



Euro flirts with parity against US dollar

Market Report 11/07/22 - By Sam Balla-Muir

USD

The US dollar rallied yet again last week, appreciating against all other G10 currencies. That included a gain of around 0.6% against the British pound, and of nearly 2.5% against the euro. Moves elsewhere in global financial markets, including the sharp fall in commodity prices, point to growing fears of a global recession. Those fears have lifted the US dollar as global investors have sought protection in USD assets such as US government Treasury bonds, widely seen as the ultimate financial boltholes. Those fears were only partially allayed by data released on Friday showing strong jobs growth in the US last month. Another factor boosting the US dollar, particularly against European currencies, has been the further surge in natural gas and electricity prices in European economies, as the energy crisis on the continent has deepened.

Forming a view on the likely path of exchange rates is complicated at present by the especially uncertain global economic environment. The extent to which weak activity and surging inflation in many parts of the world is an overhang of COVID, or something set to be more persistent, is very unclear. Given just how far the US dollar has risen against the pound and euro recently, it may struggle to make much further gains in the very near term. However, with the US economy appearing much more resilient than most others, and the potential for a global downturn also likely to lift the US dollar's appeal, I think the balance of risks points to further dollar appreciation.

GBP

The British pound had a mixed week last week, slipping by about 0.6% against the US dollar but rising by 1.8% versus the euro. There was limited economic data of note released in the UK last week, and sterling's declines against the US currency should be viewed in the context of the sharp appreciation in the dollar against most European currencies last week, on the back of fears of a global downturn and Europe's ongoing energy crisis. (See the USD section above). Turning to the pound's rise against the euro, the UK economy is at bit less at threat from the loss of Russian natural gas than many major economies in the continent are. But another factor clearly lifting the pound relative to the euro was the end of Boris Johnson's premiership. Investors appear to be hoping that his eventual replacement will be more comprising on Brexit, and will perhaps favour looser fiscal policy – in particular tax cuts – in order to appeal to the Tory grass roots. The boost to demand from tax cuts would put more pressure on the Bank of England to raise interest rates.

Political rumbling will clearly be relevant for the pound for a while yet. But, turning to the economy, the trends pointing towards further appreciation in the US dollar suggest that the pound may see further declines against the US currency, albeit maybe not as sharp falls as we have seen lately. Meanwhile, with the UK in a fundamentally stronger position vis-à-vis energy and the health of its labour market, I suspect that the pound will make further gains against the euro, as the Bank of England tightens monetary policy relative to the European Central Bank, or ECB.

EUR

The euro had a dire week last week, falling by 1.8% against the British pound and by a bit more than 2.3% versus the US dollar. While the economic data releases for the Eurozone last week were underwhelming, the more important factor for the euro has probably been the further sharp rise in natural gas and electricity prices on the continent, an ongoing consequence of the war in Ukraine leading to the loss of supplies of Russian gas. It is hard to overstate just how far energy prices have risen, to many multiples of what could be considered "normal". That threatens real harm to the Eurozone economy.

At the current levels, the euro has come very close to falling below parity with the US dollar, a risk I have warned of in recent notes. Investors appear to be coming around to my long-held view that the damage to the Eurozone economy from its energy crisis will mean that the ECB cannot raise interest rates by very much, despite high inflation. That has, in turn, undermined the euro's appeal to investors. Given just how sharply the euro has fallen, it may see a bounce in the near term. But given that the factors which have pushed it down so far seem unlikely to fade, I see the euro depreciating by more against the US dollar and British pound further ahead.

The Week Ahead

While the data calendar in the Eurozone next week is pretty sparse, with data on industrial production on Wednesday the only figures likely to garner much attention from currency traders. UK figures on GDP growth in May, also due on Monday, may suggest that the UK economy is flirting with recession, if the data show another small fall in output. A more notable batch of data is due in the US, with Wednesday's figures on inflation in June most likely to have an impact on the dollar, if they should that

price pressures remained very strong last month. Friday's data on industrial production and retail sales last month will also contain key insights into just how well the US economy is holding up.

Last Week's Changes In Exchange Rates

Exchange Rate%- change on week

€ per £ +1.84

\$ per £ -0.55

\$ per € -2.35

Key Events

| Date | Market | Time (GMT) | Release/Event | Period | Previous | Analysts' Expectation |
|----------|--------|------------|------------------------------|--------|----------|-----------------------|
| Wed 13th | US | 13.30 | CPI Inflation (%Y/Y) | May | +8.6% | +8.8% |
| Fri 15th | US | 13.30 | Industrial Production (%M/M) | June | +0.2% | +0.2% |
| Fri 15th | US | 14.15 | Retail Sales (%M/M) | June | +0.3% | +0.9% |