Easing Inflation calls US dollar rally into doubt

Market Report 15/08/22 - By Sam Balla-Muir

USD

The US dollar fell back against every other G10 currency last week, including a fall of around 0.5% against the British pound and 0.8% against the euro. The main factor behind this weakness was data released on Wednesday which not only showed headline US inflation dropping back in July, but also included news that core inflation – which excludes volatile energy and food items – fell by more than expected too. That prompted a retreat in investors' expectations for Federal Reserve interest rate hikes, a key driver of the US dollar rally which has taken place over the past year. Tentative signs that US inflation is already in retreat also appear to have reduced the chances that the Fed will need to crush demand, thereby inducing a recession, in order to bring it back under control. That has reduced some of the safe-haven demand for US dollars, another important driver of the greenback's strength this year.

Some price pressures in the US, such as for fuel and for the goods such as cars which saw large supply-chain disruptions linked to the pandemic, do now seem to be easing considerably, and seem likely to prompt much further falls in inflation in the coming months. That will likely limit the US dollar's near-term gains. But it is far too early to make the call that US inflation has been vanquished, given that other price pressures, including in wage growth, and in many service sectors of the economy remain very strong. Indeed, the US dollar recouped some of its earlier losses last Thursday and Friday, after comments from key Fed officials suggesting that they didn't see the latest drop in inflation as a sign to give up on interest rate hikes just yet. Since I see the risks as skewed towards persistently high inflation, further interest rate hikes, and a weak global economy, I see the US dollar generally continuing to climb.

GBP

The British pound had a mixed week last week, rising by around 0.5% against the US dollar, but slipping by around 0.2% against the euro. The pound's gains against the US dollar largely reflect last week's news on US inflation (see the USD section above) rather than anything UK-specific. And taking a broader view, the pound's declines against the euro, as well as several other major currencies last week, seem to reflect some poor economic news. That included data released on Monday showing a 0.6% decline in UK GDP in June, meaning the British economy shrank slightly last quarter. What's more, news about the likely path of the Ofgem utility price cap may have hurt sentiment towards the pound too, given that it suggests a larger rise in prices, greater hit to incomes, and worse outcome for the UK economy, than had previously been expected.

The UK's economic outlook is undoubtedly very challenging, with consumers' spending power taking a hit from both surging energy prices and the rate hikes needed to tackle high inflation. That is part of the reason why I expect the pound to lose a bit more ground relative to the US dollar over the coming months. However, when it comes to shifts in exchange rates, it is the *relative* picture that matters. With the Eurozone economy even more exposed to the current energy crisis, and the European Central Bank likely to find it difficult to raise interest rates by as much as the Bank of England, I see sterling making some gains from here against the euro.

EUR

The euro had a fairly good week last week, rising by around 0.8% against the US dollar and by some 0.2% against the British pound. Rather than reflecting positive news about the Eurozone economy, the euro's gains seem to more reflect news elsewhere, including the dip in US inflation (See the USD section above), and the bad news in the UK about both the recent weakness in its economy and surging utilities prices. After all, there was little in the way of good news about the Eurozone economy. Not only is there no end in sight to the continent's energy crisis, with gas prices grinding even higher last week, news that hot weather has caused the river Rhine to dry up threatens to further hobble German industry, given that the river is a key artery when it comes to moving goods up and down the country.

Generally speaking, I expect the euro to fall further against both the US dollar and British pound over the coming months. While that view partly reflects global factors, it also hinges on an assessment of the dire outlook for the Eurozone economy; which is even more exposed to the energy crisis than the UK, faces very high inflation; and yet also has a central bank in the form of the ECB which will find it hard to raises interest rates very much given that this risks a blow-up in fiscally fragile Eurozone members on the continent's periphery. Political uncertainty in Italy, where elections are due in late September, has further darkened the picture.

The Week Ahead

The key themes for currency markets next week will be ongoing questions about when, and just how far, inflation will fall, and the debate over whether the US economy is headed for recession. There is limited data due in Europe next week that will shine much light on these questions, though UK inflation data due on Wednesday will be key for the pound. US activity data for July on industrial production and retail sales – due on Tuesday and Wednesday, respectively – will also garner attention. Investors will also be on the lookout for hints from central bank officials about when they might consider halting their interest rate hikes if inflation starts to fall much further. Looking further ahead, the Jackson Hole Symposium in late August – an annual get-together of the world's central bankers – might be key for FX markets if clearer signals are given here.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	0.49
$ per €	0.76
€ per £	-0.19

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 16th	US	15.15	Industrial Production (%M/M)	Jul'	-0.2%	+0.3%
Wed. 17th	UK	07.00	CPI Inflation (% Y/Y)	Jul'	+9.4%	+9.8%
Wed. 17th	US	13.30	Retail Sales (%M/M)	Jul'	+1.0%	+0.2%