Resilient US economy shows the dollar's not done yet

Market Report 08/08/22 - By Sam Balla-Muir

USD

After falling back over the second half of July, the US dollar had a much better run last week, rising against all other G10 currencies, including a gain of around 0.8% against the pound, and of about 0.4% against the euro. One factor helping the US dollar was comments from a raft of officials from the Federal Reserve suggesting that the US central bank is a long way from done with raising interest rates and is "laser focused" – to quote one official – on bringing US inflation back down to the 2% target. The idea that the Fed's tightening cycle is nearing an end was also hurt by a couple of solid data releases, including a surprisingly strong ISM Services Survey report on Wednesday showing that the US economy's largest sector remains in good health. Other data on Friday showing that more than half a million new American jobs were created last month also painted a picture of an economy experiencing very strong demand.

This supports my view, explained in recent reports, that rising interest rate expectations have scope to push the US dollar up further, as the Fed is forced to slow the economy by much more in order to prevent high inflation from becoming ingrained in the system. Monetary policy is a blunt tool, and it will be hard for the Fed to slow the economy by enough to kill inflation, but not by so much that it prompts a deep recession further down the line, a task which could be compared to landing a jumbo jet on a country lane. So long as that recession threat looms the US dollar will probably also continue to be supported by demand from those investors searching for a financial safe haven.

GBP

The pound had a poor week last week, falling by around 0.8% against the US dollar, and by around 0.5% against the euro. There was little in the way of major economic data which could explain the pound's travails. Rather, sterling's weakness appears to have partly rested on news about the US economy (see the USD section above), but also on Thursday's Bank of England meeting. While the Bank announced a 50bp interest rate hike, this was already anticipated by financial markets. More noteworthy was the Bank's remarkably honest and downbeat economic projections, forecasting a recession beginning late this year and lasting for some time. That downbeat assessment may have hurt sentiment towards sterling, and prompted some investors to dial back their expectations for interest rate hikes from the Bank of England relative to other major central banks.

The UK's economic outlook is undoubtedly difficult. Even so, interest rates in the UK probably do have some way yet to rise if inflation really is to be brought back under control. What's more, the headwinds holding back the UK economy – most notably the shock from much higher energy prices – are blowing even more strongly on the continent. I envisage a pattern over the coming months in which sterling generally slides against a US dollar which is continuing to climb higher against most other currencies. But, at the same time, I expect the pound to make gains against the euro, given that an even worse backdrop for the Eurozone economy will prevent the European Central Bank, or ECB, from raising interest rates by very much.

EUR

The euro had a mixed week last week, falling by about 0.4% against the US dollar, but rising by around 0.5% versus the pound. While there were some mid-level data releases in the Eurozone covering retail sales and German industrial production for June, neither garnered much interest. Instead, the euro appears to have largely been a "price taker" last week, with its decline against the US dollar reflecting US-related and global factors (see the USD section above), and its rise against sterling largely a consequence of the Bank of England scaring off investors from investing in UK assets (see the GBP section above) rather than any euro-specific developments.

I see the euro's fortunes turning more sour over the coming weeks and months. So long as inflation in many parts of the world remains high, aggressive hikes to US interest rates and the threat of a global recession look set to continue to favour the US dollar over the euro. Meanwhile, the Eurozone faces an especially poor economic backdrop, being so much more exposed to the loss of Russian oil and gas. What's more, long-simmering concerns about the debts of peripheral economies such as Italy threaten to come to a head given rising interest rates, looming recession and volatile politics, providing another reason for investors to steer clear of the euro. Accordingly, I expect it to loose ground to sterling as well.

The Week Ahead

This week is a fairly quiet one in terms of scheduled economic data and events. Wednesday's data release on UK GDP in June will provide a less useful guide than usual on the underlying strength of the economy given that it will be affected by the Platinum Jubilee bank holidays, while Friday's data on Eurozone industrial production in June are, by this point, largely old news. The most important release bar none will be Wednesday's US CPI inflation report for July. A fall in oil prices means a lower headline inflation number is all but certain. More important will be what the report says about core inflation and underlying price pressures in the US. This could tip the US dollar strongly one way or the other.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	-0.78
$ per €	-0.36
€ per £	-0.49

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Wed. 10th	UK	19.00	GDP (%M/M)	Jun'	+0.5%	-0.9%
Wed. 10th	US	13.30	CPI Inflation (% Y/Y)	Jul'	+9.1%	+8.7%
Fri. 12th	EZ	10.00	Industrial Production (%M/M)	Jun'	+0.8%	+0.1%