Italian politics offer relief for euro bulls

We look at what an agreement between Italy's 5-Star Movement and the far-right League party could mean for the euro and why the US dollar rally is starting to fizzle out

EUR: Tentative signs of a bottoming out

News of an agreement between Italy's 5-Star Movement and far-right League to form a government may offer some tentative relief for euro bulls, as it reduces any lingering risk of another Italian election and ongoing political impasse. Any follow-through to euro price action should be minimal as we still await further details on policy proposals, the name of Italy's next Prime Minister and key ministerial positions. For now, it allows for EUR investors to firmly shift their attention to the outlook for the eurozone economy and ECB policy normalisation. This week's data – which includes 1Q German GDP, the ZEW surveys (both Tue) and final April eurozone CPI data (Wed) – is unlikely to give any meaningful directional impetus to the single currency. But there are tentative signs of a bottoming out in EUR/USD – with the latest positioning data showing net EUR longs stabilising.

USD: Time to tactically sell the dollar

There are signs that the counter-trend US dollar rally is starting to fizzle out – most notably with sentiment towards emerging market currencies stabilising after a difficult month or so. Indeed, of late there's been a lot of emphasis placed on widening US rate differentials driving the dollar. But we note that the theme of monetary divergence only typically works under three set pre-conditions:

1. US economic data divergence
2. positive reassessment of US inflation
3. geopolitical-led uncertainty over global growth

The first two are not a long-term concern for us; last week's softer CPI data provided a bit of a reality check on US inflation, while fears of economic underperformance in the Rest of the World look overblown now (Chinese activity data this week will be a strong test of this). It's clear, however, that trade policy and geopolitical uncertainties are unlikely to blow over anytime soon. But in the absence of any 'doomsday scenario' that destabilises global risk sentiment, we could start to see global investors revert back to 'learning to live with Trump'. As such, we do believe that the theme of MEGA: Make Everyone (else) Great Again – that worked so well at the start of the year in FX markets – will come back in play. For now, we see an opportunity to tactically sell the dollar – with GBP and AUD our top picks this week.

GBP: Solid UK jobs report to support tactical upside

Sterling has a chance to regain some of its lost cyclical swagger this week on the back of a constructive March UK labour market report (Tue) – see our Week Ahead for full details. With risks of an August rate hike being underestimated, we look for tactical upside in GBP/USD to 1.37-1.38 – supported by a solid jobs report.

Asia FX: Solid Chinese activity data could help battered EM currencies

With investors looking for signs of life in the global economy, we think Chinese activity data will play a pivotal role in setting the tone for global risk sentiment in the week ahead. Our economist Iris Pang is quite upbeat and looks for fixed asset investment growth to nudge up to 7.7% year-on-year, with retail sales growth also set to remain robust. This will be welcome news to battered emerging market currencies which have been plagued by the vicious circle of higher US rates and a strong dollar. Moreover, the fallout from the surprise Malaysian election outcome looks to be a localised event – with limited signs of a negative spillover into broader EM Asia FX sentiment. Overall, we see tactical upside in Asian-Pacific currencies this week; the Australian dollar is one of our top G10 picks, while the Asia currency index could see a 1-2% move higher.