

China: Fate lies in the hands of Washington

If Washington follows through with its threat of 25% tariffs on \$200 billion of Chinese imports, we would expect another bout of yuan weakness despite the government's attempts to stabilise the currency



Source: Shutterstock

CNY: The fate of the Chinese yuan lies in the hands of Washington not Beijing

The People's Bank of China's reintroduction of the counter-cyclical factor in the daily yuan fixing is a subtle yet significant development in the dynamics for global markets. As we showed in a recent [research note](#), changes in the PBoC's FX policy approach can mark distinct regime shifts and we expect Beijing to now pursue a stable USD/CNY policy – which will: (a) temporarily take a major source of global market risk off the table; and (b) allow for a tactical outperformance of Asian FX versus EMEA FX. But we believe the PBoC's attempts to stabilise the yuan are based on the current US-China trade war dynamics; were we to see an escalation – with Washington following through with its threat of 25% tariffs on \$200 billion of Chinese imports – then we would expect another bout of CNY weakness as the currency adjusts to a weaker Chinese economic outlook (with

USD/CNY possibly moving up to 7.20).

USD: A wider US trade deficit is a double-edged sword for global FX markets

If there's one US data point worth keeping an eye on in the coming months, it's the US trade deficit. The July data showed a widening in the goods trade deficit – but this is like a double-edged sword for global markets. On the one hand, the structural US twin deficit story commands a fundamentally weaker dollar in the medium term. But equally, the wider trade deficit could rile a President that is adamant on boosting US trade and domestic competitiveness – and the threat of more protectionist rhetoric could keep a lid on global risk sentiment. A revision lower in second-quarter US GDP (second release) could weigh on the USD.

EUR: Noisy Italian headlines likely to mean brief and limited EUR/USD rallies

All may not be lost when it comes to the euro's cyclical recovery – especially as leading indicators in Germany look to have turned the corner. But with Italian officials playing 'good cop, bad cop' when it comes to the 2019 budget proposal – with Finance Minister Giovanni Tria reassuring investors that there is no plan to breach the 3% EU budget deficit limit despite Deputy Prime Minister Luigi Di Maio saying otherwise – we expect a level of ongoing Italian budget uncertainty to weigh on Italian assets. Noisy Italian headlines – the latest being the government reportedly calling on the ECB to engage in a fresh QE-style programme to support Italian debt (which sounds absurd) – may keep EUR/USD rallies limited to 1.17-1.18 in the near term.

GBP: A Brexit storm has gathered... but the time to weather it is approaching

Patting ourselves on the back for [predicting GBP to depreciate](#) during a period of heightened Brexit uncertainty would be like high fiving ourselves for carrying an umbrella when it's raining outside. The real value is gauging how long the storm will last and when to be brave enough to resist it. For GBP, the time to weather the Brexit storm is approaching; EUR/GBP's breakout above 0.90 has as much to do with fleeting EUR strength, as it has to do with a Brexit risk premium being priced in (the correlation breakdown between EUR/USD and GBP/USD is a telling sign of the markets' Brexit fears). We think the pair around 0.91-0.92 would be reflecting a significant degree of no deal Brexit risks – and offers good value if one believes that a disorderly UK exit from the EU come March 2019 will, in fact, be avoided. We would prefer to fade this EUR/GBP breakout higher – as risk-reward would not favour chasing the marginal pricing in of no deal Brexit risks.

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