was flat against the dollar after data showed British inflation rose 5.4% in December, to its highest level in 30 years, raising rate hike expectations.

Ambrose Crofton, Global Market Strategist at J.P. Morgan Asset Management, said he expects the Bank of England will raise interest rates by 25 basis points in February.

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"The strength of the labour market will give the Bank of England the confidence to continue to remove support for the economy as it looks to get a better handle on inflation," he said. Figures from the Office for National Statistics showed both core and headline consumer prices rising 0.5% in December, well above forecasts. That pushed the annual CPI up to 4.2% and the annual core CPI up to 5.3%.

Other factors supporting the dollar have been the sharp rise in oil prices in recent days, which raises the dollar needs of non-U.S. who have to buy fixed amounts of oil. That factor may ebb a little Wednesday after Turkish officials said that a key export pipeline which had been taken offline after a mystery blast on Tuesday is now pumping at its usual rate again.

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