FX: Brexit deadlock 'broken', reinforcing our target

Breakthrough in Brexit deadlock reinforces our 1.36 target for GBP/USD

GBP rallies on divorce bill breakthrough reports

Sterling rallied by more than 1% overnight on reports that the UK and EU have in principle agreed a Brexit Divorce Bill – with a figure of EUR 60bn being floated around as the net liabilities the British government are willing to pay. While this stage of the negotiations has little economic significance for sterling, the news of a breakthrough in talks has profound political significance for a currency that is pricing in a lot of bad news. We do foresee a 'gentlemen's agreement' over a transition deal as being a bigger positive catalyst for GBP down the road, but for now, we hold the view that small steps forward are helpful for UK asset prices. We now have greater conviction over our year-end target of 1.36 for GBP/USD.

USD: Senate Tax Bill fine print set to include a 'deficit trigger mechanism'

If a jam-packed week for global markets couldn't get any busier, investors are now left to contemplate a potential renewal of North Korea-related geopolitical concerns. While on a relative scale, markets have barely batted an eyelid to the news, President Trump's response of "we will take care of it" suggests that this won't be the last that we will hear of this story. But while North

Korea currently resembles a “boy who cried wolf” risk for global markets, the focus for investors is on the White House’s economic agenda – and the progress being made here.

With the Senate Finance Committee advancing their version of the Tax Cuts and Jobs Act to the floor, a vote on the bill this week has just edged closer – and so too has the likelihood that it is thinly voted through, with GOP Senators Corker and Johnson reported to both now be on board (note that Collins and Flake are still on the fence). But there's a catch: not only are we hearing of big spending cuts being rolled back – begging the question of how a large corporate tax cut will be funded – the bill is set to include a ‘deficit trigger mechanism’ to appease the fiscal hawks. In principle, this means that tax cuts would be reversed in the future if the superficial 3% US GDP growth projections underpinning the tax plan did not materialise – and the fiscal deficit, therefore, ended up being much larger than the Republicans currently foresee (which is arguably an inevitability).

On the real economy side, Ricardian equivalence comes to mind here; the idea that taxes will rise during any future economic downturn boosts the incentive to save any marginal income gains received today. For consumers, this equates to little impetus to spend more, while businesses will also question the merits of investing in long-term projects. Similar logic can be applied to the dollar – which in theory is the price that clears all future expected capital flows. If any short-term inflows into the US economy are expected to reverse, then there is little impetus for us analysts to make sweeping assumptions to our fundamental outlook for the $. As such, we retain the view that any implemented tax cuts will generate some sort of inverted V-shaped profile for the US dollar – with the rise and fall likely to be fairly short-lived in nature. DXY to stay below the 100-daily moving average a (93.43) for now.