US tax plan unlikely to reignite inflation

We're expecting Republican tax proposals later this Wednesday

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USD: GOP tax plan unlikely to prompt re-pricing of US reflation prospects

There were enough ‘ifs and buts’ in Chair Yellen's speech for both market hawks and doves to cling onto their a priori views on Fed policy. While it seems as if the Fed Chair is intending to sign off on her term with one final rate hike in December, this story is now all but priced into short-term US rates. In fact, the near-70% probability of a Dec hike priced into markets presents a near-term headwind for the dollar, with only the slightest whiff of bad news – from either soft US inflation data or political uncertainty – prompting markets to lower their expectations of a year-end hike.

The spotlight today will be on the unveiling of the GOP 'Big Six' tax plan.

There is no set time for the release, though we note President Trump will be giving a speech on this in Indiana around 1700 ET (2100 GMT). While we may see some headline-driven moves in US yields and the dollar, we think markets have learnt their lesson from earlier this year of buying into tax reform promises too early. We stick to two basic 'trading principles':

- The economic benefits of tax reforms supersede tax cuts and
- A tax plan has to make political and economic sense.

On the political front, with the failed Obamacare repeals still fresh in investors' minds, there needs to be enough credible revenue-raising measures (beyond dynamic scoring) for the deficit hawks in Congress to sign off on the tax plan. On the economics, reforms, such as shifting to a territorial tax system and allowing for full capital expensing, would be positives for long-run US investment.

We're not holding our breath on today's tax plan ticking our 'trading principles' at this stage and prompting markets to seriously reprice US reflation prospects. But with the USD in 'correction mode', sentiment may drive it higher (DXY to 93.50/60). The true test, however, will be how far the US 10Y yield – as well as metrics like the US 5Y5Y inflation breakeven rate – can move on today's tax plan unveiling.

EUR: Keep an eye on EUR/CZK

We see a 40% chance of a rate hike by the Czech National Bank this Wednesday. The German elections may have provided a reality check on how investors evaluate eurozone political risks. Adding fuel to the fire may be noise around the Catalan referendum – which might still go ahead this Sunday, despite Spain's constitutional court declaring the vote illegal. Negative political sentiment may keep the EUR/$ on the back foot, but material downside today is unlikely in the absence of a credible GOP tax plan. Look for the 1.1740/60 support to hold. In the Czech Republic, the CNB meet today (1200 CET). Though we're leaning towards a November hike (60% probability), we do see a 40% chance of a second rate hike today. See more details on that here.

CAD: Poloz in focus

Another focus today will be on the Bank of Canada's Governor, Stephen Poloz's speech; it'll be the first time we'll have heard from him since the central bank's second successive rate hike this month and we wouldn't be too surprised to hear caution over the prospects of additional near-term tightening. We believe a pause in the BoC's hiking cycle may be warranted and a more dovish Poloz could see the ~70% probability of a December BoC rate hike priced out as markets push back expectations of the next policy move. Risks are for the USD/CAD retrace to push up towards 1.2470 (23.6% Fibo level); a more pronounced correction could even bring in the OECD PPP fair value level at 1.27, which is our year-end target.