FX: The delay in some US tariffs on China and the implications for FX

The announced delay on some of the US tariffs on China is positive news for USD vs low yielding FX such as JPY, EUR and CHF. On the flip side, the dollar should reverse some recent gains vs higher beta G10 FX (AUD) and EM currencies for now. Still, the lack of visibility on trade wars means that this should not be seen as a long-lasting trend

Stronger USD vs low yielders, weaker USD vs high yielders

The news of the delay of some US tariffs on certain Chinese goods (from September to December) is positive for risk sentiment, although the full details aren't yet known. You can see this by the initial reaction in FX markets with higher beta, high yielding FX such as AUD in the G10 FX space outperforming USD (due to the "risk-on factor") while the likes of EUR, CHF and JPY under-performing the dollar (mainly via "higher UST yield factor" - this is particularly the case for the euro). In terms of the latter, the front-end UST yields spiked on the news (helped by higher CPI as well), with the hawkish Fed re-pricing supporting the dollar against the low yielding FX segment.

JPY the most at risk for now

Among the G10 FX low yielders, JPY is to be a key underperformer (at least over the short term) as the current mix of the higher UST yields and the risk-on environment is very negative for the currency. JPY to underperform EUR and CHF with the latter two currencies both exhibiting lower correlation with risk (yet nonetheless suffer from higher UST yields)

Don't chase GBP higher

While the positive sentiment is also spilling over into GBP (mainly on the EUR/GBP cross), in our view sterling should be the last currency via which one should position for a positive shift in global risk appetite. We retain a strong view that any GBP upside is a fade given the rising probability of early elections or a hard Brexit, with both being bad news for GBP and the Brexit factor being the overriding driver for sterling. We expect EUR/GBP to head to 0.95 this summer.

AUD to keep outperforming NZD

Interestingly, AUD has outperformed the NZD despite very similar exposure to the US-China trade war. There are at least two reasons that explain the relatively higher appetite for AUD to play a de-escalation in trade tensions: monetary policy and economic outlook. Both the RBA and the RBNZ have been cutting rates, but the rate outlook in New Zealand appears more unsupportive for the currency.

Not only did the RBNZ show a more aggressive approach to monetary easing (50bp cut last week) but recent comments by the NZ Treasury Department also paved the way for negative rates and unconventional tools. On the other hand, the RBA has not sounded dovish enough - after keeping rates on hold last week – to trigger significant downward pressure on rate expectations. Looking at the economic outlook, weaker business activity and confidence indicators in New Zealand keep pointing at a slowing economy, whereas the Australian fundamentals appear more robust and suggest a better resilience to external shocks. We continue to prefer AUD to NZD.

CEE the underperformer in the EM FX space

In the EM space, CEE FX should lag other EM regions in terms of potential gains as one of the by-products of the delay in China tariffs is lower EUR/USD (due to the higher UST yield channel). This should keep the CEE FX gains vs USD limited. In terms of the knee jerk reaction, CEE FX should be the EM underperformer, with LatAm FX outperforming now (given its high beta) and Asian currencies catching up as well.

Don't get carried away with optimism

Still, the lack of visibility on the trade war outlook means that the above should not translate into a long-lasting trend. That means that the USD/JPY upside is unlikely to last long while the EM FX gains should be limited in scope too – particularly as the uncertainty about the global growth outlook remains in place.

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