FX: Perennial uncertainty is the one certainty

Italian politics and the threat of a US-China trade war suggest volatility will remain elevated and haven currencies will outperform

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USD: Italian politics masks underlying growing risks of a US-China trade war

The biggest challenge in global markets this year has been finding a dominant narrative. In fact, ‘perennial uncertainty’ is turning out to be the one thing that we can be sure of. Yesterday was a case in point; within the space of say 15-20 minutes we saw headlines noting:

1. the US-North Korea summit may be back on
2. China discontent over the US administration’s decision to follow through with $50bn worth of tariffs on Chinese tech-related imports
3. one ECB member pointing out that the bank is considering a QE taper in June
4. Turkey’s central bank willing to hike rates further (and therefore stabilise the lira – one of the sources of EM weakness)
5. reports that Italy may have fresh elections on 29 July.

These conflicting signals lend themselves to structurally higher volatility in markets, with a modest outperformance of haven currencies over time (long Japanese yen being one of our high conviction themes). Right now, the forces driving the US dollar higher – namely economic and political weakness in the rest of the world – are too difficult to fight. Although we remain structural US dollar bears and see the dollar broadly weakening over a multi-year horizon, the cost of being short USD – and the give-up in carry that US rates provide – is too high. Put alternatively, one needs conviction that the US dollar will weaken by more than the cost to hedge a short USD position (current 3M EUR/USD hedging costs are -2.9%). There's no surprise that this conviction has been lost given the constant feeling of uncertainty – and lack of clear direction – in global markets.

EUR: 1.15 level to act as interim equilibrium until clarity over Italian politics

The honeymoon period for the Euro rally had been over for a while now, with more normalised Eurozone growth momentum becoming a reality. The Italian political crisis has heaped even more pressure on the single currency – and the combination of slower growth and higher political risks is just too hard for investors to ignore. While one cannot rule out EUR/USD falling to 1.10-1.12 this summer, we do think a lot of bad news is already priced in – with the euro currently trading with a substantial 4% political risk premium. Moreover, as noted yesterday, we see three technical reasons why the EUR is unlikely to price in a similar degree of political risk premium this time around (lower contagion risks, a now stronger Eurozone external position, more favourable EUR/USD long-run valuations). For now, look for EUR/USD 1.15 to act as an interim equilibrium until clarity over Italian politics.

CAD: Bank of Canada to drop enough hints in statement for a conditional rate hike signal

Lacklustre macro data, volatile markets and the lack of tangible Nafta progress means the case for a rate hike at today's BoC meeting is pretty feeble. Instead, the main focus is on policy signals in the statement and whether we see strong enough conviction from the central bank regarding a July rate hike – the odds of which have fallen to ~50% after the latest global market rout. An explicit nod towards a hike at a forthcoming meeting is unlikely given (i) the nature of trade and geopolitical uncertainties and (ii) the flat Canadian yield curve (the 2s10s spread is below 35bp) – both of which will keep policymakers wary of any 'front-running' of tightening expectations. Subtle acknowledgement that 'further progress' has been made in the economic recovery may be a sufficient conditional signal for a July hike – leaving the Canadian dollar prime for a rally should global market jitters ease.