FX Daily: What does the tax deal mean for the dollar?

News over the weekend that the G7 has agreed on international tax reform has had little impact on FX markets so far. That's not a surprise since it could take years for these reforms to be implemented. Yet the key decisions may prompt questions such: as (i) does US big tech keep as much cash offshore and (ii) is paying more tax locally negative for the dollar?

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USD: Little reaction yet from the G7 tax deal

FX markets start what looks to be a busy week in contained fashion. Thursday looks to be the busiest day of the week with the release of US CPI for May and also an important ECB meeting. Before Thursday, the market may mull over the G7 agreement this weekend on a global minimum tax rate and jurisdictional tax changes. Recall the momentum behind this agreement has largely come from Europe levying digital services taxes on US big tech in a bid to tax a fair share of their revenues. A change in the US Administration and a welcome return to multilateralism has allowed this deal to be done.

What will the deal mean for FX markets? We've started to think about this over recent weeks and our early thoughts rest on two (opposing factors) that stem from the two pillars of the agreement. The first pillar of the agreement looks at taxing large multinationals more in the location of where they earn their revenues (i.e. to fight against the transfer pricing of profits to low-tax jurisdictions). The second pillar looks at introducing a minimum 15% global corporate tax rate. By the way, this deal needs to be approved by the G20 in July, the OECD in October and then passed into local regulation, which could take years.

The implications of the first pillar could look slightly dollar negative. US big tech are going to have to pay a larger share of their taxes where they earn their revenues - especially in Europe which has been the source of the digital services tax. Of course, those taxes should be paid in local currencies. The OECD estimates this pillar could bring in an extra $12bn per annum for governments. Though for FX markets the implications could be a little larger since it would be an issue of also switching jurisdictions where taxes are paid.

The OECD estimate that the implications for government revenues are larger from the second pillar - the global minimum tax rate of 15%. Our thoughts here are that the removal tax havens could have implications for the hundreds of billions of dollars of cash parked overseas by US multi-nationals - reducing the incentives to keep cash overseas and perhaps prompting the kind of capital repatriation seen during the Homeland Investment Act in 2005 or more recently under Trump's tax plans. This repatriation of capital would be dollar positive.

Needless to say this is a complex topic and could take years to be implemented. Clearly more work is to be done here.

Back to today, Asian equities are a little mixed after some softer Chinese trade data (chip shortages seem clearly at play here). And the PBOC fixed the CNY a little weaker, suggesting commodity and EM FX may not enjoy the tailwind of recent CNY appreciation. DXY to trade well inside Friday's 90.00-90.60 range.

EUR: Holding steady into the ECB

EUR/USD enjoyed a modest lift after the slightly softer than expected NFP figure. Remember, last month saw the dollar genty offered on a softer NFP, with the FX and Rates markets then looking through the spike in US CPI figures for April. Will the same happen again this week? Will dollar bears survive what could be the peak headline CPI reading of the cycle, which could come in near 4.8-5.0% YoY?

The EUR also sees a really important ECB meeting. These will contain new staff forecasts and the ECB will have to try to say as little about tapering as possible. It seems clear that the ECB would not want a spike higher in the EUR to damage recovery prospects this summer. So Thursday could be a negative event risk for EUR/USD.

For today, EUR/USD could trade out a very narrow 1.2130-1.2180 range.

GBP: Continued fall in EUR/GBP volatility

EUR/GBP continues to trade reasonably tight ranges and 1 month realised volatility trades in the 5-6% area. Persistent narrow ranges have allowed one year implied volatility to drop back to 6.25%, not far from the multi-year low of 6% seen in January 2020. These trends look set to continue this summer as both the UK and the Eurozone continue to enjoy the benefits of re-opening their economies.

Perhaps a key difference between the two is the stance of the central banks. The BoE looks happy to be more upbeat on UK economic prospects than the market and has, so far, done little to cool expectations that the first BoE hike could emerge as early as 2H22. In contrast, one suspects the ECB will reject any ideas of early tightening very quickly. And it would like to position itself as equally if not more patient than the Fed when it comes to tightening. For this reason, we are happy with our 0.85 EUR/GBP forecast for 2H21.

RUB: Front-loaded tightening to keep RUB in demand

The CBR meets to set the policy rate this Friday and looks set to deliver at least another 25bp, if not 50bp of tightening. Front-loaded tightening has been well received in FX markets this year and a continuation of the CBR's hawkish stance should again be welcomed.

Also, expect the Rouble to stay supported into a Biden-Putin summit expected on June 15-16th. We think USD/RUB can continue to hold levels in the 72-73 area.

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