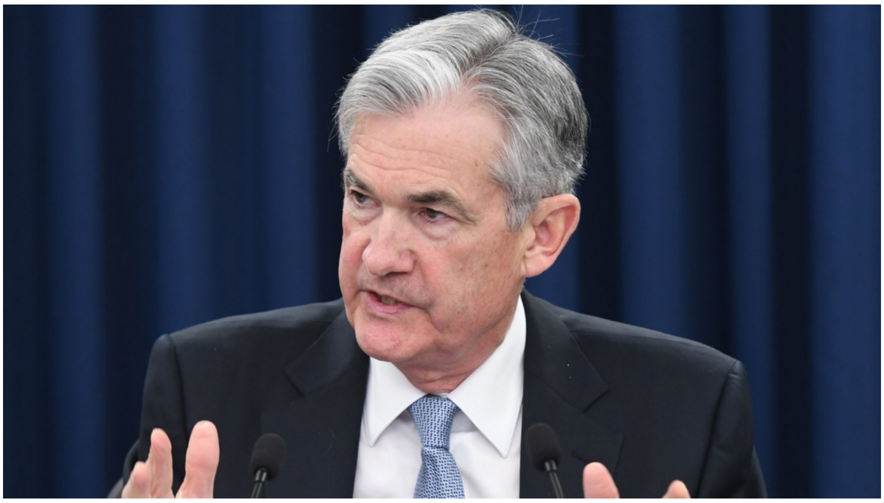
Emerging markets: I say a little Fed prayer

Central bankers gather at Jackson Hole, Wyoming, this week for their annual economic symposium. Will the Fed acknowledge that the market volatility in emerging markets is partly due to its own policy signals?



Source: Federal Reserve

USD: Risky assets hoping for a Yellen-esque Powell at Jackson Hole

All eyes will be on the Federal Reserve in the coming week – with the August FOMC meeting minutes (Wednesday) and the annual economic symposium at Jackson Hole (Friday) in focus. The MSCI emerging market FX index is down by more than 8% since April and for global investors, the question is not only whether the Fed acknowledges the EM market volatility, but also the fact that its own policy signals are playing a part in the broader deterioration in global risk appetite. Under former Fed Chief Janet Yellen, we would be pretty sure that these market conditions would have kept the FOMC in wait-and-see mode. However, Jackson Hole will allow Chair Jay Powell to either reiterate the Fed's role as the global central bank – or make a marked shift and formally adopt an 'America First' monetary policy approach. A Yellen-esque Powell will be a pretty positive outcome for EM assets in the current market environment.

EUR: Consolidation time as a lot of bad news is priced in

The euro is starting to reflect greater short-term domestic political angst; as we noted last week, the link between EUR/USD and peripheral European swap spreads suggests there may be a hefty three-four big figures worth of idiosyncratic European risks (Italy and Turkey) priced into the single currency. But while we feel that a lot of bad news is priced in, we also feel that it may be too early for any of this to be priced out meaningfully. Investors will be cautious over Turkey's medium-term economic plan (and we won't get clarity here until early September), while the next month or so will also see a narrower focus on the risks around the Italian budget (also unlikely to be resolved until September/October). Still, with Turkish markets on holiday from Tuesday this week, the former may be a reduced source of volatility for the euro in the immediate future. Eurozone data wise, we get the August PMI releases and consumer confidence (both Thursday); euro bulls will want to see some signs of consumption and investment intentions returning back online in 2H18.

JPY: Reasons to strategically like a lower USD/JPY with 110 in sight

USD/JPY remains highly sensitive to the changing geopolitical environment – and we expect the pair to remain sensitive to incoming headlines on US-China trade ties and EM geopolitics. While news of US-China trade talks has partially lifted risk sentiment, trading hopes of a better political world have proved to be unfruitful in 2018. The geopolitical reality has been a lot more damning in this new, unnerving protectionist world and on balance, we think that it's more likely than not that additional US tariffs will come in. Either way, with leading US activity indicators starting to soften, we see most future paths pointing towards a lower USD/JPY – and the pair crossing the 110 psychological level could be a big confirmation of this. Stretched short JPY positioning also supports our view.

SEK: Another one set to bite the political dust with risks of EUR/SEK at 10.60

At a time when the global trade outlook is soggy, we see the domestic channel heaping additional pressure on the Swedish krona. Investors are beginning to factor in the upcoming general election on 9 September. Polls suggest the likely outcome is a hung parliament and record support for the far-right, anti-EU Sweden Democrats. A messy election, and potential lengthy negotiations to form a new government, mean that political uncertainty is another bearish SEK factor to price in. Risk of EUR/SEK moving to 10.60 given the negative domestic and geopolitical drivers.

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