Peak protectionism

Short-term position adjustment could weigh on US assets this week

USD: Washington could go all-in on protectionism this week

Prospects of Washington extending tariffs to the entire range of Chinese imports as well as potentially opting for new tariffs in the auto sector – Trump is scheduled to make a decision by 18 May – creates a difficult environment for investors. Asian FX and activity FX will remain on the back foot and that would typically favour the dollar – especially given the 2.4% cash rates available here. However, we're also waiting to see if and when China retaliates to the latest round of US tariffs. The threat of selling US Treasuries seems too blunt an instrument for China to use, but the dollar could still be vulnerable from a decline in US equities. Here, US earnings look vulnerable to some downward revisions later this year and an all-out trade war certainly wouldn't help. Given a market reasonably long dollar already on the US macro outperformance story, we're a little worried that short-term position adjustment could weigh on US assets this week. We continue to favour the the Japanese yen on a short term basis (108.50 is the risk this week for USD/JPY) and expect the market to remain focused on CNY and CNH. Any central bank fixings of USD/CNY above 6.80 would be a surprise this week and trigger another round of emerging market weakness.

EUR: Enjoying some temporary respite

We think short covering is supporting EUR/USD. We see this as a short term story – after all most still expect the US and China to reach a trade deal by the G20 (28-29 June). Should US equities come off sharply, EUR/USD could trade through 1.1250/65 to the 1.1300/1320 area, but we doubt the market would want to chase it any higher given the threat of auto tariffs being announced later this week. German data should be slightly supportive this week, with May ZEW tomorrow and what should be 0.4% quarter-on-quarter 1Q19 GDP on Wednesday.

GBP: Shifting sands on the Brexit story

A terrible Conservative performance at European elections (23 May) looks fully priced in. It's interesting, though, to see Labour's position subtly shifting on Brexit. It now seems to be formally embracing a 'confirmatory vote' (second referendum). Another strong UK jobs data report could give GBP a brief lift and probably means cable trades in a 1.2950-3100 range early this week.

CNY: Pressing boundaries

The People's Bank of China continues to fix USD/CNY (today at 6.7954) at levels lower than market models suggest. Here they are using their counter-cyclical mechanism (manual over-ride) to prevent momentum building against the CNY. In theory USD/CNY could trade to 6.93 today. We're also monitoring the CNY-CNH basis, where a move through 400 pips suggests extreme pressure is emerging.

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