FX Daily: Geopolitical turmoil adds pressure to a fragile risk environment

Political developments in Afghanistan could well be adding to the ongoing deterioration of the global risk environment due to Covid and the re-rating of Asia's growth outlook. It's one reason why the safe-haven dollar may find fresh support in a week where the FOMC Minutes could continue to fuel the Fed's hawkish expectations

A helicopter flies over Kabul as the Taliban entered the Afghan city

USD: Plenty of reasons to stay bullish in the near-term

Geopolitical developments in Afghanistan over the weekend are dominating the world's headlines but it is probably too early to assess what could be the fall-out in the FX market. Normally, geopolitical tensions fuel runs for safety and benefit the safe-haven USD, JPY and CHF. For now, those developments are likely exacerbating an already fragile risk appetite, and indeed the JPY and USD have started the week on the front foot.

Away from geopolitics, it will be a week (as discussed in our "G10 FX Week Ahead") where markets will keep a close eye on the minutes from the 28 July FOMC meeting, scanning for hints about how close policymakers saw the US economy to the "progress" mentioned in recent communication, as well as any indications about when the tapering process will start.

It will also be the week where the two most hawkish central banks in G10 will announce policy. The RBNZ in New Zealand should – in our view – hike rates by 25bp on Wednesday (here's our meeting preview note), while the Norges Bank in Norway should announce they will hike in September. Still, with both moves fully priced in, NZD and NOK still have to rely on some improvement/stabilisation in global risk sentiment to see some material benefits.

For now, the global risk environment still has to deal with concerning news as the Delta-variant spread is causing record daily cases (and in some cases, also hospitalisations and deaths) in numerous countries. Asia may continue to see more re-rating of growth expectations as generally low vaccination rates compared to Western economies raise the risk of tight containment measures. China's weak retail sales and industrial production released this morning kept weighing on the region's sentiment. In our view, 6.50 in USD/CNY is a key benchmark to gauge whether markets are decisively shifting towards a pessimistic view. AUD remains the most vulnerable currency in G10 in this sense, as it also has to absorb the negative impact of falling iron ore prices and a serious Covid crisis in Australia.

In such an environment, we expect the dollar to stay mostly bid this week, although some local stories may continue to drive divergence within the G10 and EM space. Domestically, a lighter US data calendar should not drive wide moves in the market. Today, the main release to watch will be the Empire Manufacturing index for August, which is widely expected to have dropped.

EUR: Friday's rally should not have legs

We doubt that the jump in EUR/USD on Friday to the 1.1800 level was the start of a more extended rally. Not only do we continue to expect some pressure on the pair coming from a strong dollar in the short term, but the EUR also seems to be lacking strong bullish drivers: the ECB's ultra-dovish stance is generating a stark policy divergence with the Fed, and any stabilisation in sentiment – paired with the low-volatility FX environment - may see the EUR suffer from its funding character if interest for carry trades re-emerges. All in all, we are inclined to think EUR/USD risks remain skewed to the downside this week, and we could see the pair moving back to the lower half of the 1.1700/1.1800 range.

GBP: Data to keep testing the BoE's optimism

It's going to be a busy week for UK data (employment, inflation, retail sales and PMIs are all due), and investors will likely look for indications that may underpin (or cast doubts on) the Bank of England's relatively upbeat growth outlook. Some more dollar strength could continue to cap GBP/USD and prevent a move to 1.4000, while EUR/GBP may well find fresh bearish pressure if UK data remain supportive for the pound, and move back below 0.8500.

CAD: Snap elections could be good news for the loonie

Canadians will head to the polls on 20 September after Prime Minister Justin Trudeau saw his request for snap elections granted on Sunday. Trudeau has been leading a minority government since the 2019 election, but his party has seen a rebound in popularity during the pandemic and latest polls suggest it could reach the 170 parliament seats needed for a majority government at the September elections. This should be generally good news for CAD, especially if investors expect Trudeau to secure a majority in the parliament, although the magnitude of the FX impact should not be very significant. Canada has already passed huge fiscal support packages since the pandemic hit and can already count on the best vaccination rate in the world. One point where markets may see the positive impact from Trudeau's party gaining full majority is on the oil pipelines issues, as the current coalition allies (the New Democratic Party) strongly opposes some pipeline projects.

Looking at the shorter term, inflation data for July will be the key highlight in Canada this week. Barring a major deviation from June's 3.1% headline figure (and especially if inflation remains above 3.0%), there should not be major repercussions on CAD, as the release should not materially change the Bank of Canada's plans for unwinding stimulus. We continue to expect, by year-end, to see the end of QE in Canada, and to see USD/CAD trade close to 1.20.

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