From bad to worse for sterling

Market Report 09/05/22 - By Sam Balla-Muir

GBP

The British pound had another dire week last week, falling by around 1.7% against the US dollar, and by more than 2% against the euro. With limited UK economic data of note, the main trigger for the pound decline was the Bank of England's policy meeting on Thursday. The Bank hiked interest rates another 0.25%, but signaled that the hit to disposable incomes from the cost of living crisis meant the UK economy was at risk of a recession, and may mean that it does not need to raise interest rates by as much in order to lower inflation. All else equal, downward revisions to investors' expectations for interest rates in the UK mean a weaker pound.

While the UK undoubtedly faces a challenging economic backdrop, the experience of high inflation in the 1970s suggests that the Bank of England is underestimating the extent to which weak economic growth will bring down inflation by itself. If so, the Bank may yet have to raise rates some way further to add to the downward pressure. Although the pound may struggle to rise by much against the US dollar, given the Fed is set to deliver large rate hikes of its own, I expect sterling to eventually make decent gains against the euro. After all, the headwinds currently faced by the UK economy are blowing even more forcefully against the Eurozone. That said, the pound's near-term struggles may not end until the Bank of England clearly bows to the economic reality that it is not done raising interest rates just yet.

USD

The US dollar had another reasonably good week last week, strengthening against every other G10 currency bar the Australia dollar and the euro. Indeed, the US currency rose by around 1.7% against the

British pound. Part of the US dollar's rise is likely due to the volatility in global stock markets. As the world's de facto reserve currency, the US dollar typically appreciates during periods of volatility. And while the US dollar initially struggled to find much direction following the US Federal Reserve's policy meeting on Wednesday – as investors struggled to digest the central bank's mixed messages – long-term interest rates in the US ended the week higher, boosting the US dollar's appeal. What's more, strong labour market data on Friday – which showed the US added another 428,000 jobs last month – indicated that interest rates may have to rise further still if the Fed is going to slow the US economy by enough to bring high inflation there back under control.

With the US economy still in robust health, particularly compared to other major economies, I still suspect that investors are underestimating how much the Federal Reserve may have to raise interest rates to bring down price pressures, and that it will need to do far more than central banks in the UK and Eurozone. If investors come around to that view, the US dollar is likely to continue to climb higher, particularly against the euro.

EUR

The euro's gains of 0.4% against the US dollar last week, and more than 2% against the pound, look odd given the dire economic data released on the continent last week. Data revealed that retail sales fell by a larger-than-expected 0.4% in March, and that German industrial production collapsed by 4% in the same month, as supply disruptions linked to war in Ukraine took their toll. Other data showed that the labour market, at least, remained in relatively good shape. But the main factor pushing up the euro appears to have been hawkish comments from a raft of key figures from the European Central Bank, suggesting that the ECB might be on course to end its government bond purchases in June, raise interest rates in July, and get European interest rates out of negative territory by year's end – all much more rapid than investors had expected.

With the ECB's rhetoric on higher interest rates so out of kilter with the dire recent data, I suspect that the euro will soon drop back against both the US dollar and British pound, as it becomes clear that the Eurozone economy cannot handle as many interest rate hikes as both the ECB, and investors, seem to envisage. Although high costs for energy are an issue for the UK economy, they are an even bigger issue for the Eurozone given its greater dependence on Russian gas. Meanwhile, its manufacturing supply chains are also more deeply connected to those of Eastern Europe, and its labour market does not appear to be as in a strong of a position as Britain's.

The Week Ahead

Next week sees some key data releases. Although figures due on Wednesday may show that the annual rate of US inflation fell in April for the first time in nearly a year, this may not undermine the US dollar if the also show that prices still rose by much more on the month than US policymakers are comfortable with. GDP data for Q1, due on Friday, are likely to show that the UK economy is at least not contracting like the Eurozone economy seems to be. Indeed, data due on Friday are likely to confirm that industrial production for the Eurozone overall also fell very sharply in March. Finally, if, as is rumoured, the EU agrees next week to end its imports of Russian oil by the end of this year, that would further underline the challenges faced by Europe's economy.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	+0.26
$ per £	-2.50
$ per €	-2.34

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Weds. 4th	US	19.00	Fed Reserve Policy Meeting	Apr.	0.25% -0.5%	0.75% -1%
Thurs. 5th	EZ	12.00	Bank of England Policy Meeting	Apr.	0.75%	1%
Fri. 6th	US	07.00	German Industrial Production (%M/M)	Mar.	+0.2%	-0.7%