Italy woes weigh on EUR; China concerns also remain on the radar

Top FX drivers:

• **EUR**: EURUSD continues to pay attention to the widening Italian bond – German Bund yield spread. Event risk looms in the horizon: the government met on Saturday to discuss budget and tax issues. Meanwhile the Italian government is expected to respond by noon Monday to the EU Commission’s letter published last week, although Italy is unlikely to change its budget plan. That means it will almost certainly be rejected.

• Another event risk to consider is rating downgrades. Moody’s has cut Italy’s credit rating by a notch to Baa3 over concerns about plans for larger deficits and the high public debt load as the country’s populist government clashes with Brussels over its budget. S&P’s decision is due October 26. The Italian bond – German Bund yield spread is in a state of fragility and can be rocked by risk-off events anywhere as well as domestic political headlines. The best-case scenario is Citi’s base case – a one notch downgrade from Moody’s, but no downgrade from S&P.

• **RMB**: China’s GDP printed 6.5% YoY for Q3 vs 6.6% expected, a decade low. While industrial output for September also missed (5.8% YoY vs 6% forecast), retail sales came in better than expected. Citi analysts expect growth to slow further to 6.4% YoY in Q4. RMB proved to be resilient to the soft data however, largely thanks to a plethora of reassurances from Chinese authorities. USDCNY closed at 6.9325 as a consequence. However, Citi analysts think that the fundamental reasons to be bearish RMB remain.

**USD**: Citi expects 3 further rate hikes this cycle

• The latest FOMC minutes bring no real surprises but like the recent Fedspeak, read more hawkish. Perhaps what the market should be taking in most is the Fed’s continued level of emphasis on how trade could unravel the markets - especially considering that November could bring a Trump-Xi meeting on the sidelines of the G20 meeting. **Citi analysts continue to expect three further rate hikes this cycle – in December, March and June.**
GBP: Weakness continues

• GBPUSD continues to look fragile as of last week. Citi analysts see no real compelling reason to hold significant GBP risk for now. Headline risk only increases as time progresses but it seems nobody really knows what the outcome is going to be. BoE Governor Carney spoke last Friday, but given that the central bank is on hold for the foreseeable future, his remarks are likely to have a limited impact.

Commodity Bloc: AUD may continue to struggle, NZD may continue its strong run, Canada CPI and retail sales data in

• AUD: AUD price action may struggle. Citi analysts also point out that there is an increasing divergence between Australia’s terms of trade and AUD, which suggests that commodity price rises will not stand in the way of AUD declines.

• NZD: NZD was last Friday’s top performer – but there hasn’t been any news to trigger this. Instead, technical breaks may have caused this which suggest that NZD will continue to perform well in the crosses.

• CAD: Consensus is for retail sales to stay in line while CPI is expected a touch lower. Poloz noted in his speech last month that temporary factors, such a higher gasoline prices, have been driving prices higher. Although the print is critical for the data dependent BoC, its unlikely to derail the hike next week which is fully priced in.

Asia EM: Chinese regulators offer assurance

• CNH options are seeing relentless buying across the vol curve even as USDCNY and USDCNH have stabilized slightly after Chinese authorities stepped in last week to reassure market participants. There were soundbites from three of China regulators in early Asia last week. Heads of the central bank, banking and insurance regulator and securities regulator spoke to markets. A quick recap courtesy Bloomberg:

• Yi Gang (PBoC chief) China will support financing to non-state-backed firms China’s macro leverage ratio has stabilized and its growth potential is extremely strong. Guo Shuqing (China’s banking and insurance regulator) : Recent abnormal fluctuations in China’s financial market does not reflect the country’s economic fundamentals. Allow insurance companies to launch products designed to ease share-pledge risks. Liu Shiyu (China Securities regulator): Encourage funds backed by local governments to help ease pressure on listed companies from share-pledge risks. Explore measures to help private firms issue bonds.
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