Our summer of discontent

We expect investors to stay on the defensive over the coming months, as trade tensions escalate and political uncertainty weighs

USD: Trade wars, politics and higher US rates make dangerous cocktail

2018 is fast becoming the year of squandered opportunities for world growth. A fully-fledged trade war, major political risks and what looks to be a Federal Reserve wanting to take rates to neutral and beyond will prove substantial headwinds to growth. Over the near-term, the focus will be retaliatory tariff measures from the EU. As the second-largest economy in the world and with a population twice the size of the US, the EU will be less intimidated by President Trump than some. However, ahead of November mid-term elections, there is every likelihood that Trump will raise the stakes with proposed tariffs on the European auto sector, whose exports to the US are five times as large as the steel and aluminium sector. Trump will feel he has a stronger hand given the relatively closed nature of the US economy (the US vastly outperformed the eurozone in 1Q18) and the tailwind of fiscal stimulus. Which brings us to the Fed. In an articulate speech yesterday, former Fed dove Lael Brainard said the Fed's forward-guidance language 'is growing stale' – perhaps laying the groundwork for a hawkish shift in the FOMC statement 13 June. Add in unsettled politics in Europe and what should be a big win for the left in the Mexican Presidential election 1 July, we expect investors to stay on the defensive this summer. In FX that means the Japanese yen should do well on the crosses with the dollar staying strong. For today, we look for 0.3% month-on-month growth in US hourly earnings (nonfarm payrolls due out at 13:30 BST), which could prove a slight dollar positive. DXY to trade 94-95.

EUR: Some stability in Italy, focus switches to Spain

The euro has found some stability after the Italian populists managed to form a government. The good news for the euro is that the populists did respond to market discipline. The bad news is that the new government will be on a collision course with Brussels, focusing the minds on what concessions, if any, EU leaders have for Italy at the June summit. For today, the focus switches to Spain where the removal of Spain's prime minister now looks a formality in a no-confidence vote. Euroscepticism is less entrenched in Spain than in Italy, but uncertainties about a weak Spanish government won't help the current mood. Charts suggest EUR/USD could have put in a significant low at 1.1510 this week, yet macro events suggest the bounce to 1.1720/1850 will be weak & vulnerability remains.

GBP: Manufacturing confidence coming off the boil

Sterling is performing poorly, failing to hold gains against a beleaguered euro. Trade trends won't be helping. Manufacturing confidence could dip today and if the dollar stays strong, we may consider a 1.31 scenario.

Asian FX: Holding up surprisingly well

We're surprised at how well Asian FX is holding up given the uncertain trade environment. Perhaps it's because equity investors have to invest somewhere.

Author

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