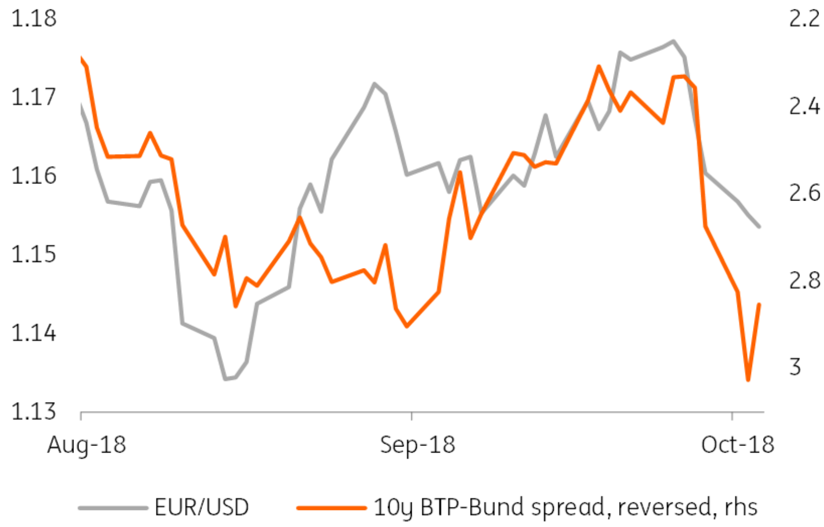
FX: Still a very clouded path ahead

While Sterling remains caught in the Brexit negotiations, we retain a constructive EUR/USD outlook for the next year, expecting the pair to move into the 1.25-1.30 area. And we remain cautious about the extent of the potential upside to emerging market FX as trade war rhetoric may return again

Italy weighing on the euro yet again

Yet again, Italian politics hit the euro - and this time by the higher than expected Italian budget deficit plan which translated into the BTP sell-off and a lower euro. But with the Italian authorities at least signalling their willingness to adjust the path of the deficit lower for the years beyond 2019, the worst for the euro may be behind, for now at least.

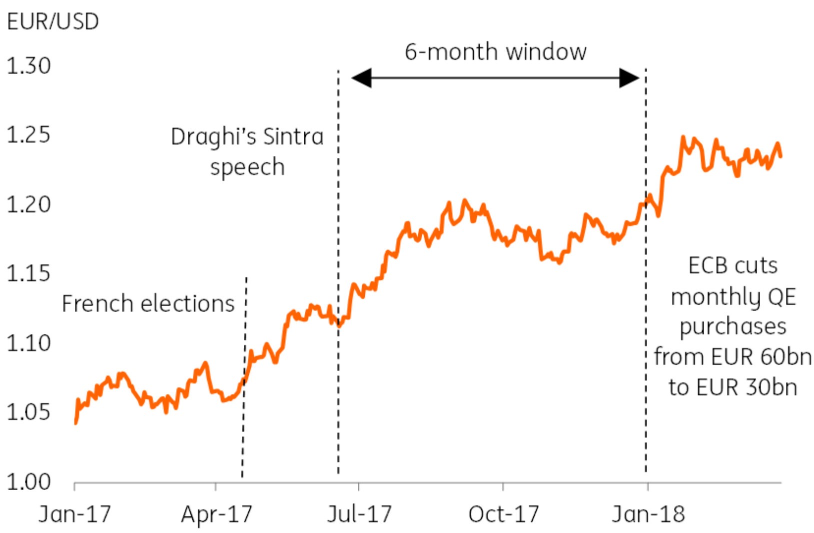
Italian politics yet again sent EUR lower



Source: ING, Bloomberg

Our rate strategists expect the BTP-Bund spread to stabilise below the 300 basis point level. Still, this suggests a fairly limited upside for the common currency into the year-end, with EUR/USD broadly range trading around 1.15. This is in line with the euro "survival" experience so far this year whereby the EUR/USD negative factors such Eurozone politics, a period of higher US growth and interest rates didn't translate into a profound EUR/USD collapse

Markets front run the policy normalisation



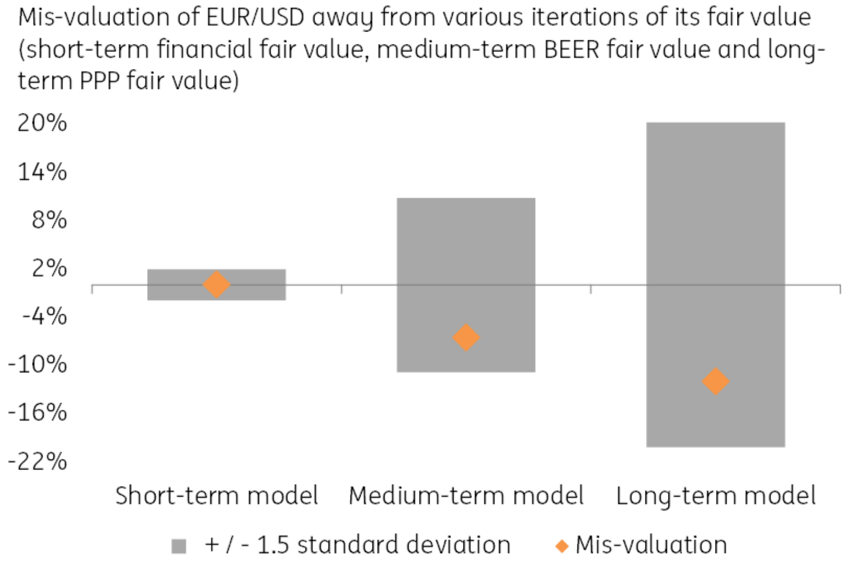
Source: ING, Bloomberg

The 2019 euro outlook is still constructive

We continue to retain a constructive EUR/USD outlook for the next year, expecting the pair to move into the 1.25-1.30 area. The euro should receive a boost from the second step of the European Central Bank policy normalisation – the deposit rate hikes.

But although a story for 3Q19, as was the case with the ECB quantitative easing tapering, we expect markets to front-run the event and start pricing that in the undervalued euro around six months ahead. The ECB President Mario Draghi's comments about the "vigorous" rise in the core inflation supports this view.

EUR/USD is cheap on medium and long term basis



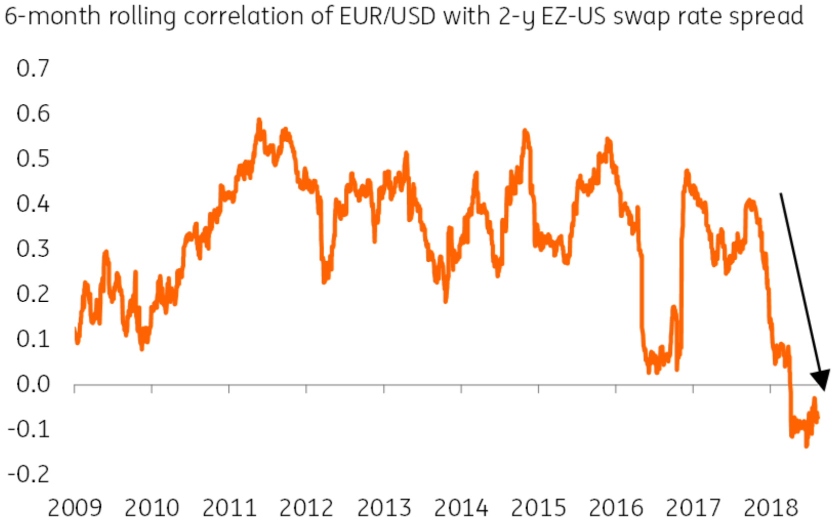
Source: ING

A fair degree of tightening is already priced in for the Fed

On the dollar side, although the Federal Reserve is hiking, a fair degree of tightening is already priced in, meaning that the Fed rising interest rates three times next year (vs two hikes priced in – in addition to the one hike this year) is unlikely to change EUR/USD prospects much.

Indeed, as the figure below shows, the EUR/USD correlation with short-end rate spread collapsed this year, in fact, it turned negative, supporting the view that it was largely one-off idiosyncratic factors driving EUR/USD lower rather than the market materially re-thinking the relative Fed – ECB outlook.

EURUSD correlation with short-end rates collapsed



Source: ING, Bloomberg

Ongoing hurdles for GBP, but hope for some upside potential

With Sterling safely navigating the Tory Party conference event risk relatively unscathed, the focus in October now turns to finalise a Brexit Withdrawal Agreement ahead of the EU summit later this month. Reports that Prime Minister Theresa May will make a concession on the Irish border backstop in the coming weeks – effectively allowing the whole of the UK to remain in an EU customs union beyond 2021, if there is no trade deal in place by then – has helped nudge the dial towards a deal being finalised by year-end.

But there are two hurdles that still need to be overcome before GBP markets can safely price out no-deal Brexit risks: (1) whether Brussels would be willing to play ball on a de facto extension of the transition period beyond Dec 2020; and (2) whether there are enough MPs in the House of Commons to support this type of deal, namely the Democratic Unionist party or the Brexiteer factions in the Tory party.

We continue to warn investors of the possibility of a GBP/USD rebound to 1.36-1.38 in the event of a deal being effectively wrapped up (both informally and legislatively). Any continued impasse would weigh on GBP crosses more meaningfully as we approach year-end.

Cautious about the extent and sustainability of the EM FX rally

As for the emerging market FX segment, the currencies stabilised following the large sell-off, partly due to credible responses from the local central banks (Turkey and Russia) and more attractive valuations. But more importantly, we have seen a tentative pause in the trade war rhetoric. The latter remains the key driver of emerging markets FX, given its negative implications for global trade. As noted above, there is a non-negligible risk of a further escalation in trade wars after the US mid-term elections. This, in turn, means that investors should treat the recent emerging markets FX rebound with great caution given the downside risks ahead.

We also note the ongoing idiosyncratic risks in various emerging market countries

These include the Brazilian elections (though the latest polls point to a more market-friendly outcome), the risk of additional US sanctions on Russia and the latest question marks about how Turkish authorities respond to the sharp rise in inflation (which was above 24%YoY) or sharply rising oil prices hurting currencies of emerging market oil-importers with substantial current account deficits – think the Indonesia rupiah or the Indian rupee.

Hence, despite the seemingly more attractive valuations, the case to turn fully bullish on emerging markets FX isn't strong enough, particularly where the domestically focused Fed is steaming ahead and continues to raise interest rates.

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