GBP: Bracing for a volatile week

An eventual extension of Article 50 is our base case but we don't think that will happen this week, and with no short-term risk premium priced into sterling, UK markets could be in for a volatile week

Theresa May, UK Prime Minister

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USD: China trade data to have temporary effect on risk sentiment

Risk assets and higher beta FX dipped overnight in response to the soft China trade data. While the December trade balance improved, the meaningful fall in both import and export components points to a further trade slowdown. Yet we note that the number already reflects a very downbeat market outlook for trade from late last year/very early this year but doesn't reflect the latest tentative signs of improvement in the US-China trade rhetoric. With the Federal Reserve already signalling a pause in the tightening cycle and signs of improvement in the US-China trade rhetoric so far this year, we don't expect today's numbers to have a long-lasting negative impact on sentiment and risk assets.

EUR: Range bound EUR/USD

We expect EUR/USD to remain broadly range-bound during the week, with the possible reversal in optimism about an Article 50 extension (see below) likely to have a modest negative secondary impact on EUR/USD, keeping it below 1.1500.

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The key focus of the week is the meaningful vote on the Brexit deal tomorrow (likely to be voted down by the Parliament). Although sterling started moving last week on rumours of Article 50 being extended, we note that events this week may tame such expectations somewhat. Although an eventual Article 50 extension is now our base case, we see it as likely that after losing the vote on the Brexit deal tomorrow, Prime Minister Theresa May will not immediately suggest extending Article 50, but instead may intend to bring back an enhanced version of the deal (i.e. a May Deal 2.0) aiming to receive more assurances from the EU. Should this be the case, current hopes for an extension of Article 50 may cool somewhat and EUR/GBP move could above the 0.90 level again - particularly given there is no short-term risk premium priced into GBP at this point (vs 3-4% last autumn) as our models suggest. While an eventual extension of Article 50 is our base case, we note that not all scenarios under which Article 50 is extended would be sterling positive (recall, there must be a legitimate reason for it). For example, early elections would bring EUR/GBP to 0.95 in our view.

SEK: Low core CPI supporting Riksbank cautious stance

In Sweden, our economists expect headline inflation in December to remain around the 2% target but core inflation will remain low at 1.4%. This means no change to the cautious Riksbank stance (which already delivered a hike in December, albeit a dovish one). We now see Swedish krona upside as largely exhausted and look for EUR/SEK to converge into the 10.30/40 area. Our short-term model suggests that EUR/SEK undershot its fair value (SEK being 2% rich vs EUR). This should, in turn, limit any further SEK gains.