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Article

USD: Return of a mercantilist dollar policy

President Trump's remark that he is "not thrilled" with the Federal Reserve raising interest rates is unlikely to hit the dollar as hard as the previous time the administration tried to talk down the currency. Here's why

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USD: Trump reignites mercantilist dollar policy risks that may see rally fizzle

In an interview with CNBC, President Trump cited that he's "not thrilled" with the Fed raising interest rates and noted that the Chinese yuan is "dropping like a rock". The administration's desire for a weaker US dollar shouldn't come as much of a surprise to markets – we've heard this before. But we suspect the president's comments will most likely put an end to the USD rally – and in the absence of any abrupt escalation in the global trade war, it's a mini lifeline for emerging markets and risky currencies elsewhere. While back in January 2018, the dollar index fell around 5% over a short window (with Treasury Secretary Steven Mnuchin partly adding fuel to the weak USD fire) – we shouldn't get too carried away. The political economy of the dollar is a medium-term negative; however, the fundamental outlook for major currencies – such as the euro, Japanese yen and Chinese yuan – is considerably weaker relative to January 2018 (when markets were dominated by the theme of synchronised global growth, which the current trade wars have put a dent into). As such, the president's comments are more likely to, on the margin, stem flows into USD assets given renewed uncertainty over the US administration's dollar policy – and we're unlikely to see the same degree (and sharp extent) of USD weakness that we saw the last time the administration talked about the dollar. Equally, a weaker CNY remains a source of risk for global FX markets – and this may also keep a lid on any relief rally in high-beta currencies for the time being.

EUR: Trump dollar talk steers the euro away from the dangerous 1.15 level

The European Central Bank meeting next week (Thursday) will be a shadow of last month's rollercoaster ride – though there may be some pressure for officials to clarify the meaning of summer (see [Carsten Brzeski's preview](#)). The clever wording of the ECB's forward guidance has given the central bank wiggle room to hike rates anytime in 2H19 – though we prefer to let the eurozone inflation outlook dictate the exact timing of the move. Trump's comments may put a de facto floor under EUR/USD at 1.15; yet, we see limited EUR-specific fundamental reasons for a move to 1.20 this summer.

GBP: Politics to trump economics... meaning risks of a 1.27-1.28 trough in 3Q

The pound is cheap both on a short-term (Bank of England and UK economy) and long-term (soft

or smooth Brexit) basis. But for now, the political chaos in Westminster makes it a good reason to trade at a discount. A benign scenario would be an easing of short-term political headwinds that sees GBP/USD moving back to 1.35 (EUR/GBP to 0.87). But the difficulty with this is that we don't see the stormy political clouds over Westminster lifting any time before October (ahead of key events like the Tory Party conference and the EU leaders summit). Only a concrete resolution between UK and EU officials over the Irish backstop dispute – which would effectively conclude the Withdrawal Agreement and significantly reduce the odds of 'No Deal' Brexit – would trigger a material move higher in GBP over the coming months. In the absence of this, we are confined to pencilling in a 1.27-1.28 trough for GBP/USD in 3Q18 – as heightened short-term political risks and a dovish BoE rate hike. Equally, we see greater risks for EUR/GBP to move up to 0.92 in the near-term. Our base case continues to look for GBP/USD to move to 1.35 on the easing of short-term political risks in 4Q18, setting Cable on a path towards 1.40 in early 2019 – conditional on reduced structural Brexit risks (a steer towards a soft or status quo Brexit) and a weaker US dollar.

