USD: Let's talk about tax maybe

Congressional leaders in the US are set to unveil details on proposed tax reforms this week but leaked reports suggest investors have good reason to remain sceptical

Source: istock

Theme of the week: Trump tax package still nowhere near the endzone

Congressional leaders in the US (the 'Big Six') have promised to unveil more details on proposed tax reforms this week. Leaks on Capitol Hill suggest that the package will contain household tax cuts – including a lower top individual rate, with the corporate tax rate being cut to 20%. While such a tax plan is unlikely to be revenue-neutral, last week's deal by Senate Budget Committee members to allow for a $1.5 trillion increase to the budget deficit over the next 10 years has given the Big Six some fiscal leeway.

We take the view that tax reforms have to make both political and economic sense for markets to seriously reprice US reflation prospects. On the political front, deficit hawks are unlikely to be convinced by dynamic scoring as a way to balance the books, while GOP centrists won't be overly happy to see tax cuts for corporate America and the wealthy. On the economics of tax reforms, policies that fail to address the low productivity and infrastructure issues facing the US economy are unlikely to yield the same long-run growth benefits as straight tax cuts. Overall, the lack of credible details on how lower taxes will be paid for means that we are not expecting any change in the current sceptic tone within markets over a Trump tax package.

Elsewhere, the Fed story is a major risk to the dollar this week. We suspect markets may have misinterpreted the signal from the dots last week, with the market-implied probability of a December rate hike shooting up to 60-65%. Fed talk this week – including a speech by Chair Yellen (Tuesday) – may show that the dots are not a firm commitment to a December rate hike. We think that the flattening bias in the US rate curve is set to remain in place – especially with Fed officials downgrading their neutral rate estimates by 25bps and signalling greater uncertainty over the extent of current hiking cycle. The bottom line is that chasing dollar strength on any Fed tightening hopes has limited upside potential and will ultimately prove unfruitful.

Majors: Trump tax plan, German elections and Brexit talks

GOP tax reform talk, Fed policy debate and rising US-North Korea tensions set to provide conflicting narratives for the USD this week, while the fourth round of Brexit negotiations may put Theresa May's Florence speech into some perspective for GBP markets. In Europe, flash EZ CPI data for September will test the ECB's hawkish resolve ahead of next month's meeting.

EUR: European integration suffers a setback

- GOP leaders have promised to release details on tax reforms this week. The devil will be in the detail when dissecting any USD positive factors stemming from repatriation tax breaks or lower corporate taxes. Overall, we take the line that tax reforms have to make both political and economic sense for markets to seriously reprice US reflation prospects; the lack of credible details on how lower taxes will be paid for means that we are not expecting any change in the current sceptic tone within markets over a Trump tax package. Core PCE inflation (Friday) will be the main data point in the US, while the array of Fed speakers on show are likely to highlight the dichotomy within the committee on the Fed's policy trajectory. Dovish cries may prevail in the absence of any convincing economic data, while most officials may see it as too early to give any firm commitments to a Dec rate hike. This presents downside risks to the 60-65% probability of a year-end policy move priced into markets.
- Sunday's German elections saw a disappointing result for Merkel's CDU/CSU party and the centre ground in general. The right-wing AFD picked up the protest vote from Merkel's refugee policy. The results have slightly weighed on the EUR, although the prospect of normalised ECB policy is providing a strong backstop. Both President Draghi speaking (Monday) and Eurozone flash CPI data (Friday) may test the market's hawkish ECB resolve.

		Week ahead bias	Range next week	1 month target
EUR/USD	Spot ref: 1.1930	Neutral	1.1830-1.2050	1.20

Source: Source: ING

JPY: Snap election to inject short-term political uncertainty

- Prime Minister Abe is expected to announce a snap general election for 22 October at a press conference scheduled on Monday. The tactical move is aimed at shoring up the current coalition's two-thirds majority in the lower house, while also securing a mandate to press ahead with Abenomics and further reflationary policies. Local media reports suggest that the Japanese PM may be willing to abandon the policy of fiscal discipline and introduce corporate tax breaks to foster economic growth. Investors are likely to be wary of the positive implications of any modest fiscal easing, while the prospect of higher budget deficits may warrant a larger fiscal premium in JPY assets.
- The BoJ meeting saw a minor spanner thrown into the works; new member Kataoka bravely dissented from the no-change policy decision – citing that BoJ's JPY80trn a year asset purchasing will be insufficient to bring CPI inflation to 2%. We believe it is highly unlikely that the BoJ will step up their easing efforts, though Japanese CPI data (Friday) printing at just 0.7% may support the dovish Kataoka's case.

		Week ahead bias	Range next week	1 month target
USD/JPY	Spot ref: 112.20	Mildly Bullish	111.50-113.50	109

Source: Source: ING

GBP: May's Florentine renaissance?

- Theresa May's speech in Florence last week signalled a shift in the UK's position towards an 'economically rational' Brexit – one that seeks to reduce some of the medium-term economic uncertainty clouding GBP markets. This can only be good news for a significantly undervalued pound – although any potential upside may be less imminent and obvious at this stage. While the merits of a two-year transitional period pose upside risks to our GBP forecasts, we note the finer details – such as the exact budgetary and judiciary conditions of any transition phase – still need to be ironed out. Michel Barnier's response to the Prime Minister's speech suggests that this could be one of the focal points of this week's fourth round of Brexit negotiations – and therefore we still retain a constructive GBP outlook in the near-term.
- Both the BoE's Carney (Thursday) and Broadbent (Friday) will speak this week and may look to reinforce market expectations of a November rate hike. We expect GBP to remain highly sensitive to UK data in the near-term as every release will either corroborate or contradict the BoE's hawkish stance; the week ahead sees the final release of 2Q GDP (Friday), as well as consumer and business confidence surveys. Moody's downgrade of the UK's credit rating to Aa2 on Friday (with the outlook 'stable') brings it in line with S&P and Fitch; we expect any GBP fallout to be limited given that the structural reasons cited for the downgrade – both weaker UK public finances and lower potential UK growth in a post-Brexit world – are in our view already reflected in sterling's price.

		Week ahead bias	Range next week	1 month target
GBP/USD	Spot ref: 1.3540	Neutral	1.3450-1.3700	1.33

Source: Source: ING

Dollar bloc: New Zealand election throws up more uncertainty

As investors grapple with the post-election NZD fallout and ensuing government uncertainty, the focus quickly turns to dollar bloc central banks. The RBNZ meets on Wednesday, though this is likely to be a non-event. Instead, watch out for the BoC's Governor Poloz speaking this week; we've been looking for the CAD to undergo a dovish reality check and the BoC chief may just be the catalyst for a downward correction.

AUD: Carry on in a low volatility environment

- A very quiet week in the local calendar, though we do have a couple of RBA officials (Bullock and Debelle) to note. Governor Lowe's comment that we should be prepared for higher interest rates seems to have gone under the radar in a noisy Fed week; further talk along these lines would instil a steepening bias in the front-end of the Australian rate curve and keep AUD crosses supported.
- The post-Fed shakeout means that AUD positioning is likely to be much cleaner, lending itself to a potential rebuild of long positions in a low-interest rate volatility and carry-friendly environment. Tail risks to this view remain heightened geopolitical tensions or a bond market sell-off driven by global central banks; the latter seems unlikely as it's becoming increasingly clear that embedded in asset prices is now the assumption that central banks will take the least market disruptive path when it comes to policy normalisation.

		Week ahead bias	Range next week	1 month target
AUD/USD	Spot ref: 0.7970	Neutral	0.7900-0.8150	0.78

Source: Source: ING

NZD: Political uncertainty to prevail as RBNZ meets

- The New Zealand general election failed to produce an outright winner as expected. PM English's National party did manage to secure 58 seats in a 120-seat parliament and a coalition with the anti-immigration NZ First party (9 seats) looks on the cards. However, it is still technically possible for the main opposition Labour party (45 seats) to form a weak majority government with the Green and NZ First parties. With much of the election risk premium priced out last week, NZD crosses have moved ~1% lower in Asia overnight and we expect it to remain at these more neutral levels given that political uncertainty is set to prevail for another couple of weeks. NZ First's Winston Peters has said he will announce which major party (National or Labour) he will seek to form a coalition with by 12 October.
- The post-election NZD focus will turn to the RBNZ meeting (Wednesday). External factors - not least domestic and global political uncertainties - are likely to dominate the statement narrative. On the macro front, while 2Q New Zealand GDP printed in line with expectations (0.8% QoQ), concerns over stubbornly low inflation will remain the prevailing theme. We look for the reference on "a lower NZD is needed" to be repeated. Overall, a cautious RBNZ bias is unlikely to weigh on the kiwi given that markets aren't pricing in the first rate hike until Sep-2018. Risks are more skewed towards markets bringing forward RBNZ tightening assumptions under a swift government resolution.

		Week ahead bias	Range next week	1 month target
NZD/USD	Spot ref: 0.7260	Mildly Bearish	0.7250-0.7450	0.71

Source: Source: ING

CAD: Poloz and GDP data major event risks

- The focal point of the week will be BoC Governor Poloz's speech and press briefing on Wednesday. It'll be the first time that we hear from the BoC chief since the central bank's second successive rate hike last month and we wouldn't be surprised to hear greater caution over the prospects of additional near-term tightening. Deputy Governor Lane's comment that officials are "paying close attention" to the economic impact of higher short-term rates and a stronger CAD supports our view of a pause in the BoC's hiking cycle for the remainder of this year. A more cautious Poloz could see the ~70% probability of a December BoC rate hike priced out as markets push back expectations of the next policy move.
- Domestic data-wise the July GDP release (Friday) may confirm that 3Q economic activity has slowed after an impressive 1H17. This would inject a bit of realism into the domestic economic recovery and support a more cautious policy outlook. We look for a CAD reality check this week, with risks of the USD/CAD retrace pushing up towards 1.2470 (23.6% Fibo level).

		Week ahead bias	Range next week	1 month target
USD/CAD	Spot ref: 1.2330	Mildly Bullish	1.2200-1.2470	1.24

EUR crosses: Quiet week ahead

We expect EUR/NOK to take a pause for a breath following the last week's Norges Bank meeting, while second-tier Swedish economic data is unlikely to influence SEK too much

CHF: Merkel fallout

- The poor performance of the centre parties at the weekend German elections has seen EUR/CHF correct lower. What that may mean for Italian elections in 1Q18 remains to be seen, but the rise of the AFD in Germany warns that the prospect of greater European integration suffers a setback.
- Local events next see the Swiss business confidence index on Friday. A pickup is expected. Yet Swiss growth has been sluggish this year (eg SNB revising down 2017 GDP forecast to 1% from 1.5%) and we doubt any modest uptick in sentiment can help the CHF much.

		Week ahead bias	Range next week	1 month target
EUR/CHF	Spot ref: 1.1580	Mildly Bullish	1.1530-1.1600	1.17

Source: Source: ING

SEK: Limited catalysts for a break below 9.50

- We don't expect any significant change in the EUR/SEK trading pattern this week and the cross should hover around the 9.50 level. While a modest upside potential to the Swedish Sep Economic Tendency Survey (Wed) can be SEK positive, the likely correction in Aug retail sales (Thu) lower should offset it.
- While CPI is above the target, the last week's Riksbank minutes showed that the central bank is in no hurry to pre-emptively tighten the policy.

		Week ahead bias	Range next week	1 month target
EUR/SEK	Spot ref: 9.5300	Neutral	9.51-9.58	9.50

Source: Source: ING

NOK: Norges Bank effect fully in the price

- We expect EUR/NOK to take a pause for a breath following the last week's NB induced drop in the cross prompted by the gentle upward revision in the NB's own interest rate forecast.
- July unemployment rate or Aug retail sales are not enough for markets to further re-price the NB outlook. Even Governor Olsen stressed that despite the new forecast's modest implied probability of a hike in late 2018, tightening will most likely start only when 'well into 2019'.

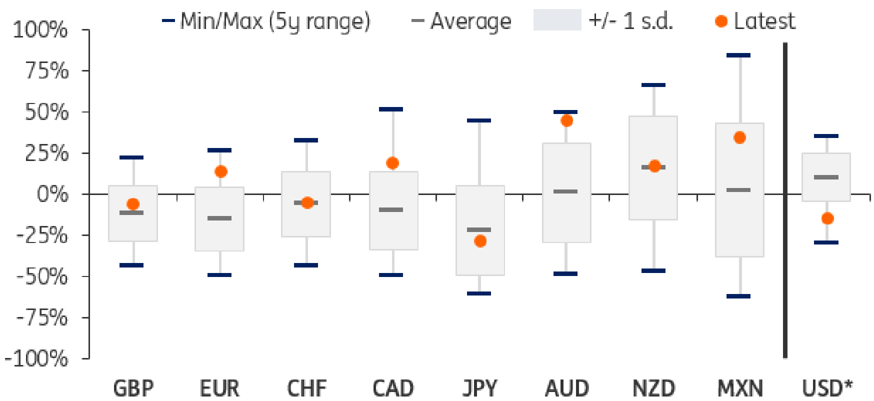
		Week ahead bias	Range next week	1 month target
EUR/NOK	Spot ref: 9.3180	Neutral	9.2310-9.3930	9.30

Source: Source: ING

G10 FX Positioning: AUD & GBP longs increase

- Both AUD and GBP net long positioning increased on the week, registering a bullish signal on our weekly sentiment indicator
- NZD longs were pared amid election uncertainty, while EUR and CAD positions are normalising as the positive impulse from central bank policy shifts shows signs of fading
- USD positioning overall remains net short and close to 5-year lows; constructive tax reform talk this week - while not our base case - could be a reason for some of these short positions to unwind

Speculative positioning (% of open interest)



Source: Source: CFTC, Bloomberg, ING as of 12 Sep 2017 (data reported with a lag). *Aggregate USD positioning against G10

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