FX Daily: $ bid as EM continues to falter

Trade-weighted measures of the dollar are pushing to the highs of the year as investors both re-appraise global growth prospects and remain wary of early Fed tapering. Emerging equities continue to show massive underperformance and have suffered $15bn of outflows since late July. With USD/CNY now moving above 6.50, the worst may not be over for EMFX.

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USD: Safety in the dollar or should it be the Yen?

Trade-weighted measures of the dollar are pushing to new highs for the year. This comes at a time of bullish flattening in the US yield curve - typically representing a more pessimistic re-assessment of growth prospects. So even though the mood-music from the Fed is very much one of a glide-path to tapering, it looks like a lot of demand for the dollar is coming from investors pulling out of growth stories overseas.

That is most evident in the performance of geographical equity benchmarks. The MSCI EM equity benchmark (heavily weighted to North Asia) is down 1% YTD. This compares to the 16% YTD gains for the MSCI World, led by the 17% YTD gains of the S&P 500. Driving that EM underperformance has largely been events in China - be it local authorities cracking down on tech companies, debt problems amongst some of its biggest name corporates or continued deleveraging in the likes of the property sector. Indeed, this week's potentially positive news of a state-led bail-out of Huarong has been over-shadowed by Chinese developer Evergrande being told to fix its debt problems - and its dollar bonds now trading at 47 cents on the dollar.

We are now worried that the onshore USD/CNY has started to trade above 6.50. Previously there had been a school of thought that the PBOC would like to keep 6.50 intact - and the Renminbi strong on a trade-weighted basis - as it continued to fend off higher import prices. But with commodity prices now falling sharply, will the PBOC now let the Renminbi fall too? Today look out for whether USD/CNH pushes through the recent high at 6.5285. Most vulnerable to such a move will be the commodity FX complex, but also in the EM space we note the CZK has a reasonably high, positive correlation with the CNH. Also the ZAR looks especially vulnerable since its large trade surpluses will now mcome into question.

Pressure on EMFX should keep the dollar generally supported. But if there is a risk that investors move squarely to a glass-half-empty proposition, e.g. as virus cases pick-up in the US, then the chances of a broader equity correction build. Given that speculators have been adding to long dollar positions since late June, it may be better to look for defensive positions in owning the JPY - where speculators are short and correlations with the Renminbi are low.

For today, the US data calendar is very light - just Fed's Kaplan speaking at 17CET - and instead, we expect the focus to remain on the sell-off in the commodity complex and whether the Renminbi does indeed start to see a sharper sell-off. Expect DXY to stay gently bid, with 94.50 looking the direction of travel.

EUR: Saved by its funding currency status?

Normally a big sell-off in the commodity complex and a bullish flattening of yield curves would hit the EUR - traded as a pro-cyclical currency. However, it has been finding a little support - along with the JPY and the CHF - perhaps because of its newfound status as a funding currency. Yet any short-term strength, perhaps to the 1.1740/50 area in EUR/USD, would be position adjustment and again the direction of travel looks towards 1.1600 - and potentially 1.1500 in September.

The Eurozone data calendar looks light ahead of the flash August PMI readings early next week and news from the auto sector that it sees supply chain and semi-conductor disruption lasting until 2Q22 will not be welcome news for the European manufacturing sector.

In addition, our credit strategy team are warning that conditions favour a pick-up in Reverse Yankee issuance - raising debt in EUR for USD working capital - which may also weigh on EUR/USD.

GBP: Hit by the global re-pricing of tightening cycles

Another impact of the loss of confidence in the global recovery is the re-pricing of tightening cycles. GBP had been a beneficiary of a seemingly more confident BoE earlier this month, but is now susceptible to that pricing coming out. For example the GBP 1 day OIS priced 2 years forward could still fall a further 7bp - back to levels where it started the month.

With the risk environment staying fragile, short-term leveraged funds that have recently bought GBP may offload those positions. 1.3570 is a big support level for Cable, below which losses may accelerate.

CZK: At risk of a short term correction

We mentioned above that CZK does have a high correlation with the Renminbi, suggesting CZK could be vulnerable to a further position unwind near term. Indeed, if a theme emerges that tightening cycles need to be re-priced, where 132bp of tightening is expected from the CNB over the next year, then the CZK could see one of its short, sharp corrections.

EUR/CZK briefly traded to 25.64 yesterday and could trade there or even 25.72 again should the Renminbi and broader equity markets come under concerted pressure. Yet expect there to be good demand for CZK on any dips, where the CNB may argue that a weaker than expected CZK may actually give cause for a more aggressive tightening cycle! We still favour EUR/CZK to trade down to 25.20 towards the end of the year.

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