FX Daily: Overestimating the Johnson effect

Markets appear to be overestimating the policy implications of a possible change in UK leadership, which explains the big GBP swings around Monday's no-confidence vote, which the PM narrowly survived. We see downside risks for the pound, but not related to political noise. Elsewhere, JPY remains on a slippery slope, as does AUD despite the RBA's 50bp hike

Britain's Prime Minister Boris Johnson leaves after attending a cabinet meeting in London

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USD: Yen underperformance in focus

Global risk sentiment started to weaken yesterday during the US trading session and stock indices have opened lower across Western markets today. Let’s see whether this triggers some recovery in the bond market, after another material correction higher in yields yesterday has once again proven to be narrowly dollar-positive.

The yen remains the major victim in the higher-yield environment, with USD/JPY breaking fresh two-decade highs and currently trading close to the 133.00 mark. At a time when the prospect of Fed tightening is a major driver of USD strength, the sharply widened differential with the ultradovish Bank of Japan surely warrants a sharp rise in USD/JPY. Yesterday, BoJ Governor Haruhiko Kuroda firmly reiterated that no tightening plans are under discussion, so it may be down to FX intervention (or the threat to deploy it) by Japanese authorities to stabilise the battered yen.

When USD/JPY was last trading above 130.00 – in May – it appeared that verbal intervention may have been enough to stop the JPY selloff. Still, most of the steam out of the USD/JPY was taken from an actual correction in Treasury yields from the 3.12% peak throughout May. Now, markets are seriously testing Japanese authorities' determination to act in support of the currency, and mere verbal intervention may not prove enough this time. For today, some potential correction in global yields if risk sentiment deteriorates may offer a breather to the yen, but unless we see a material recovery and stabilisation in the currency, we'll likely hear more on FX intervention in Japan by the end of the week.

Looking back at the US, the data calendar is very light today and will remain so until Friday, when inflation numbers for May are released. Some risk-off today may offer some support to low-yielders but apply pressure to higher-beta currencies, and we think the dollar will remain broadly supported on balance, as the underlying stories of Fed tightening and good US economic momentum continue to put a floor under the greenback.

EUR: Gently pressing lower

EUR/USD has broken back below the 1.0700 mark, largely on the back of widespread dollar strength. We'll have a bunch of non-market moving data out of the eurozone today and tomorrow, but we might see a decrease in EUR volatility relative to other G10 currencies as a "wait-and-see" approach dominates price action ahead of the European Central Bank announcement on Thursday. Here is our preview of the meeting.

As we discussed in yesterday's FX Daily, the bar for a hawkish surprise on Thursday is set quite high and we see some downside risks for EUR/USD. For today, we expect either some stabilisation or another marginal depreciation in the pair as external factors dominate, and we could see it test the recent 1.0627 low.

GBP: Political impact may fade soon

Prime Minister Boris Johnson survived a no confidence vote yesterday evening, although as many as 148 party members voted to oust him. This is a narrower victory than the one secured in December 2018 by former PM Theresa May, who resigned six months later.

According to the rules, Johnson cannot face another no confidence vote for a year, but lots of commentators are making the point that when this has happened before, leaders have often struggled to carry on beyond a few months given the open division in the party. Accordingly, uncertainty surrounding the leadership is unlikely to fade despite Johnson winning last night's vote.

That said, we currently cannot see any clear implication for economic policy and – by extension – for the pound's fundamentals. Looking at yesterday's swings in the pound, we must remember that UK markets were reopening after a four-day break and that might have contributed to increased trading volumes on GBP. At the same time, it is clear that markets attached some positive implication to the currency from a change in leadership in the UK, and the bigger drop this morning may instead signal some concerns of political instability ahead as the Conservative party appears quite divided and the Prime Minister weakened.

However, we think markets are overpricing the impact of recent political noise on the UK economy and we expect volatility in the pound to decrease over the coming days, with the focus potentially shifting back to other drivers such as the Bank of England's policy or a slowing economic outlook. In our view, downside risks to the pound persist, but they are not strictly linked to the recent political developments. EUR/GBP may soon touch 0.8600 while cable may extend the drop to the 1.2300-1.2350 area in the near term.

AUD: Still vulnerable despite RBA 50bp hike

The Reserve Bank of Australia raised interest rates by 50bp, above the market (25bp) and consensus (40bp) expectations. While flagging the risk of a 50bp move, we thought that the RBA still wanted to “do less” compared to the Fed in regard to tightening. Now, this bigger-than-expected hike means that the RBA has given itself some extra time to turn a bit more data-dependent and possibly default to 25bp increases in the coming meetings even if the Fed goes on with 50bp hikes.

We discuss all this in our RBA Review piece, where we also highlight the reasons behind the very short-lived positive reaction by the Aussie dollar. In our view, this is another testament to how short-term rate differentials have de-linked from AUD/USD dynamics and how markets are still reluctant to turn less bearish on AUD given its exposure to China’s clouded demand outlook.

We continue to expect a drop to 0.7000 over the coming weeks in AUD/USD.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com