The dollar: It ain't looking pretty... again

The US fires tariff shots that take risky assets down, but there'll be limited FX spillovers. Here's our look at how currencies could be moving this Wednesday

USD: A mixed day ahead

It didn't take long for the global risk relief rally to turn on its head – with the US administration overnight releasing the list of $200bn worth of Chinese imports that they will seek to impose tariffs on. While it certainly 'ain't looking pretty' for equity markets – with US and European stock futures pointing to a sharp sell-off at the start of trading (taking its cue from Asia) – we note that none of this should be 'new news' for global macro markets (bonds or FX). The US has telegraphed these tariffs well in advance and thus, the economic effects should, in theory, be priced in. USD to gain against EM FX, but flat against EUR and JPY.

EUR: Trade war noise picks up but euro starting to show safe-have resilience

While last week saw the release of strong German data, the ZEW survey index conversely indicated that market participants are not fully convinced over an economic rebound. Yet, we don't blame investors for their negative sentiment given that trade wars are escalating and the USTR continue to drip feed tariffs on China. It's difficult to anticipate which sectors will be hit the hardest from the geopolitical uncertainty which ultimately clouds the outlook for the Eurozone economy – and by extension ECB monetary policy. It will be interesting to see what President Draghi has to make of all of this – he's speaking today and we don't expect the ECB chief to deviate much from the script of cautious policy normalisation. Expect a risk-neutral EUR/USD to stay stable around 1.17 today.

GBP: What will the Governor Carney make of all this political uncertainty?

Governor Carney speaks today and as we noted earlier this week, the Bank of England's post-Brexit policy reaction function goes beyond economics – officials have explicitly conditioned their policy outlook on the assumption of a 'smooth Brexit adjustment'. Even the slightest of political risks (and a political leadership vacuum is by no means trivial) could see the MPC hold-off on raising rates in the short-term.

The biggest initial risk to GBP from a period of heightened political uncertainty is a one-off dovish BoE re-pricing in markets, while odds of an Aug BoE rate hike have now bounced back to 72% following yesterday's solid May GDP print and a stabilisation in UK political risks. Were this to be fully priced out (ie, effectively drop to 0%), then we could see GBP/USD fall sharply below 1.30. What's clear is that it'll be politics – not the current state of the economy – that will be the catalyst for this sharp re-pricing in BoE policy bets and GBP rates. Carney is unlikely to comment explicitly on UK politics (for obvious reasons), but it'll be interesting to see if there's any subtle shift from last week's hawkish bias.

CAD: Not convincingly pricing in a BoC hike today, upside risks if Poloz delivers

Judging by the Canadian dollar's choppy price action this week, you wouldn't think that the Bank of Canada are about to hike rates. But they are expected to do so today – with markets pricing in an 88% probability of 25bps rate increase. Investors will be focusing on the overall tightening path signalled by BoC officials; should Poloz keep the door open to another year-end policy move, then we could see the CAD OIS curve steepen further – lending support to CAD (not probability of another 25bp hike by year-end is only at 38%). If this was a pure interest rate and global risk story driving the loonie, we estimate USD/CAD to be in the 1.29-1.30 range (short-term fair value). A BoC rate hike today could see a correction down towards this area – not least as markets unwind bearish CAD positions.

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