Eurozone: Looking through political risk premium

We think speculation about Italy exiting the euro and/or writing down Italian debt has been exaggerated

Source: istock

EUR: EZ political risk premium to exert a limited effect

EUR/USD continues to trade with a persistent degree of risk premia (around 1.5% based on our finance fair value model) with the previous dollar short squeeze now appearing to be replaced by the eurozone political risk premium. Indeed, as the BTP-Bunds spread spiked this week, so the EUR/USD moved below 1.1800. Yet we note that the market may have exaggerated the headline news that the new coalition Italian government (in the making) wants to exit the euro or/and write down Italian debt (both parties already denied such reports). Moreover, in large part due to the ECB's credible threat to provide a backstop to any risk of EU break up, the eurozone political risk premium as a driver of EUR/USD has diminished meaningfully over the past years (recall the flattish EUR/USD during the summer 2015 Greek crises and the lack of EUR/USD downside ahead of the first round of French presidential elections last year). We thus don't look for any eurozone political risk premia driven EUR/USD downside.

USD: 10y UST above 3.10% does not mean detrimental effect for EM FX

The 10-year US Treasury yield pushed through the 3.10% level, but with EUR/USD still hovering around 1.1800 (and not declining materially), the immediate spillover into the global emerging markets FX space does not look overly detrimental. It will likely take another, more pronounced EUR/USD decline for EM FX to suffer more heavily across the board. The focus still remains on the idiosyncratic stories such as the Turkish lira, where emergency hikes are needed to calm markets and stem the downside. Without it, USD/TRY is likely to move above the 4.50 level persistently.

CZK: Only hawkish CNB will push EUR/CZK lower

Despite the Czech National Bank governor's comments that the CNB may opt for an earlier rate hike than currently projected should the koruna remain weaker than the CNB forecast suggests, the impact on EUR/CZK was muted and the pair has remained above 25.50. Given that a non-negligible degree of tightening is already priced in and still one-way long CZK positioning, we believe the CNB will have to turn to a hawkish mode and deliver earlier and a more pronounced pace of tightening to push EUR/CZK towards 25.00. We continue to expect two hikes this year.

MXN: Banxico pausing the hiking cycle

Mexico's Banxico should keep rates stable at 7.5% (see Banxico Preview) as the stronger peso and inflation data should give central bankers enough breathing room to pause the hiking cycle. Looking beyond today's meeting, the prospects for one additional hike in 2Q remain high, as officials may consider it prudent to continue to support the Mexican peso by matching an eventual Fed rate hike in June. We expect MXN to sail through today's meeting (no change is a consensus expectation), while it is the external environment that is the key driver for MXN at this point.