Global slowdown fears prompt renewed US dollar rally

Market Report 04/07/22 - By Sam Balla-Muir

USD

The US dollar performed well last week, rising against nearly every other G10 currency, including a gain of around 1.4% against the British pound and 1.2% against the euro. That further rise in the US dollar seems to have been largely due to the “safe-haven” flows into US dollar-denominated assets that typically arise due to concerns about the health of the global economy. Indeed, last week global stock markets faltered, the prices of commodities like oil and copper dropped, and “safe-haven” currencies like the Swiss Franc and Japanese yen held up best against the US dollar. These worries seem to have been heightened by last week’s data, including figures showing that real consumer spending in the US fell by 0.4% in May and an ISM Manufacturing activity survey for June which fell to a two-year low. That adds to concerns that the US Federal Reserve’s interest rate hikes will heap pressure on a US economy that is already slowing.

In my view, a further climb in the US dollar against most other currencies from here is likely, even if it does not continue to appreciate quite as sharply as it has recently. With monetary policy having to be tightened to get US inflation back under control, the Federal Reserve will probably have to continue hiking rates even if the economy is weak, making a US recession at some point in the next year or so hard to avoid. Meanwhile, given the stronger inflation backdrop in the US, I suspect that the Fed will raise interest rates by more than most other central banks, something that would typically put upward pressure on the US dollar by boosting its appeal relative to other currencies.

GBP

The British pound struggled again last week, falling by around 1.4% against the US dollar and by 0.2% against the euro. In part, sterling's weakness against the dollar was the result of worries about a slowdown in the global economy. But some poor data in the UK also probably played a role, and help to explain its decline against the euro. Consumer credit figures for May showed that UK households are becoming less inclined to borrow, presenting the risk of a sharper slowdown in consumer spending. That chimed with the bleak message from the GfK Consumer Confidence survey released late last week which showed confidence falling to its lowest level in the survey's history, including lower than the trough reached during the 2008-09 global financial crisis.

With the UK economy struggling and concerns about the health of the global economy fuelling safe-haven demand for US dollar assets, I suspect that the British pound might yet lose a bit more ground against the US currency. That said, I also think that some of its recent losses against the euro will be reversed. Although the UK consumer sector is clearly weak at present, Europe's economy appears in an even worse position. With inflation also appearing more persistent in the UK, I suspect that the Bank of England will soon feel that it needs to raise interest rates much further, at the same time as weak activity on the continent means that the European Central Bank disappoints expectations for monetary tightening in the Eurozone.

EUR

The euro had a less than stellar week, falling by around 1.2% against the US dollar, although gaining about 0.2% against the British pound. The weakness against the US dollar was to be expected, given the "flight to safety" in financial markets last week that appears to have been prompted by growing fears of a global economic slowdown. In fact, the euro might have fared even worse last week were in not for some moderately supportive economic data. The June EC ESI activity survey released on Monday was weak, although not quite as bad as similar business activity surveys for last month. Other data showing a rise in Eurozone inflation to a fresh high of 8.6% in June also supports the case for higher interest rates on the continent.

Those figures notwithstanding, I think that the euro will weaken further against the US dollar from here. That partly reflects how a global slowdown, and perhaps even a recession, now appears to be on the horizon, something that would typically be associated with the euro sliding. Meanwhile, inflation in the Eurozone still appears – much more than elsewhere – to be a result of global factors like food and energy prices, rather than a symptom of strong European demand. As the underlying weakness in the Eurozone economy returns to the fore, I expect its currency to struggle. I also suspect that the euro will fall back against the British pound over the coming months, given the relative outlook for interest rates in the UK and Eurozone.

The Week Ahead

Monday's Independence day holiday in the US may mean a relatively quiet start to the week in FX markets, though US data on the strength of the services sector in June – due on Wednesday – and employment – due on Friday – will be watched closely for signs of a slowdown. Few key data or events are scheduled in the UK next week, though speeches by a raft of Bank of England officials next week could move sterling if they include any clues on the near-term outlook for monetary policy. Finally, Eurozone data for May on retail sales – due Wednesday – and German industrial production – due Thursday – are likely to suggest that the continent's economy remains very subdued.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	-0.16
$ per £	-1.37
$ per €	-1.19

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Wed 6th	EZ	10.00	Retail Sales (%M/M)	May	-1.3%	+0.3%
Thu 7th	US	15.00	ISM Services Survey (%Y/Y)	June	55.9	54.3
Fri 8th	US	10.00	Non-Farm Payrolls (%M/M)	June	+390,000	+250,000