FX Daily: Too early to price out a US-China trade war?

We observe that key China proxies like AUD have erased their risk premium on the back of a consensus view that Beijing will secure a deal with the US and prevent an escalation in trade tensions. We suspect markets might have moved a bit too aggressively on the optimistic side, as Trump is arguably in less of a rush to halt tariffs compared to Canada and Mexico

A consensus US-China deal does seem the most likely scenario, but we sense markets are under-pricing the risk of a more prolonged trade spat

USD: Some data to watch amid tariff news

The dollar has continued to lose ground since the US border deal with Mexico and Canada was agreed on Monday. The focus is now on China, and a relatively measured response by Beijing to Trump's tariffs is keeping markets optimistic that some deal can be struck before China's retaliatory tariffs kick in on 10 January. We note that AUD/USD – a key proxy for China sentiment – has entirely erased its short-term risk premium (i.e. undervaluation).

A consensus US-China deal does seem the most likely scenario, but we sense markets are under-pricing the risk of a more prolonged trade spat. Tariffs on China aren't as impactful on US consumers/producers as those on Canada and Mexico, and that allows Trump to take his time to discuss a deal. Indeed, Trump has indicated he is in no rush to speak to China's President Xi Jinping. We suspect the balance of risks for the likes of AUD and NZD – which are pricing in a deal – is skewed to the downside.

In other news, markets are treating Trump's announced intention to take over the Gaza Strip and evacuate Palestinians to neighbouring countries with scepticism. Should we see hints that the US is planning to deploy troops in the Middle East, the market implications can be risk-off, oil-positive and dollar-positive, as Arab nations should firmly oppose the move.

For now, the protectionism story remains the key driver, even though US macro news is regaining some centrality. Yesterday's JOLTS job opening figures painted a less upbeat picture for the US labour market compared to December's strong payrolls. Our economists look with interest at the falling quit ratio, which measures the proportion of workers leaving their jobs for new employers, and is a key indicator of wage pressures in the US. If quit rates fall, it suggests a cooling job market with fewer attractive opportunities, reducing employers' incentive to offer pay raises. The ratio has hovered around 2% for the past six months, aligning with long-term trends and consistent with private wage growth of about 3% YoY. The Fed will likely be pleased with this stability.

Today, we'll get ADP employment figures for January, which are expected to come in a bit stronger than December at 150k. Those have not had good predictive power for actual payrolls, but can still move the market. The other important release of the day is the ISM services surveys; the consensus is for consolidation in the main index around 54, although greater scrutiny should be on the price paid subindex, which spiked to 64 in December, sparking inflation concerns.

We see a bit more room for the dollar to correct lower on the back of optimism about a US-China deal, but as highlighted above, markets are underestimating alternative scenarios. Anyway, the new layer of uncertainty generated by this tariff scare argues against a sustained dollar decline, in our view.

Francesco Pesole

EUR: Still reluctant to chase euro much higher

We stick to our call that EUR/USD will start to lose support once crossing 1.040, as the euro remains broadly unattractive from a macro fundamental perspective and Trump has indicated that the EU should be next on the tariff list. A EUR:USD two-year swap rate gap at -185bp is a mirror of that – via the monetary policy channel – and a key disincentive to chase EUR/USD much higher.

Domestically, the eurozone calendar is quite quiet for the remainder of the week. Trade news will dominate in EUR/USD price action, although we'll be interested to hear whether the slightly hotter-than-expected inflation figures trigger some minor change in the narrative by ECB members. Chief Economist Philip Lane speaks this afternoon.

EUR/JPY downside remains interesting. Japanese nominal cash wages accelerated to 4.8% YoY in December, well above the 3.7% consensus. Real earnings were up 0.6% YoY. That reinforces our call for two rate hikes by the Bank of Japan this year and improves the outlook for the yen.

Francesco Pesole

CAD: A bit more upside room, in the near term

The Canadian dollar is reemerging from the tariff scare and is now up 1.5% since Friday's close. There is a residual 1% risk premium embedded into USD/CAD in our estimation, which suggests some additional room on the downside for the pair if tariff risks are entirely priced out.

That said, we are not sure markets will or should move to a completely optimistic stance on the US-Canada trade spat. Even if the worst-case scenario of 25% duties may be averted (although tariffs are only delayed for 30 days), there are no clear hints Canada could be spared in another round of trade-related, and not border-related – universal tariffs.

So, if in the short term we can surely see a move to 1.42 in USD/CAD, the risks remain skewed to the 1.45 handle towards the summer.

Francesco Pesole

PLN: Zloty is the main winner of NBP hawkishness

Today, the National Bank of Poland is likely to leave rates unchanged again at 5.75% in line with expectations and market pricing. The decision itself should be a non-event. We may get some information from the statement, which last sent a hawkish signal in January. However, the main event will be Governor Adam Glapinski's press conference tomorrow. Both the statement and the press conference in January were strongly hawkish. We can probably expect something similar today and tomorrow. However, it's hard to imagine at this point what more the governor might add to the hawkish message from January. Previously the market did not buy the hawkish message and market pricing quickly saw a correction in the following days. Therefore, we believe the governor's hawkishness has run out and the market may see a more dovish NBP today and tomorrow.

Despite all this, FX is the main winner of the whole story, with EUR/PLN reaching its lowest levels since pre-Covid levels in recent weeks despite all the global volatility. In our view, nothing will change on FX at the moment. Due to the collapse in EUR rates, the interest rate differential has widened again and justifies the current EUR/PLN lows in the 4.200-220 level in our view. PLN rates are pricing in roughly 80bp of rate cuts for this year with the first move in July. The market is visibly focused on a peak in inflation and given our current knowledge of the situation, pricing seems fair to us. Given the peak in hawkishness we discussed here, we may see some pressure for more dovish pricing tomorrow.

Frantisek Taborsky

Authors

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