

## FX Daily: What implications from Italy's latest political drama?

We identify four scenarios for Italian politics as a new government crisis exploded yesterday: the risks for BTPs and the euro are non-negligible. Elsewhere, bank earnings and data will remain in focus in the US today amid mounting global concerns (fuelled by China's grim GDP print). The balance of risks for the dollar remains tilted to the upside



Italy's Prime Minister  
Mario Draghi

### ➔ USD: Balance of risks tilted to upside

Global risk sentiment continues to be challenged by adverse developments across the world. The US banking earning season has kicked off on the wrong foot, China reported the weakest growth numbers (0.4% YoY, vs 1.2% expected) in more than two years, new Covid variants are boosting infection and hospitalisation numbers globally, Italy is facing a new political crisis and markets keep flirting with the idea of a 100bp Fed hike in July.

With fears of global recession adding pessimism to the overall picture, we struggle to see a material recovery in sentiment for now. European equity futures are showing signs of a rebound this morning, but that seems largely related to hopes that Mario Draghi may stay as Italian Prime

Minister. US stocks could continue to feel the strains of multiplying downside risks today.

Equity instability may continue to put a limit to any dollar correction for now, and further upside risks to the greenback may come from a further repricing higher in Fed's rate expectations. Our view is that there isn't enough reasoning to back a 100bp move in July, but the Fed's Chris Waller (a known hawk) suggested that this is not off the table, and we cannot exclude that markets may continue to speculate on such prospect. We'll hear from another big FOMC hawk, James Bullard, today, as well as from the more moderate Raphael Bostic and normally more dovish Mary Daly.

A number of US data releases will also be in focus today. The University of Michigan indices – and in particular the inflation gauges – will be closely watched, but Empire Manufacturing for July, retail sales, and industrial production for June can also have some market impact.

A stabilisation in the dollar around current levels is possible today, but we continue to highlight: a) limited scope for a correction; b) a balance of risks still tilted to the upside in the near term. Expect more volatility around EUR/USD parity to keep affecting other USD-crosses.

## ➔ EUR: Italian political crisis in focus

EUR/USD continued to hover around parity, and to show elevated intra-day volatility. This looks unlikely to change for now unless we see the pair rebound decisively above 1.0150 (safely away from parity) or drop to the 0.9800-0.9900 area. We think the latter scenario is more likely given the still grim macro picture (yesterday's revised EU Commission estimates were a case in point) and lingering uncertainty around the Russia-EU spat on gas supply.

Adding to the eurozone's recent woes has been a sudden return of Italian political risk. [In this article](#), we discuss four scenarios for the country's political crisis, along with the expected impact on BTPs and the euro. In two of these scenarios, Mario Draghi leaves the political picture – either by being replaced as Prime Minister or if early elections are announced. For now, the President of the Republic has asked Draghi to work on a new stable majority, and his staying as PM appears to be a slightly more likely scenario despite a quite volatile situation. He faces a new confidence vote on Wednesday.

The market implications of Draghi leaving would be non-negligible. Italian sovereign spreads have embedded some sort of “Draghi put”, and are surely at risk – especially in the event of snap elections – of widening significantly and calling for another (far from granted) intervention by the ECB. No ECB protection could see the 10-year BTP-Bund spread widen to above 250bp levels. In FX, EUR/CHF has the strongest correlation with sovereign spreads, and we could see further pressure on the pair.

EUR/USD appears primarily driven by other factors (macro picture, Russian gas supply, Fed pricing), but history tells us that political risk can cause a significant build-up in the risk premium on EUR/USD, so that's a threat not to be ignored.

There are no market-moving data releases in the eurozone today.

## ➔ GBP: TV debate for Tory candidates

It will be interesting to see the first TV debate between the remaining five candidates in the Tory leadership contest today, mainly to start gauging what positions on policy and Brexit can be associated with each contender. Rishi Sunak has remained the front runner, while the potentially

most pro-Brexit of the leading group, Liz Truss, looks set to receive a vote boost from the endorsement of Suella Braverman, who dropped out of the race yesterday. This could put Truss as the second-most voted candidate, ahead of Penny Mordaunt, in the next ballot scheduled for early next week.

Away from political developments, the UK data calendar is very quiet and there are no scheduled Bank of England speakers today. Cable looks at risk of moving to 1.1600-1.1700 in the coming days on the back of USD strength, while EUR/GBP may keep hovering in the 0.8400-0.8500 area for longer – unless EUR-specific woes trigger another break lower.

## 📌 AUD: Big divergence between external and internal drivers

The Australian dollar is currently looking at a significant divergence between internal and external drivers. The latest jobs numbers data came in very strong, as [unemployment dropped to the lowest on record](#) (3.5%) thanks to a sharp increase (88k) in employment, driven mostly by full-time jobs, which generally implies a greater impact on disposable incomes than part-time hirings. The RBA takes the labour market into consideration a lot, and we think the latest numbers might pave the way for even larger than 50bp rate hikes. Surely, the 27 July CPI numbers will be a key input.

Despite all this, AUD has remained under pressure this week, and that mostly relates to the currency's much greater reliance on external factors, which arguably look grimmer by the day. China (Australia's number one export market) may face new lockdowns, and the latest data showed a larger-than-expected slowdown. That out shadowed the positive news that Beijing may end its ban on Australian coal. At the same time, iron ore prices continued to be under significant pressure, having now dropped below \$100 on demand concerns.

When adding a still strong USD and unstable risk appetite, we struggle to see an imminent rebound in AUD/USD. We could instead see a further drop to the 0.6600 mark over the coming days.

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