FX: The US China bond question

The unpredictability of Trump is a key pillar of our bearish dollar view

Source: Shutterstock

Our dollar view

While unconfirmed reports that China is looking to reduce its US Treasury holdings added fuel to the start of the year sell-off in global bond markets yesterday, we remain somewhat reluctant to chalk this to the current list of reasons for upside risks to global bond yields (ie, rising inflation expectations due to higher oil prices and global QE taper talk). Chinese government officials have since played down these reports – noting that they are merely looking to diversify their FX reserve holdings.

But even reasons for doing this are a telling sign of the USD's medium-term attractiveness – and not too dissimilar to the broader reasons that we have outlined before. For a US economy in the latter stages of its economic cycle, structural factors like the twin deficit risks – as well as the ambiguous economic and repatriation effects of the GOP Tax Bill, relative US asset valuations and the better goldilocks investment opportunities outside of the US – is why we think the dollar is losing its status as an investment currency. But equally, a fragile US political environment ahead of the November midterms also reduces the USD's investment appeal. The unpredictability of an 'America First' Trump is no doubt an unnerving factor for global investors.

The President's State of the Union address later this month could well be a defining moment for markets in 2018; as we've seen with NAFTA break-up noise (albeit quashed rumours), we believe a more anti-trade, 'America First' policy focus would be negative for the USD – especially against the current account surplus currencies like the EUR (end-2018 target of 1.30) and JPY (outside risks of a move to 100- 105 by year-end). Any correction higher in DXY likely to be limited to 93.00.

EUR: ECB minutes – look for any discussion on broader financial conditions

ECB minutes will be the focal point for markets today (1330 CET) – and once again it's worth looking out for any comments on Eurozone financial conditions (which implicitly captures the EUR). The ECB's path of least resistance will be a gradual appreciation in the EUR. Our estimates show that the central bank's 'pain threshold' – that is the point at which currency appreciation starts to weigh on the real economy – is a sharp move above 1.25 this side of summer. With policymakers likely to be wary of this – we expect to see fairly neutral ECB rhetoric, at least until they are comfortable to allow markets to price in the next stages of policy normalisation. For us, that's a summer 2018 story (Sintra Part II) – with EUR/$ moving up to 1.25. For now, broad stability around 1.20 is likely.

CNY: Ignore the noise, gently lower USD/CNY trend still in play for 2018

China has arguably, and unexpectedly, stolen the market spotlight for two days in a row now. On Tuesday, it was news of the PBoC removing its countercyclical factor from its daily USD/CNY fixing mechanism. And despite the initial negative reaction, we actually believe the move should be interpreted as a positive one for the CNY's medium-term outlook – not least given that it signals a greater level of comfort over the PBoC's efforts to liberalise its FX regime. But like the China Treasuries story, we doubt that noise around the removal of the countercyclical factor has altered the general trend. At best, the PBOC will be willing to tolerate a bit of appreciation pressure in the Renminbi this year – and in a weakening $ environment, we expect USD/CNY to gently nudge lower to 6.30 by year-end.