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Article

For the US dollar, the only way is not up

If the global trade war ratchets up further over the coming months, we do think there are a few glaring mispricings in markets

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USD: While tariffs don't make you, they can certainly break you

News that US motorcycle company Harley-Davidson plans to shift some of its production away from the US due to retaliatory EU tariffs eventually filtered its way to the top of the White House yesterday – with President Trump tweeting that he was 'surprised' over the company's decision to 'wave the white flag'. The president's dismissal of Harley-Davidson's decision is indicative of an administration that is not overly concerned about the potential backlash from its nationalist policy agenda. And it suggests no single person or business will be able to stop the current trade warpath.

If that's the case, then the landscape for FX markets looks set to remain murky this summer. If the global trade war does indeed ratchet up over the coming months, we do think there are a few glaring mispricings in markets – especially when it comes to assessing how the US dollar performs in this scenario:

- Expectations for US growth, and by extension Fed policy tightening, have shown little sign of adjusting to the global trade war paradigm. It seems a little baffling to us to see consensus US GDP growth expectations for 2018 continuing to nudge higher (currently 2.90%) – despite an unprecedented degree of uncertainty over the global trading system. If the Harley Davidson anecdote is anything to go by, the US economic outlook is not immune to any trade war escalation – and small retaliatory tariffs from a large number of major trading partners will most likely surmount to something noticeable. In that case, it's also difficult to see the Fed pressing ahead with another two hikes this year – and three next. At this stage, the 70-80bps of Fed tightening priced into markets over the next year looks more like a headwind for the dollar.

- The USD's role as a safe-haven currency should not be overstated given its large negative net international investment position. Although one should expect the dollar to exhibit its typical safe-haven characteristics against risky emerging market currencies in any global trade war – as the evidence has clearly shown over the past few months – the same cannot be said for how the USD fares versus current account surplus currencies like the euro and Japanese yen, if there's a sustained move lower in global markets. Indeed, the euro may have been pro-cyclical in recent months (and sensitive to a deterioration in risk appetite). But if things were to get worse, we'd expect the euro to revert back to being a safe-haven.

EUR: Climbing from its post-ECB lows but still stuck in a broad 1.15-1.18 range

It’s a fairly quiet day in Europe – but look out for speeches by the European Central Bank's Benoit Couere and Bank of England's Ian McCafferty (both could be modestly supportive for EUR and GBP).

CNY: There may be better ways than FX for China to play the trade war game

The narrative that China will use the potential weapon of ‘yuan devaluation’ in any looming trade war with the US seems a bit misplaced to us. If one views it from the lens of the Chinese, any self-engineered weakening of the yuan is an inefficient way to deal with a more protectionist White House. We make three general observations here:

1. A weaker currency doesn’t (fully) offset any lost competitiveness stemming from tariffs.
2. Tariffs tend to have a sectoral effect, while the currency impact is broader and provides less targeted support for those companies directly in the firing line.
3. The cost of devaluation – and the risk of fuelling capital outflow sentiment (as we saw in late summer 2015).