FX Daily: Remember the China risk factor?

Deteriorating political ties between Beijing and Western economies, along with further signs of a crackdown on Chinese tech companies, have caused a sell-off in Chinese equities, and a risk-off environment to start the week. This could help USD stay supported into the FOMC on Wednesday, while German IFO should be no game-changer for the EUR.

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USD: Focus on China before the FOMC

US equities rebounded strongly last week and closed at record highs on Friday. In the Asian session, gains in Japanese stocks were more than offset by a sharp drop in China's equity indices, which looks set to negatively impact Western risk assets today. The cause is the further deterioration in China's relationship with some Western economies, in particular the UK and US, paired with Beijing's ongoing crackdown on tech companies. The British government is reportedly about to remove China's CNG from all future power plants, signalling a harder line by the UK on China's economic influence. Meanwhile, some high-level China-US talks in Tianjin have started on a somewhat confrontational tone, with Chinese officials saying the ties with the US are at a "stalemate".

China will likely remain a key focus for markets at the start of a week that sees the FOMC meeting on Wednesday as the key event (here is our FX Week Ahead preview). Tomorrow, as the IMF will publish updated forecasts for the world economy, it will be interesting to see whether there will be some downgrade to the Chinese growth forecasts. Any further hits to China-related sentiment (either through the geopolitical channel or the growth expectations channel) should prove beneficial for USD heading into the FOMC meeting, especially versus high-beta currencies and the highly exposed AUD and NZD.

For today, the data calendar is light in the US, with some focus only on the Dallas Fed Manufacturing Activity index, which is expected to have inched higher in July.

EUR: Lots of data, but unlikely to turn the tide

Last week's ECB did not provide enough reasons to the market to speculate on any imminent tapering discussion, or any hawkish shift at all. The relatively limited impact on the EUR was likely a signal that the market was pricing very little in terms of hawkish expectations, but the further shift towards the dovish end of the spectrum of the ECB's strategy review left EUR/USD vulnerable to the downside in the short term. This week will mostly be about data in the eurozone: we will see EZ growth numbers (and likely an exit from technical recession) for Q2 later in the week, while today's focus will be on the German IFO and consensus is looking for an increase in the main indices in July. While further evidence that supply-chain disruptions are not taking a big toll on the German economy is surely a welcome development for the EUR, this will likely prove insufficient to decisively turn the tide for EUR/USD, which we expect to remain unsupported before and after this week's Fed meeting.

At the same time, Eurozone countries' response to the flare-up in Delta-Variant cases remains in focus. So far, the shared approach appears to be aimed at encouraging vaccinations rather than applying new restrictions. Signs that this will remain the approach even if cases continue to rise will likely be needed to avert another re-rating of Eurozone recovery prospects.

GBP: Downside risks persist

In a week without market-moving data in the UK, sterling's upside may remain capped due to the ongoing clash between the EU and the UK over the Northern Ireland protocol. It appears very little downside risks related to this topic are priced into GBP, and a combination with a USD-positive FOMC meeting could make Cable re-test the 1.3600 support this week.

JPY: Good moment may not last long

The yen is finding some fresh bullish interest this morning thanks to the sell-off in Chinese equities and overall risk-off mood in markets. As we head into the FOMC meeting, JPY may continue to benefit from geopolitical concerns, although we think that US big tech earnings releases could help the US equity segment find more support, and ultimately cap JPY gains. The FOMC meeting on

Wednesday could see the Fed acknowledging the above-trend growth and inflation and help USD against low-yielding currencies. With signs that the Olympics are maintaining their schedule despite the pandemic not a game-changer for the Japanese growth prospects (after all, the crowd presence remains strictly limited), we see the balance of risks for USD/JPY becoming increasingly skewed to the upside as the week proceeds.

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