Pound advances ahead of no-confidence vote

Market Report 06/06/22 - By Sam Balla-Muir

USD

Last week was a mixed one for the US dollar, which made decent gains against a handful of major currencies – including a big increase against the Japanese yen, and a roughly 1.0% rise against the British pound – but fell against many others, and was more or less flat against the euro. That may have reflected a fairly mixed week for US economic data leaving traders confused on which direction to bid the US currency. On the one hand, Wednesday's ISM Manufacturing survey for May increased yet again, pouring cold water on the idea that the US economy is headed for recession, bolstering the case for the US Federal Reserve to raise interest rates aggressively and thereby supporting the US dollar. On the other hand, the survey also suggested that inflationary pressures are easing as disruptions to supply chains fade. That would reduce the pressure on the Fed to raise rates. Friday's May employment report, which showed another strong month for job creation, but also falling wage growth, painted a similarly mixed picture.

In my view, the economic data in the US is unlikely to remain quite so varied in tone. Although inflationary pressures will probably continue to ease, I suspect that they will remain much higher than the Fed is comfortable with for some time yet. Meanwhile, I suspect that the US economy will continue to hold up quite well. With that in mind, I expect the Fed to press on with plans to rapidly raise rates, helping the US dollar to make gains against the euro, and to some extent the British pound, from here.

GBP

The British pound struggled last week, falling by around 1% against both the US dollar and euro. With limited UK economic data of note published on a bank holiday-shortened week, the slide in the British pound may partly reflect how there was little news that could support sterling, in the same way that strong data on growth and inflation supported the US dollar and euro, respectively (see the USD and EUR sections). Political uncertainty, as a growing number of Conservative MPs voiced their dissatisfaction with Boris Johnson's leadership, may also have played a role.

While the pound might not rebound sharply against the US dollar anytime soon, I expect sterling to reserve its recent declines against the euro. That slide against the euro appears to have reflected a divergence in investors expectations for interest rates in the UK and Eurozone, with the Bank of England unnerved by the hit to consumer incomes due to the cost-of-living crisis, but the European Central Bank, or ECB, pushing on with plans to begin raising interest rates despite Europe's struggling economy. As high inflation in the UK proves persistent, I suspect that the Bank of England will have to raise rates by a lot more yet, despite its concerns about growth. And since the Eurozone economy is in a much weaker position than the UK's, I find it hard to see how the ECB can match the extent of interest rate hikes likely from the Bank of England, denting the euro's appeal relative to the pound.

EUR

The euro rose slightly against the US dollar last week, and climbed by around 1.0% against the British pound. The euro's gains were probably almost entirely due to data showing that inflation in the single currency area topped 8% for the first time in its history, well above what analysts had expected. Core price pressures – excluding the energy and food items that have more to do with global factors than supply and demand in the Eurozone – also intensified. This seems to have done even more to convince investors that the ECB will soon begin raising interest rates quite rapidly to bring inflation back under control.

Even so, other data released last week suggested that investors, and also, perhaps, the ECB, may be getting ahead of themselves. May's EC activity survey, released on Monday, remain at a depressed level, consistent with weak growth. Friday's data showing that Eurozone retail sales fell by more than 1% in April also add to the evidence that its economy may already be in recession. What's more, things may get worse before the get better, with the EU finally agreeing last week to end its imports of Russian oil earlier than planned. While arguably the right moral choice, that will be a further problem for the Eurozone economy, especially if it prompts Russia to end exports of natural gas to the continent. Indeed, the Netherlands was the latest country to be cut off from Russian gas last week. With all these economic headwinds, I find it hard to see how the ECB can raise interest rates by very much. As that dawns on investors, I expect the euro to fall back against both the US dollar and British pound.

The Week Ahead

With another quiet week for major economic data and events in the UK, the focus will be on data due in the US and the ECB's Thursday policy meeting. While May's data on US inflation – probably the most widely watched data release in the world right now – could show price pressures moderating, they will probably remain far more intense than is consistent with the Fed's 2% inflation target. Although they have been a poor guide to household spending of late, US consumer confidence data for May could also grab a couple of headlines. It is unclear whether the ECB will raise interest rates at its Thursday meeting, or wait until its next meeting in July. Either way, its guidance on where it might raise interest rates over the coming year or so look set to have a major bearing on the euro.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	-0.99
$ per £	-1.04
$ per €	-0.08

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Thu. 9th	EZ	12:45	ECB Policy Meeting	May	-	-
Fri. 10th	US	13:30	US Core CPI Inflation (%Y/Y)	May	+6.1%	+5.9%
Fri. 10th	US	15:00	Uni' of Michigan Consumer Confidence	May	58.4	58.9