The euro's resurgence may be short-lived

Market Report 04/04/22 - By Sam Balla-Muir

USD

The US dollar's fortunes were mixed once again last week. The US dollar's roughly 0.7% fall against the euro and 0.6% rise against the British pound were largely driven by factors specific to the Eurozone and British economies (see the EUR & GBP Sections below), rather than developments in the US. However, looking at the bigger picture, the US dollar appears to have risen against the currencies of net commodity exporters – such as the Norwegian krone, Australian dollar and New Zealand dollar – and fallen against the currencies of net commodity importers, especially in Europe – this second group includes the euro and Swedish krona. This shift is probably explained by the roughly 15% drop in the price of oil last week, and the falls in the prices of many other commodities. That in turn has reflected the apparent shift in Russia's military strategy which has reduced the risks of a further disruptions to global oil supply.

In some ways it is surprising that the US dollar did not rise more decisively last week. After all, last Friday's key non-farm payrolls data release showed that the US economy added a hefty 431,000 jobs last month, pushing the US unemployment rate down 3.6%, essentially back to its pre-pandemic low. Such good news about the US economy would usually prompt investors to anticipate more interest rate rises in the US than elsewhere, typically something that would push the US dollar higher. The risk that the US dollar would not rise higher on the back of strong economic data was one that I flagged in last week's FX note. With a lot of interest rate hikes already anticipated by investors from the US Federal Reserve, there appear to be limited room for investors to raise their expectations further in the near term. Meanwhile, with many investors and traders already having bet on high interest rates fueling gains in the US currency there appears to be fewer potential buyers on the sidelines able to push the US dollar higher for now.

While that may remain the case for a few weeks yet, I suspect that the US dollar will ultimately resume its upward trajectory before long. Investors appear to be expecting that a fairly modest increase in US interest rates will be sufficient to bring US inflation down from its current multi-decade highs. If this proves to be wishful thinking, painfully high US interest rates could end up boosting the US dollar's appeal further, pushing up its value. What's more, with the headwinds to the global economy strengthening, there is a growing risk that the US dollar is pushed up by safe-haven flows from investors seeking a financial bolt hole in uncertain times.

GBP

The British pound struggled last week, falling by around 0.7% against the US dollar and by about 1.2% against the euro. The pound's weakness last week was at odds with the limited economic data released last week, including a small upward revision to the final estimate of Q4 GDP growth, and data released on lending for February which showed that investors seemed to have – until that point at least – retained their appetite for borrowing and spending. The softness in sterling was also in contrast to the gains seen in the currencies of other net commodity importers last week. (See the USD section above.)

The pound's fall seems to reflect how investor's expectations for interest rates fell marginally in the UK last week, while rising slightly in the euro-zone and US. Differences in interest rate expectations tend to have a powerful influence on exchange rates in the short run. Why investors did not upgrade their expectations for rates rises in the UK in line with those in other economies is not entirely clear, though it could perhaps reflect how traders were unwilling to bet on further rate rises in the UK against a backdrop of rising energy prices, increases in national insurance contributions, and headlines about a "cost of living crisis". I highlighted the risk of this happening to sterling in last week's FX note. Although high inflation in the UK would typically call for higher interest rates in response, the Bank of England has clearly shown that it is worried about raising interest rates too far given the hit to consumers disposable incomes from rising energy prices and taxes. A similar set of concerns may mean that the pound struggles against some other currencies over the next few weeks and months, and especially so against the US dollar. However, given that – in my view – higher interest rates are much more likely in the UK than the Eurozone, the pound should eventually make some small gains against the euro, if not the US dollar.

EUR

The euro was one of the top performers last week, rising by around 0.6% against the US dollar and by around 1.2% against the British pound. The euro was partly helped by global factors. As mentioned in the USD Section above, Russia's shift in military strategy prompted a sharp fall in the price of oil last week, boosting the currencies of net commodity importers, such as the euro, and reducing the perceived risks of investing in the Eurozone more generally.

Meanwhile, the Eurozone also saw some positive economic data releases last week, including figures showing that the unemployment rate in the currency block fell to a record low in February. Surprisingly strong inflation data last week for both Germany and the Eurozone as a whole has also strengthened the case for the European Central Bank to begin raising interest rates, another euro positive.

Even so, I remain downbeat about the euro's prospects over the coming months. Despite inflation hitting 7.5%, an all time highs in the trading bloc, I would be surprised to see any tightening in policy any time soon. The war in Ukraine has certainly dimmed the Eurozone's economic prospects. While labour market data for February – largely covering a period before Russia's invasion – were strong, the widely tracked ESI Survey for March suggested the continent's manufacturing sector is struggling. Meanwhile, it seems more likely than not that Germany's economy entered recession in Q1. And, as the latest spat involving Russia demanding payment for gas in Russian rubles has highlighted, the Eurozone economy remains at risk from being cut off from Russian energy. With all that in mind, I suspect that the investors which are currently betting on a very sharp rise in Eurozone interest rates are likely to be disappointed.

The Week Ahead

The coming week appears to be a quieter one in terms of key data releases and events to watch. The US will probably see the most notable releases, with the ISM Services Survey for March due on Tuesday potentially on course to suggest that the largest sector of the US economy remained strong last month, despite war in Ukraine and rising petrol prices. Otherwise the release on Wednesday of minutes from the US Federal Reserve's March policy meeting could also prompt a stronger US dollar if they reveal imminent plans for "Quantitative Tightening" – essentially selling government bonds in order to reduce the supply of US dollars available to financial markets. The coming week in the UK is set to be particularly quiet, with speeches by Bank of England policymakers Catherine Mann and Jon Cunliffe the main events of interest. Finally, while February data on industrial production and retail sales for the Eurozone may paint a relatively favourable picture for the euro, these data will be mostly old news, given that they largely focus on a period prior to Russia's invasion of Ukraine later on in that month.

Exchange Rate	%- change on week
€ per £	-1.15
$ per £	-0.58
$ per €	+0.66

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Tue. 5th	US	15.00	ISM Services Survey	Mar.	56.5	58.6
Wed 6th	US	19.00	Minutes of FOMC March Meeting	Mar.	-	-
Thu. 7th	EZ	10.00	Non-Farm Payrolls	Mar.	+0.2%	+0.5%