US dollar rally gathers pace

Market Report 03/05/22 - By Sam Balla-Muir

USD

The big story in FX markets last week was the further surge in the US dollar. It rose against every other G10 currency, including by around 2.1% against the British pound, and by roughly 2.3% against the euro. That continued a recent strong run from the greenback, with the DXY Index, a broad-based measure of the US dollar's strength, hitting its highest level in 20-years.

The US dollar may have received some support from the past week's data releases. While figures released on Thursday showed that US GDP contracted slightly in Q1, this mainly reflected shifts in the erratic net trade and inventories components of the data. Robust growth in consumer spending and investment suggests that the US economy has retained its underlying strength. This may have left investors more willing to bet on the extent of interest rate hikes in the US, which boost the US dollar's appeal. The other factor pushing up the US dollar last week appears to have been safe-haven flows into what is the world's de facto reserve currency, on the back of the volatility in global stock markets recently.

With the US dollar having already risen sharply in 2022 so far, and a large amount of interest rate rises in the US already priced into financial markets, there is a chance that it takes a pause in the near term. The bar in terms of expectations is set high for the US Federal Reserve's policy meeting next Wednesday, where investors expect the central bank to raise rates by 0.5% and confirm plans to shrink the US money supply. But taking the longer view, I suspect the balance of risks over the coming months favours further US dollar strength. One likely path to further US dollar gains is that persistently high US inflation means that interest rates need to remain higher for longer than investors currently anticipate. Alternatively, if the monetary tightening that the Federal Reserve plans to deliver start to take a big toll on the global economy, safe-haven inflows to US assets could also push up the dollar.

GBP

The British pound struggled last week, falling by just over 2% against the US dollar. That plunge was partly a reflection of “US dollar strength”, rather than “pound weakness”, with sterling rising by around 0.3% against the euro. That said, news that Russia has cut Poland and Bulgaria off from supplies of natural gas, and threatened to do the same for other European economies, poses another threat to the near term economic outlook in the UK. Comment’s from Chancellor Rishi Sunak that now might not be the right time to provide households with additional support in the face of a cost-of-living crisis, along with a batch of weak public finances figures last week, may have also disappointed traders.

Whether the British pound can bounce back in the near term will depend on the Bank of England’s messaging next week at its policy meeting. Although the Bank is widely expected to raise interest rates by 0.25%, it may sound cautious about further rate hikes in light of the hit to household incomes from higher bills, and some recent poor activity data. But beyond the next few weeks, I suspect that the British pound will hold up well against the euro if not the US dollar. Despite the hit to incomes a strong labour market and wage growth suggests that the Bank of England still has some work to do in terms of raising rates if it is to stop expectations for high UK inflation becoming more deeply ingrained. What’s more, the risks to Europe’s economy from an energy and income shock are even worse than for Britain’s.

EUR

The euro had another poor week last week, slipping by 2.3% against the US dollar and by some 0.3% against the British pound. Other than the general strength of the US economy, and perhaps some safe-haven inflows into US dollar assets as global stock markets whipsawed, another factor pushing down the euro was Russia’s announcement that it will stop supplying gas to Bulgaria and Poland. Russia has also threatened to cut off supplies to other Eurozone economies if they refuse to pay for gas with Russian rubles, rather than hard currencies, such as euros. That has raised the threat of further surges in energy prices on the continent, as well as power rationing and blackouts, which could severely dent activity.

Despite the bleak backdrop for economic activity, one factor stopping the euro from falling further thus far has been that investors continue to expect the European Central Bank to hike interest rates more aggressively than at any time in over a decade in order to push back against high inflation. I suspect that the euro will fall further as some of these rate hikes fail to materialise. In my view, investors appear to be underestimating the current struggles of the Eurozone economy, and overestimating how persistent inflation is on the continent. A fall below parity against the US currency – one euro becoming worth less than one dollar – for the first time since 2002 is a real possibility.

The Week Ahead

Key to the near term outlook for currency markets will be next week's raft of central bank policy meetings, including in the US and UK. With investors already expecting a lot of interest rate hikes over the coming months, what the US Federal Reserve signals on interest rates further ahead will be key to whether the US dollar can keep on rising. That said, some economic data releases due in the US next week, including the widely watched non-farm payrolls numbers and ISM business activity surveys for April could also provide the US dollar with some support if they show that its economy remains robust. Otherwise, there is a risk that the pound could slip a bit further if the Bank of England sounds cautious at Thursday's policy meeting, while data due in the Eurozone on employment, industrial production and retail sales could underline the case for a weaker euro, if they show continued weakness.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	+0.26
$ per £	-2.50
$ per €	-2.34

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts’ Expectation
Weds. 4th	US	19.00	Fed Reserve Policy Meeting	Apr.	0.25% -0.5%	0.75% -1%
Thurs. 5th	EZ	12.00	Bank of England Policy Meeting	Apr.	0.75%	1%
Fri. 6th	US	07.00	German Industrial Production (%M/M)	Mar.	+0.2%	-0.7%