

USD: The only game in town

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USD: The only game in town amid strong US data, heightened risk

We look for dollar differentiation to emerge as a theme for FX markets in 2H18 and think there are two dollars to now consider: (1) the USD against emerging market FX and (2) the USD against major currencies. For the USD against EM FX, we feel it's still too early to call a top given the risks associated with US trade and foreign policy over the coming weeks (not just China tariffs but also Russia sanctions). Saying that, however, we do see a brief window ahead of the midterm elections where US policy plans are effectively put on the shelf – which may allow for EM assets to recoup some their heavy summer losses. As for the USD versus other major FX, we do believe the relative cyclical forces will start to work against the dollar: relative economic momentum (despite the stonkingly high manufacturing ISM), relative monetary policy expectations and relative political uncertainty will start to exhibit similar dynamics that broadly weighed on the USD in 2H17. This story is difficult to pitch right now with the dollar seemingly the only game in town in FX markets due to a Fed on a relentless tightening path, a resilient US economy supported by short-term fiscal stimulus and EM economies exhibiting a series of local negative shocks. The current world, however, is an anomaly not the norm.

EUR: Limited directional conviction as currencies remain driven by politics

Besides the ongoing Italian budget noise, it's pretty quiet in terms of local drivers for the euro. Investors have put off chasing any ECB policy normalisation story – making Chief Economist Peter Praet's speech today a non-event. We see EUR/USD trading with little directional conviction (stuck in the 1.15-1.17 range).

CNY: Trump restricted in formally labelling China a 'currency manipulator'

[Last week we argued](#) that the fate of the renminbi actually lies in the hands of Washington – and not Beijing. This is because we think the catalyst for another adjustment lower in the Chinese yuan will be the next round of US tariffs on Chinese imports (we could hear more from the White House on this as early as today). The size of tariffs enforced will likely determine the extent to which USD/CNY moves up – anything close to the extreme 25% tariffs on \$200 billion Chinese imports could see USD/CNY appreciating to 7.00 in the coming months (albeit in a more controlled manner with the help of the countercyclical factor). While President Trump may well cry 'currency manipulation', there is little in fact the US Treasury can do to formally label China a currency manipulator – [at least based on the mechanical process outlined within US trade law](#). We expect this to be the outcome of the US Treasury's semi-annual FX report in October, which will tie the White House's hand when it comes to imposing any penalties on China for 'unfair' FX policies.

CAD: Looking for conditional rate hike signal but actual hike possible

While the consensus among both markets and analysts is that the Bank of Canada will not 'surprise' with a rate hike today, we do feel the odds are a lot higher than what is currently being discounted. Certainly the argument that 'Poloz didn't warn us' is something that regular BoC watchers will know not to fall for. Either way, we think the hawkish signals stemming from today's policy statement will lift the Canadian dollar. The tail risk of a 25 basis point hike would see USD/CAD moving sub 1.30 – with the 2s10s curve flattening to less than 10 basis points (one reason to stay on hold). We chalk most of CAD's fall this week to rising NAFTA cancellation risks and recommend staying short USD/CAD above 1.32 given the trivial probability of this occurring.

Author

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com