Market Report 07/03/22

Price of oil soars as conflict in Ukraine escalates - By Sam Balla-Muir

USD

The US dollar lost a small amount of ground last week to some safe-haven currencies – such as the Swiss franc and Japanese Yen – and to the currencies of some major commodity exporters – including the Australian dollar and New Zealand dollar. Yet, the greenback ended the week up considerably against most other major currencies, rising by around 1.3% against the British pound, and by more than 3% against the euro.

Some of the US dollar's gains were probably driven by data suggesting that the US economy remained very strong last month, with the key ISM survey of activity in the manufacturing sector rising significantly, and payrolls data showing that the US labour market created nearly 700,000 new jobs in February. However, a lot more of the US dollar's rise appears to have been due to the ongoing conflict in Ukraine.

As I suggested might be the case last week, this appears to have partly reflected a "flight to safety" into dollar-denominated assets by investors, the typical pattern during a global crisis. But it probably also reflects a judgement by investors that the US economy is far more insulated than the economies of either the UK or the euro-zone, due to its greater geographical distance from Russia, and because the US is not reliant on Russia for imports of energy commodities. For example, European natural gas prices have more than doubled over the past week, presenting a major headwind to the UK and Euro-zone economies. By contrast, natural gas prices in the US have risen by only 12% over the same period. Mirroring these trends, expectations for interest rates in the US have fallen by much less than either in the UK or on the continent.

The next move for the US dollar from here will hinge on the course of the conflict in Ukraine, its impact on the prices of commodities such as oil and gas, and how economic policymakers respond. So long as the conflict grinds on it seems highly likely that the US dollar will continue to climb, as investors seek the relative safety of dollar-denominated assets, and rising prices for energy threaten to do more harm to many economies elsewhere in the world. How the conflict affects that US Federal Reserve's plans to raise US interest rates will also be crucial, though this may not be clear for some time yet.

Federal Reserve Chair Jerome Powell kept his cards close to his chest when asked about the outlook for US interest rates during his testimony to the US Congress last week, and the central bank's top brass has now entered their customary "blackout" phase ahead of their monetary policy meeting on 15th March.

Signs of a possible end to the conflict might lead the US dollar to fall back, but probably not by much. After all, an easing of geopolitical tensions would arguably clear the runway for the Federal Reserve to raise US interest rates quite aggressively, given the strength of the US economy, and the need to tackle high inflation.

GBP

The British pound had a mixed week, rising by around 1.7% against the euro, but falling by about 1.3% against the US dollar. With little in the way of important economic data releases sterling's fortunes have probably depended mainly on investors' judgements of how exposed the UK is to the war in Ukraine relative to its peers, and how the conflict might affect the Bank of England's plans to raise interest rates.

As I suggested would be the case last week, investors appear to have taken the view that the UK economy is more exposed to the conflict than the US, but less exposed than the Euro-zone, largely because its greater distance from Russia means that the UK trades less with Russia, and is less reliant on Russia for its energy needs.

With the UK economy also at a more healthy starting point that the Euro-zone, the Bank of England has less incentive to dial back on its plans to raise interest rates. Policymakers at the Bank appear concerned that high inflation in the UK may become entrenched if workers see it as a reason to demand higher wages. Despite the downside risks to the UK economy, higher oil and gas prices may heighten those concerns. Indeed, investors' expectations for interest rates have shifted considerably in the pound's favour relative to the euro over the past week.

As with the US dollar, and FX markets more broadly, the outlook for the pound also hinges on events in Eastern Europe. Provided the conflict wages on, and commodity prices keep on climbing, sterling looks set to fall further against the US dollar, but grind higher against the euro. The Bank of England's take on recent events will also be key, but as with the US Federal Reserve, policymakers at the UK's central bank will also observe their media blackout period ahead of the Monetary Policy Committee's next meeting on 17th March.

EUR

As discussed in the *USD* and *GBP Sections* above, the main determinant of moves in FX markets last week has been the ongoing conflict in Ukraine, and the extent to which investors have judged different economies to be vulnerable to the war and its spill-over effects. While the currencies of many Eastern European economies and Sweden's krona have fallen by more, the euro still had a tough time last week, falling by over 3% against the US dollar and by about 1.3% against the British pound.

The Euro-zone economy's reliance on Russia for imports of oil, gas and coal – the prices of which have all been surging – leaves its economy much more vulnerable. Even more so than the dollar or pound, I suspect that the outlook from here for the euro will depend on events in Russia and Ukraine. A key factor to watch will be any indication that Western countries appear willing to include Russia's energy sector within its economic sanctions, or if Russia decides to cut Europe off from its oil and gas supplies in retaliation.

The Week Ahead

The main data release in the coming week will be Thursday's data on US consumer price inflation for February. If, as many seem to expect, inflation in the US remains at a multi-decade high, that may underline the case for the Federal Reserve to raise interest rates sooner rather than later, which could further fuel the US dollar's recent rise. The other main event will be the European Central Banks policy meeting on Thursday. This meeting presents some downside risk for the euro, if the ECB indicates that its concerns about the war in Ukraine mean it will shelve plains to raise interest rates later this year. That said, if the ECB suggests that it might press ahead, the euro might see some recovery.

Currency Moves

Exchange Rate	%- change on week
€ per £	1.71

$ per £	-1.34
$ per €	-3.03

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Thu. 10th	EZ	13.45	ECB Interest Rate Announcement	Feb.	-0.5%	-0.5%
Thu. 10th	US	13.30	CPI Inflation (%Y/Y)	Feb.	7.5%	7.9%
Thu. 10th	US	13.30	Core CPI Inflation (%Y/Y)	Feb.	6.0%	6.4%