G10 FX Week Ahead: The trade war trap

To truly gauge the long-run market impact of the escalating US-China trade war, we need to look at how Trump retaliates to moves by China (either counter-retaliate or take it on the chin). The likelihood of more protectionist threats means that global asset prices will remain stuck in a 'trade war trap' and lack any clear direction

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EUR: Calm after the storm

	Spot	Week ahead bias	Range next week	1 month target
EUR/USD	1.1616	Neutral	1.1510 - 1.1740	1.1700

- Following the close to three big figure decline after the ECB meeting, we expect EUR/USD to stabilise as (a) the bulk of the adjustment in response to the dovish ECB interest rate forward rate guidance is likely behind us (the market is now pricing in a full 10 basis point deposit rate hike only by the very end of 2019, which is in our view overdone) and; (b) the EUR/USD trades with a persistent 3% risk premium (vs its short-term fair value of 1.20). As was the case in previous months, it was again the eurozone event risk (ECB this week, and negative eurozone data surprises and Italian politics prior to that) rather than the US data (i.e. the hawkish FOMC hike) that has been affecting the EUR/USD.
- With the data calendar rather light both in the US and eurozone, there seems to be limited potential for a more pronounced EUR/USD move. In the eurozone, the June PMIs (Friday) are likely to nudge modestly higher, supporting our and the ECB's view that the previous data weakness was a temporary soft patch and should improve from here.

JPY: Tariff cries suggest it's time to seek safety

	Spot	Week ahead bias	Range next week	1 month target
USD/JPY	110.80	Mildly Bearish	109.50 - 111.40	110.00

- The status quo from the Bank of Japan meeting - and caution over the inflation and policy outlook - has put the yen slightly on the backfoot. Still, Governor Haruhiko Kuroda retained a fairly upbeat view on the economy - with soft inflation the only (and eternal) challenge for Japanese policymakers. The domestic calendar sees May CPI data (Friday) and trade data (Monday).
- With US and China tariffs on the horizon, we would expect USD/JPY topside to run out of steam. Indeed, while we may not necessarily see a sustained flight-to-safety in the yen, we think global markets will remain stuck in a 'trade war trap' for most of the summer - and greater threats of protectionist noise from all major countries will mean limited directional bias in broad asset prices.

GBP: The Bank of England's Silence of the Lambdas*

	Spot	Week ahead bias	Range next week	1 month target
GBP/USD	1.3230	Neutral	1.3130 - 1.3450	1.3500

- While it looked like PM Theresa May had agreed on an amendment with the rebel Tory Remainers that would effectively take a 'No Deal' Brexit scenario off the table, a last-minute addition to the legislation tabled by the government - one that would see any 'meaningful vote' on the Brexit deal in parliament as being a final 'take it or leave it vote' - has left the group of Remain MPs 'apoplectic'. It seems to us that calm heads will eventually prevail and that it's in everyone's interest to avoid the worst case cliff-edge Brexit scenario. But as we outlined in our Impossible Brexit Trinity framework, this continuous Tory infighting ('muddling through') will keep GBP sidelined in the interim period.
- Aside from the politics, the Bank of England meeting next week (Thursday) will require some attention - although the likelihood of a fairly vague policy signal in the post-meeting statement means that GBP should be fairly unaffected. Indeed, the mixed batch of UK data releases over the past week has generally had a neutral impact on the policy outlook - and with Brexit politics and the short-term economic backdrop both highly fragile, we think the MPC will feel little need to send any pre-committing rate hike signal this month. GBP/USD has been also dragged through the wars by a lower EUR/USD (though GBP has still outperformed the EUR); any breach of 1.32 could open up a painful move down towards 1.30.

*Note: 'Lambda' is the term used by the Bank of England to describe the trade-off between stabilising inflation and supporting economic growth. We expect the MPC to remain silent over their current 'lambda' assessment this week.

AUD: US trade and monetary policy a real source of menace

	Spot	Week ahead bias	Range next week	1 month target
AUD/USD	0.7490	Neutral	0.7400 - 0.7640	0.7600

- While a soft Australian jobs release has dented the Australian dollar, the real source of menace remains US policy. On the monetary side, higher short-term US rates continue to weigh on high-beta commodity currencies, while on the trade side, the follow-through of US tariffs on Chinese imports is a particular blow for the trade-sensitive AUD.
- In a quiet week for global markets, we suspect the latter will be the prevailing narrative - and this doesn't strike us a particularly conducive risk-taking backdrop. The June RBA minutes (Tuesday) - as well as Governor Philip Lowe's participation at the ECB's Sintra conference (Wednesday) - are likely to be non-events for the AUD. Look for the pair to remain contained in the 0.7400-0.7600 range in the absence of any further directional catalysts.

NZD: An unsuspecting haven amid trade war turmoil

	Spot	Week ahead bias	Range next week	1 month target
NZD/USD	0.6980	Neutral	0.6900 - 0.7100	0.7100

- While it may appear to have been a difficult week for the NZD/USD - with the pair retreating back below the 0.70 level on the back of a stronger USD - the reality is that we've seen the kiwi continue to outperform its more vulnerable G10 peers. Indeed, against the Australian dollar and Canadian dollar - both of which remain caught in the crossfires of US trade policy - the New Zealand dollar looks like an unsuspecting haven (year-to-date it is around 3% higher against its two dollar-bloc peers).
- Our conviction of NZD outperformance would be higher if there was a solid domestic fundamental story to latch onto. Favourable terms-of-trade have helped thus far - although this channel looks to be steadying. Instead, the focus will be on 1Q NZ GDP in the week ahead (Tuesday); while markets are looking for 0.5% quarter on quarter, the risk of a softer figure is unlikely to fuel any RBNZ tightening sentiment. We'll be keeping a close eye on this release - as any glimmer of hope would see NZD jump to the top of our preferred short-term FX picks.

CAD: Risks are that it goes from bad to worse

	Spot	Week ahead bias	Range next week	1 month target
USD/CAD	1.3280	Neutral	1.2950 - 1.3200	1.2800

- External dynamics are starting to shift into reverse for the Canadian dollar - with both US-Canada trade tensions and lower oil prices weighing on the currency. The former is set to be a perennial threat to CAD this summer - with Foreign Affairs Minister Chrystia Freeland noting that Nafta talks will continue despite both countries pressing ahead with bilateral tariffs on selected goods. On the oil side, the forthcoming OPEC semi-annual meeting (22 June) could see a gradual easing of production cuts (see Crunch time for OPEC). The likelihood is that we'll have seen a peak in oil prices - and therefore limited additional support for the CAD.
- While the net trade effects of US and Canadian tariffs may be cancelled out (we'll address this in a piece later this summer), the genuine risk for the currency is a sharp re-pricing of central bank policy (BoC) expectations. Currently, markets see a July rate hike as a close to sure-fire bet (~75% priced in); should trade tensions with the US escalate, it would be easy to see the Candian central bank momentarily shelve any rate hike plans. Any softening of data would give the BoC an easy excuse to hold fire; the week ahead is fairly quiet but sees trade sales and ADP payrolls (both Thursday).

CHF: Trade wars to be less of a boost for the franc

	Spot	Week ahead bias	Range next week	1 month target
EUR/CHF	1.1580	Neutral	1.1510 - 1.1670	1.1600

- The franc received a boost from the market's dovish reaction to the ECB June meeting. Yet, compared to the safe haven flows into the Swiss franc during the Italian political crises, the EUR/CHF reaction was more muted and short-lived. With the adjustment to the new ECB rate forward guidance behind us, the downside to EUR/CHF should be very limited next week. The likely headline news about US-China tariffs (mainly related to Chinese retaliation) next week should have a limited impact on CHF. This is because, from a risk-off perspective, it is primarily European politics rather than trade wars, which have been driving the franc this year.
- On the data front, the Swiss National Bank has a rate-setting meeting on Thursday. We and the consensus unanimously look for no change. With EUR/CHF lower and CPI at 1.0%, the SNB is unlikely to provide a catalyst for more CHF strength by signalling a tighter policy stance. Any EUR/CHF upside is likely to be bound by the 200-day moving average EUR/CHF 1.1670 resistance.

NOK: Norges Bank to reconfirm divergence from the ECB

	Spot	Week ahead bias	Range next week	1 month target
EUR/NOK	9.4615	Bearish ↘	9.3790 - 9.5320	9.4000

- The key data point of the week is the Norges Bank meeting (Thursday). While the NB is unlikely to increase interest rates just yet, the central bank should stick to projecting a first rate hike in September. This makes the NB a relatively hawkish outlier in the European central banking space.
- With the ECB providing more dovish interest rate guidance, the NB confirming its path of interest rates increases should be NOK supportive and cement the policy divergence. EUR/NOK is likely to test the 9.4000 support level.

SEK: Missing catalysts for a further rally

	Spot	Week ahead bias	Range next week	1 month target
EUR/SEK	10.2250	Neutral	10.1350 - 10.3400	10.4000

- We see the further downside to EUR/SEK as very limited from here. With the Swedish krona rebounding over the past two months, the probability that the Riksbank delivers earlier tightening has decreased sharply.
- On the data front, the focus is on the June Economic Tendency Survey. However, with the dovish ECB June meeting further decreasing the odds of a shift in the Riksbank's monetary stance, the reaction of SEK to any positive data surprises should be more muted. This is particularly the case when the short-term risk premium has been completely priced out of SEK, as our financial fair value model suggests.

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