Not so fast: Currencies struggle to reclaim trade war losses

Despite some promising news on a 'phase one' US-China trade deal, pro-cyclical currencies are struggling to reclaim some of the heavy losses seen since May. We think it is too early to chase recovery stories and stay cautious on risk currencies this quarter

Source: Shutterstock

Limited positives

Those currencies most exposed to the US-China trade war – or the pro-cyclical currencies representing open economies with exposure to the global industrial cycle – have enjoyed a rally over recent days on news that US and China have reached a limited trade agreement. This has surprised markets since President Trump had tended to rule out interest in a partial deal.

However, our team feel there is a long way to go until a comprehensive deal can be secured and most importantly none of the existing tariffs have been rescinded. Equally, the most recent Chinese trade data was as bad as expected and Chinese officials are even now saying they need more talks before signing the phase one deal.

In terms of currency performance and outlook, it's useful to look at the moves seen since 1

May 2019 – that's when the US-China trade truce broke down and President Trump accused China of reneging on previously agreed terms.

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As our chart below shows, only the JPY, CHF and CAD are stronger against the dollar since May, with other currencies in the G10 space generally 2-5% weaker. The worst performers are NZD and the NOK, whilst EUR/USD is down just 1.5% since May. Unless we see significant signs of improvement over the next five weeks, we retain bearish views on most pro-cyclical currencies as outlined in October's edition of FX talking. That means we still see EUR/USD dropping into a 1.05-1.10 range.

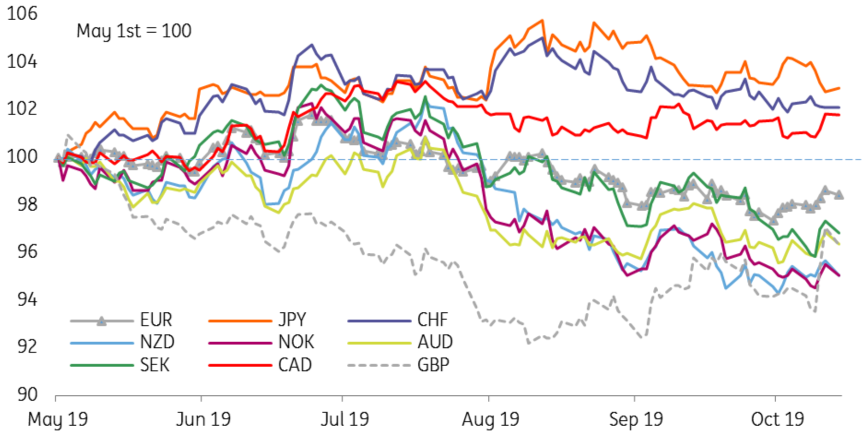
In particular, the global economy remains in the thralls of a slow-down – especially now that US business sentiment is deteriorating as well. No doubt the market will now pay even closer attention to sentiment surveys, such as the PMIs and confidence indices. Unless: i) the Fed cuts aggressively enough, ii) real progress is made on trade, including clarification that the US won't impose tariffs on EU auto imports mid-November or iii) there are more concrete signs of substantial fiscal stimulus emerging from Germany, it's hard to see much of a recovery in business confidence.

Obviously Brexit will play a role here as well, particularly for European FX, and even here we struggle to see a Withdrawal Agreement being passed this month. We thus stay negative on most European FX (excluding- CHF) this quarter.

Elsewhere we continue to favour the JPY. We do note here that Japan's Government Pension Investment Fund's (GPIF) recent decision to carve out more room for foreign bond purchases, seen as JPY negative, but suspect that FX buying from Japanese pension funds does not emerge until USD/JPY is closer to the 105 area. Also, out-performing has been the CAD, buoyed by US consumption and the (somewhat surprising) prospects that the USMCA can still be ratified in Congress.

FX Talking: The Teflon Dollar

G10 FX performance against USD since May 1st 2019



Source: Bloomberg, ING

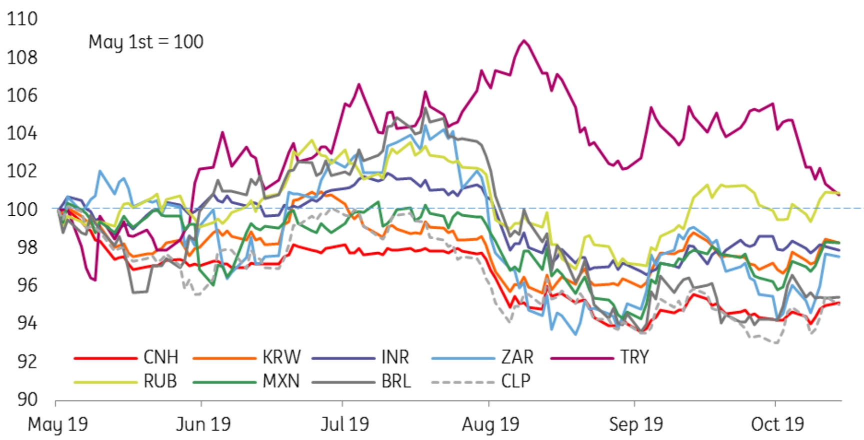
Renminbi yet to unlock a sustainable EM rally

Turning to the EMFX space, we don't see enough US-China trade compromise or reflationary policies in major economies to justify changing our conservative/bearish EMFX forecasts for year-end. We still hold a 7.20 end year forecast for USD/CNY, with most of the Asian FX complex expected to hand back recent gains. Of these, we are most worried by the INR, where growing twin deficits could see recent INR optimism evaporate. Also, look out for a possible rate cut in Singapore hitting the SGD this month.

In Latam, we still have concerns over the MXN, where the sharp slow-down in activity and collapsing inflation warn of an accelerated Banxico easing cycle. In contrast, we think the BRL (still 5% lower against the USD since May) offers some longer-term value at current levels.

In EMEA, geopolitical concerns have seen TRY hand back its mid-year out-performance, while the RUB is one of the few EMEA currencies firmer against the dollar since May. Here better BoP trends in 4Q19 suggest the RUB may be one of the few currencies to out-perform its steep forward curve into year-end. As per the EUR outlook, we expect CE4 FX to under-perform in 4Q19, hit by the on-going industrial slow-down in Europe.

Seleccted EMFX performance against USD since May 1st, 2019



Source: Bloomberg, ING

We do not see enough improvement in US-China trade tensions to prompt an upgrade in our bearish forecasts for pro-cyclical currencies into year-end.

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

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