

FX Daily: \$/JPY caught between carry and politics

It has been a quiet week in FX markets. Neither Thursday's ECB meeting nor French politics have managed to move the needle on the euro. USD/JPY is currently the focal point for markets, where powerful incentives for the ongoing yen carry trade are colliding with politics. There could be a case for a slightly softer dollar if President Biden stands aside



The dollar could soften a little if President Biden stands aside

➔ USD: Democrats try to save the Senate

FX markets remain quiet and continue to focus on politics on both sides of the Atlantic. In the US, it looks like the markets think - and the betting odds suggest it as well - that the Presidential contest is a done deal. Former President Trump is given a 61% chance of winning, according to Predictit, while his closest rival is now Kamala Harris at 29%. Joe Biden's chances of winning in November are priced at just 12% and show a conviction in the markets this week that President Biden will step aside. That seems to be the take from the news cycle, where the Democratic party looks to be focusing its efforts on retaining control of the Senate. Were President Biden to step aside, there is a scenario where the dollar could come a little lower on the view that Democrats would have a better chance of retaining the Senate and that we would be looking at a 'Trump Constrained'

scenario.

There is very little on the US calendar apart from a couple of Fed speakers today. The highlight will be New York Fed President, John Williams, speaking on monetary policy at 1640CET. He is seen as mildly hawkish, so any remarks about greater confidence in the disinflation process could be mildly negative for the dollar.

Chris Turner

➔ EUR: French politics fails to dent the euro

The latest developments in French politics reflect the realities of the recent election results. No one party can muster a majority, including to elect the influential speaker of the house position in parliament. This leaves a caretaker government in place largely led by officials from President Macron's party. Threats to France's fiscal position have, therefore, not worsened, but equally progress to address France's 5%+ budget deficit remains distant. That is why the French-German government bond spread is trading steady around the 65/70bp area - i.e. narrower than the 85/90bp peak earlier this summer, but wider than the 45/50bp levels that prevailed before President Macron called snap elections. In short, it does not seem like the euro requires a substantial political risk premium currently.

As to the ECB, one might have thought EUR/USD could have done a little better on the view that a September ECB rate cut was now less likely. As discussed in [our review](#), the ECB has made it clear that there is no forward guidance and sticky services inflation now casts doubt on whether the ECB can indeed cut both in September and December. Yet EUR/USD has softened a little. Perhaps this is a function of a slightly less optimistic for world growth, where the ECB has now switched its short term activity assessment to the downside and [China's third plenum](#) has failed to deliver on (unrealistic) expectations of fresh stimulus.

Expect EUR/USD to stay steady near 1.09 today.

Chris Turner

➔ JPY: Inflation makes the case for a BoJ hike July 31st

Today's release of Japanese inflation for June, we think, adds to the case for a Bank of Japan rate hike on 31 July. Growing prospects of a BoJ hike and a Fed rate cut, plus more strategic BoJ FX intervention seemingly make the case for a lower USD/JPY. Yet USD/JPY has rebounded 1.5% from yesterday's lows as investor demand for the carry trade continues. Here continued low volatility in the rates space continues to encourage yen-funded carry trades. We think USD/JPY will come lower later this year - led by the US rate story - but a major turnaround in the USD/JPY bull trend remains a battle.

Chris Turner

Latam: Staying soft

While yen-funded carry trades might make the case for the out-performance of the high-yielding Latam currencies in Brazil and Mexico, both the real and the peso remain fragile. On the former, the real may receive some support today from news that President Lula is prepared to freeze government spending after all. Yet the market will remain concerned that further fiscal

consolidation will be difficult to achieve when budget plans are reviewed in late August. We expect USD/BRL to continue trading around the 5.50 area.

As to USD/MXN, we revised our forecasts over recent months to the 19 area multi-quarter. Recently USD/MXN tested the 17.60 area amidst the benign carry environment. yet the issue of market-unfriendly constitutional reforms hangs over the peso. These could again hit the headlines in September when President AMLO will try to push judicial reforms through before he steps aside on 1 October. As such, we're still happy with those calls for 19.00 here.

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