FX Daily: Managing Chinese risk

FX markets start the week on a nervous footing, where the biggest threats are faced from: i) the travails of Chinese real estate developer Evergrande and ii) Wednesday's FOMC meeting. Today also sees a tight Canadian election, where a failure to get a clear result may not help a CAD already under pressure as the commodity complex feels the strain.

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USD: Playing it safe with the dollar

The week starts with risk assets under pressure (S&P 500 futures off 0.7%) and the focus very much on how Chinese real estate developer Evergrande will resolve its $300bn debt hangover. Its 2025 $ bonds trade at just 26 cents on the dollar and Bloomberg reports there is focus on whether it meets interest payments on bonds due this Thursday. Most presume that some form of debt restructuring is arranged such that a crisis of confidence does not spread within the Chinese financial sector - the FT reported on Friday that a large Chinese issuer had to issue a press release that it had no exposure to Evergrande or other real estate developers in the news. China is closed today and tomorrow for a holiday, but Hong Kong's Hang Seng index is taking the strain (currently off 3.2%) and USD/CNH has turned bid again. Expect Evergrande to remain a key market focus all week and USD/CNH trading through 6.50 could hit EM currencies, especially the ZAR.

In a very busy week for central bank meetings (ten in large DM and EM economies), the highlight will be Wednesday's FOMC meeting. Read our full preview here. Expect the dollar to stay supported going into the meeting on the risk that there is another important move in the Dot Plots - a move that did so much damage to dollar bears in June. In the background as well, we are starting to hear a lot more about the US debt ceiling and it seems Republicans in the Senate have no interest in voting for an increase in the current $28trn limit. This issue looks set to come to a head in mid-October.

With speculators currently short JPY, look for safe-haven positioning to favour JPY on the crosses this week and USD/JPY could make a run to its recent lows at 109.10. Despite a soft $/JPY, DXY could make a run to the 93.50/70 area as pro-cyclical European currencies stay soft in a risk-averse environment.

EUR: Focus on the crosses this week

EUR/USD is trading towards the lower end of recent ranges as a more cautious tone envelops the market. As we have mentioned recently, September is typically the softest performance month for US equities and with 18% YTD returns for the S&P 500 already, investors may be tempted to switch to more conservative positioning.

After all the focus on the ECB over recent weeks, attention this week turns to central bank meetings in Norway, Sweden, and Switzerland. Norway stands apart from the other two in that the Norges Bank looks ready to hike. However, NOK is a high beta currency and may not enjoy the benefits of a rate hike if global equity markets are under pressure.

The pull-back in some commodities (iron ore on the China steel story) and from emerging markets, in general, is giving the dollar a bid. Although the EUR has been a popular funding currency as well. The Euro's funding status may help it at the margin this week, meaning that support levels at 1.1670/1700 may hold.

GBP: Rates versus risk

UK money market rates delivered a decisive break to the upside last week, yet GBP is starting to struggle a little. This probably relates to the big weightings in UK equity benchmarks of the miners (Metals & Miners have a 10% weighting in the FTSE 100) and the big sell-off in the ferrous complex as China reins in steel production.

GBP in general does not perform well in a weaker equity environment and the balance of risks looks skewed to the 1.3600 support zone for Cable today.

CAD: Risks of more political uncertainty as Canadians head to the polls

Canada holds the second federal election in two years today. As discussed in "Canadian election: Back to square one?", opinion polls suggest we should see Prime Minister's Trudeau Liberals win but fall short of a full majority, with also a non-negligible risk of a surprise win by the conservatives. Either way, it seems quite likely that we'll see another minority government come out of today's vote. A win by the Liberals may see markets welcome the prospect of extended stimulus, but also raise concerns around the energy/pipeline policy impact (where instead the Conservatives have a more market-friendly stance). The extent by which another potential Trudeau government will have to give in to other parties opposition to oil and gas industry subsidies and pipeline projects will depend on how many House seats the Liberals will secure, which will ultimately determine whether Trudeau will be able to continue with case-by-case support by other parties or seek a more structural coalition deal with the New Democratic Party.

However, what we think will matter the most from a market perspective is whether there will eventually be a workable majority. Up until some majority emerges, the Canadian dollar may continue to discount political uncertainty. At the same time, barring the worst-case scenario of a hung parliament and new elections, we still expect a gradual dissipation of political risk in the coming weeks to help CAD close its mis-valuation gap (USD/CAD is 2% overvalued, according to our short-term fair value model) as the loonie may start to benefit more freely from its good fundamentals – and above all, the prospect of more BoC policy normalisation. We still expect USD/CAD to trade below 1.25 in 4Q21.

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