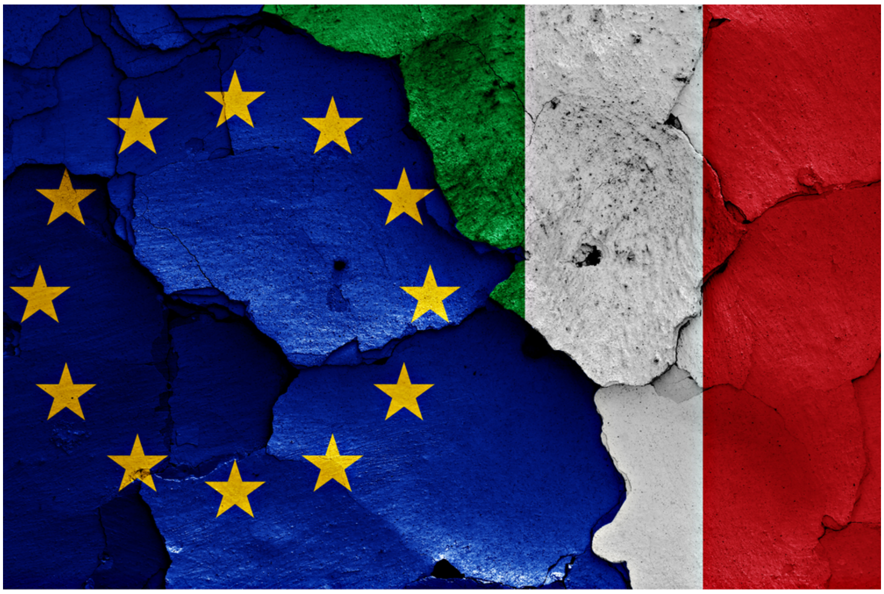
Global FX: Political headwinds strengthen

Global markets, already shaken by last week's dive, start the week in a cautious mood, as Brexit talks stall, Italy gets ready to submit its budget plan to the European Commission and the US prepares to release its semi-annual FX report



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USD: China in focus with US Treasury Report and 3Q GDP data due this week

It's almost strange to think that when considering what's on the cards for global FX markets, we need to be primarily talking about what's happening in relation to China – more so than anything else (including the US economy). This week is no different, with two big events on the agenda: 3Q China GDP (due Friday) and, perhaps more importantly for the FX world, whether the US administration opts to officially designate Beijing a currency manipulator. We do not expect the US Treasury's semi-annual FX report (due anytime this week) to find any economic or technical grounds to label China a currency manipulator; however, this does not give us enough comfort to believe that the Trump administration won't be explicitly extending its trade war into the currency arena. Indeed, with some bending of the rules and discretion, there is a possibility that Treasury Secretary Steve Mnuchin overrides the findings of the report and presses ahead with labelling Beijing a currency manipulator. This scenario would possibly create more of a geopolitical storm –

rather than any practical implications – as it may put a serious dent in the ability of Congress to place checks and balances on US trade and foreign policy. This would be a worrying outcome for global markets. Look for a neutral broad USD trend – as Rest of World FX differentiation emerges as a theme.

EUR: Bad news priced in but messy European politics to keep a lid on things

It's shaping up to be another difficult week of politics for the euro. The highlight will be the Italian government's submission of its budget plan and the response from Brussels. Plans for a structural deficit of 1.7% of GDP for 2019-2021 will not be greeted well by the European Commission and may presumably spark a war of words. We struggle to see Italian officials backing down anytime soon – and this could see the euro come under pressure again. And it's not just Italy that's providing a bit of political discomfort for EUR markets; as ING's Carsten Brzeski notes, Sunday's elections in Bavaria will have created a landslide – not only for Bavaria, but also for German national politics. While the CSU's worst result since 1950 could bring some short-term relief for Angela Merkel – as CSU government members should refrain from starting fights that put the coalition at risk – a hugely disappointing election for the SPD could see internal voices to leave the coalition growing louder. The Hessen state elections (28 October) will be next big test for German politics. With Brexit unlikely to provide European assets with good news this week either, the latest tea leaves for the euro don't make for pretty reading.

GBP: No early Brexit deal isn't a disaster but raises concerns over any rally

GBP markets may want to put the champagne on ice because if the latest reports overnight are anything to go by – then a UK-EU deal on the Withdrawal Agreement at this week's EU summit (Thursday) won't be happening. While no early Brexit deal is not a disaster for the pound, it will surely raise questions over the stability of the UK government – and the degree of political risk premium that needs to be priced into GBP assets. Please see here and here for more details.

EM FX: Not out of the woods just yet but some value to be extracted

Recent stability in Turkey and Argentina is helping emerging market FX, but as we note above, China remains a major vulnerability. We fear a test and marginal break of 7.00 in USD/CNY will undermine the nascent EM recovery. Still, there is some value to be extracted – and the likes of the Brazilian real and Mexican peso may outperform, as investors warm to new presidents. Our latest FX TalkING discusses our big calls in more detail.

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