

USD: The Trade War Trap

What makes today's global investment environment particularly challenging is the fact that there isn't just one major source of market risk. Here's how it's playing out in the FX markets



➔ USD: Flattening yield curve telling of two worlds investors are grappling with

While global trade war risks have dominated the agenda of late (and rightly so), another red flag is the ongoing flattening of the US yield curve – with the 2s10s spread hovering at a mere +27bp. For FX investors, watching the shape of the US yield curve goes beyond just gauging recession risks – it can also help to provide a bit of context around the current trading environment. And right now, the flattening of the US yield curve is telling of the two conflicting world's that investors are having to contend with:

- (1) current economic optimism that is fuelling central bank policy normalisation and higher short-term rates; and
- (2) longer-term pessimism over the global economy that is spurring a stealth flight to safety

As the Bank of Canada's Governor Poloz put it yesterday, much of the flattening yield curve dynamics can be chalked down to 'absolutely huge' demand for longer-dated bonds that has risen as a result of trade war and geopolitical tensions. What we will continue to see this summer is the narrative switching between these two broad themes – or what we call the 'Trade War Trap'. And

in the FX space, the evidence suggests that the USD wins in the 'Trade War Trap' world – with the Fed leading the way when it comes to policy normalisation and US Treasuries still the go-to haven asset.

As for today, bond markets will turn their attention to the latest US CPI inflation release; while there are risks of a 3% headline CPI print (core at 2.3%), it's worth remembering that high inflation and a late-cycle US economy confirms the 'Trade War Trap' that we're in – short-term optimism and long-term pessimism. [The breakout in USD/JPY](#) suggests that FX investors are happy to focus on the signals from the short-end of the US curve for now.

➔ EUR: Not worth chasing an ECB rate hike story with all these trade war risks

If the ECB's Governing Council are internally confused about their own forward guidance on policy ([read this Reuters report](#)) then there's little doubt that markets are equally uncertain over what the ECB mean by keeping rates on hold 'through the summer'. We do think that market expectations have shifted too much to the dovish side, but in the current 'Trade War Trap' chasing a hawkish ECB normalisation is unlikely to be rewarding. EUR/USD looks set to be stuck in the 1.15-1.18 this summer.

➔ GBP: Well at least we can turn our attention back to Brexit now... oh the joy!

While England's World Cup journey has been a welcome distraction for many of us analysts here in the City – there was a major (ironic) reality check last night when the most recent country to join the EU triumphed over the first country to leave the EU. We have the 'joy' of focusing our attention back onto the latter story today – with the UK government set to release its Brexit White Paper. As we've been noting, the devil will be in the details (which may take a while to digest) – but for GBP's initial reaction over the coming days, one should focus on the EU's response to May's Brexit plan. [If Brussels feel that they can work with Downing Street](#), then GBP/USD could drift back to 1.33-1.34. If not, then there are major risks of a sharp fall to below 1.30 as risks of a 'no deal' Brexit pick-up.