
**Hawkish Fed & Le Pen fears prompt FX volatility**

Market Report 11/04/22 - By Sam Balla-Muir

## USD

The US dollar had a very strong week last week, rising by around 0.6% against the British pound, roughly 1.6% against the euro, and ending the week higher versus every other major G10 currency bar the Norwegian krone. The US currency's latest strength had very little to do with the recent economic data, with Tuesday's international trade and ISM Services survey releases receiving little interest from currency traders.

Instead, the US dollar's rise appears to have been mainly driven by announcements from the US central bank, the Federal Reserve, about its plans to shrink the size of its balance sheet. In practical terms, this involves the Fed selling very large quantities of government bonds on net to investors, taking US dollars out of circulation, reducing the available supply. A speech by the Fed's second-in-command, Lael Brainard on Tuesday, and release of the minutes from the Fed's policy meeting last month on Wednesday, indicated that the Fed plans to do this at a much more rapid pace than investors' had anticipated. While the main aim of such a policy is to push back against very high rates of inflation, one channel through which this works is pushing up the value of the dollar, lowering import prices, and reducing demand for US exports.

As I had suggested in recent FX notes, it was somewhat surprising that the US dollar had not risen by more in recent weeks. After all, it had become increasingly clear that the Fed plans to tighten monetary policy very aggressively in order to bring inflation under control, the relative stance of monetary policy in different economies being a key factor driving exchange rates in the short run. The past week's announcement seem to have meant that last week saw the penny finally drop. Even though a lot of monetary tightening is already expected by investors in the US, I suspect that they are still underestimating how hard the Fed will have to go in order to bring inflation back under control. If so, the US dollar may yet rise much further.

**GBP**

Last week was a relatively quiet one in terms of economic data in the UK, with final S&P Global/CIPS PMIs – widely tracked business activity surveys – providing little new information, and speeches by Bank of England bigwigs Jon Cunliffe and Catherine Mann providing few clues on the near term outlook for monetary policy. Accordingly, the British pound struggled to find much direction, falling by around 0.6% against the US dollar, but rising by nearly 0.9% against the euro. Rather than anything UK-specific, those moves largely reflected developments state-side – the Fed's hawkish shift (see the USD section above) – or on the continent – concerns about Marine Le Pen's election chances.

I remain of the view that this pattern – the British pound falling against the US dollar, but rising against the euro – could continue. This is informed by my view about the outlook for monetary policy in the UK compared to elsewhere. Although the Bank of England needs to raise interest rates and tighten monetary policy significantly to get inflation under control, it is unlikely to do so as aggressively as the Federal Reserve, given that a series of recent economic shocks has left the UK economy in a more precarious position. Even so, the Bank of England still seems likely to tighten monetary policy by more than the Eurozone's ECB. Although the ECB also faces high inflation, raising rates there will be more challenging, given Europe's even weaker growth prospects, and the fragile debt positions of many Eurozone governments.

**EUR**

The euro performed worse than any other G10 currency last week, falling by roughly 0.9% against the British pound and by around 1.6% against the US dollar. As with most other currencies, those moves did not really reflect the week's economic data, with releases on Eurozone retail sales and German industrial production now largely old news, given that they mostly cover a period prior to Russia's invasion of Ukraine, with all the challenges to Europe's economy which that presents.

Rather, three other factors hurt the euro. First was the hawkish policy announcements by Federal Reserve officials (See the USD section above), which partly explains the euro's weakness relative to the US dollar. Second has been growing calls for Europe to end its imports of Russian gas immediately, in the wake of reported war crimes by Russia during its invasion of Ukraine. Notwithstanding the strategic and moral justifications for such a move, Europe halting its imports of Russian gas immediately would do major damage to the Eurozone's own economy. And, third, investors also appear to have woken up to the growing risk that incumbent French President Emmanuel Macron will be unseated by the Eurosceptic Marine Le Pen.

While both candidates appear to have won the votes that they needed from Sunday's first round election in order to move on to the head-to-head second round on April 24th, Macron's lead in the polls had narrowed sharply, and – according to last night's exit poll – Le Pen appears to have fared much better than many had expected in the first round. Although Le Pen has ditched former proposals for France to leave the EU and the euro, her victory would nonetheless heighten concerns about the future of the single-currency, and probably increase the perceived risks of investing in Europe.

With the second and final round of the election due to take place on Sunday 24th, political developments in France will probably remain a key driver of the euro in the short term. But even if the euro dodges a political bullet this week, I still expect the currency to depreciate against the British pound and US dollar over the coming months. With the German economy perhaps in recession, and a outright contraction in the Eurozone economy as a whole a real possibility, I suspect that investors are overestimating the extent to which the European Central Bank is likely to raise interest rates.

## The Week Ahead

This coming week sees a much busier calendar in terms of data and events that could move FX markets. In the US, a raft of economic data, including on inflation (Tuesday), retail sales (Thursday) and industrial production (Friday) will probably show that amid surging prices and a robust economy, there is a strong case for the Federal Reserve to tighten monetary policy. The raft of data on UK economic activity in February that are due next week are of less note, given that they mostly precede Russia's invasion of Ukraine, though data on the labour market (Tuesday) and inflation in March (Wednesday) will be key in terms of the Bank of England's near-term plans to raise interest rates. The coming week looks set to be an even more hectic one for the euro. The ECB's policy meeting next week could undermine the single currency if policymakers there are getting cold feet about their current plans to raise rates. But a bigger threat to the euro, this week at least, surely comes from French politics. (See the EUR section above.) That said, victory for Macron this coming Sunday will surely mean a "relief rally" in the euro.

**Last Week's Changes In Exchange Rates**

| Exchange Rate | %- change on week |
|---|---|
| € per £ | +0.88 |
| $ per £ | -0.62 |
| $ per € | -1.60 |

**Key Events**

| **Date** | **Market** | **Time (GMT)** | **Release/Event** | **Period** | **Previous** | **Analysts' Expectation** |
|---|---|---|---|---|---|---|
| Tue. 12th | US | 13.30 | Consumer Price Inflation (%Y/Y) | Mar. | 7.9% | 8.4% |
| Wed. 13th | UK | 09.30 | Consumer Price Inflation (%Y/Y) | Mar. | 6.2% | 6.7% |
| Thu. 14th | EZ | 12.45 | ECB Policy Meeting | Apr. | - | - |