

Euro: Under the veil of Italian politics

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Source: Flickr

EUR: Under the veil of Italian politics

The euro declined and the 10-year BTP bund spread widened materially (this time the 2yr BTP also sold off sharply) in response to President Sergio Mattarella's refusal to appoint a populist government of the League and Five Star movement with a eurosceptic finance minister. With the proposed "neutral" government unlikely to obtain a vote of confidence, the probability of early elections (sometimes in September / October) has increased materially. As per [Italy: Last minute showdown](#), current opinion polls suggest populist parties are leading the pack. This, in turn, suggests the veil of political uncertainty is likely to remain, capping any material euro upside and weighing on the currency (particularly if populist parties radicalise their message). That said, we note that some of the euro decline yesterday might have been exaggerated by thin liquidity, as both the UK and the US were closed for a holiday. We also note that EUR/USD now trades with a rather significant risk premium (worth 3.0% based on our short-term financial fair value model, which is well outside its 1.5 standard deviation band). This suggests a degree of cushion against

any pronounced EUR/USD decline.

USD: Still supported despite the drop in UST yields

US Treasury yields reversed in response to the mix of Italian political uncertainty and lower oil prices (10-year UST now trading below 2.90%). While USD/JPY is set to grind lower, the dollar, in general, should retain support particularly against European currencies (the FX segments most sensitive to Italian woes) and emerging markets FX.

JPY: Attractive yet again

The Japanese yen received a boost from the mix of Italian political uncertainty and lower US Treasury yields. JPY will likely stay supported, though we may see some modest reversal in USD/JPY upwards on Friday in response to a solid US labour market report.

TRY: The big leap forward to turn lira fortunes around

In the next big step towards restoring credibility and following a 300bp hike last week, the Central Bank of Turkey decided to simplify its policy set up, making the one-week repo rate relevant again (increasing it to 16.5% from 1 June) and setting up a symmetric corridor around it (+/- 150bp). We see it as positive for the Turkish lira, providing some stability to and scope for outperformance of the currency in coming days (even in the currently challenging environment for emerging market assets). We note that following the pronounced sell off, the lira is extremely undervalued, by around 30% against the US dollar based on our BEER model. Although not our base case, we don't rule another hike at the CBT meeting on 7 June in order for the CBT to cement its improving credibility. We don't expect market concerns about the post-election policy mix to fully subside, though for now, the CBT has made two ultra-important steps to stem the downward lira spiral.