



High inflation fuels US dollar rally

Market Report 13/06/22 - By Sam Balla-Muir

USD

The US dollar strengthened sharply against all other G10 currencies last week, rising by 1.4% against the British pound, 1.9% versus the euro, and by even more against the currencies of most other major advanced economies. Sharp falls in global stock markets on Thursday and Friday presumably prompted some investors to seek out safe US dollar-denominated assets, the typical pattern during periods of financial turmoil. What's more, Friday's data showed that CPI inflation in the US accelerated to a new high of 8.6% in May. Core inflation – which strips out the prices of the volatile energy and food items – also remained much higher than the Federal Reserve's 2% target, and shows little sign of coming down quickly anytime soon, further strengthening the case for aggressive interest rate hikes.

While the US dollar might not continue to appreciate quite so rapidly, I suspect that last week's patterns are still a sign of things to come, with the US currency generally creeping higher against its peers. That is partly because I expect much more deeply ingrained inflationary pressures in the US to mean that the Federal Reserve hikes interest rates by much more than central banks elsewhere. And if – as seems likely – the threat of higher interest rates continues to weigh heavily on stock markets, safe-haven demand will probably continue to support the US dollar too.

GBP

While the British pound fell by around 1.4% against the US dollar last week, that largely reflected a couple of factors pushing up the US dollar (see the USD Section), rather than UK-specific weakness. Sterling, in fact, rose last week against the currencies of every other major advanced economy but the

US dollar, including a gain of around 0.5% against the euro. Despite there being limited UK economic data of note released last week, investors' appear to have raised their bets on the extent to which the Bank of England will raise interest rates over the coming months, a sterling positive, all else equal. The pound also seems to have welcomed Boris Johnson's victory in a vote of no confidence among Tory MPs early on in the week. Under current rules the Prime Minister's win leaves him immune from another leadership challenge for twelve months, providing a degree of political stability in the near term.

Although sterling may continue to lose some ground against the US dollar over the coming months, I doubt that it will depreciate a great deal further, and suspect that it will make meaningful gains against the euro. This follows from my view that the Bank of England will have to up the ante in terms of its plans to raise interest rates if it is to get on top of high inflation, with higher rates boosting the pound's appeal. The Bank's next policy meeting on Thursday might provide clearer signs of such a shift.

EUR

The euro had a trying time last week, dropping by around 1.9% against the US dollar, and by about 0.5% against the British pound. The 0.7% rise in Germany's industrial production in April was disappointing, reversing only a small fraction of the 4% decline in March, and highlighting that spillovers from the war in Ukraine are taking a heavy toll on the Eurozone economy. The European Central Bank's policy meeting last week was also a mixed blessing for the euro. On the one hand, the Bank's signals that it plans to raise interest rates more rapidly over the next few months than investors had anticipated should have been a euro positive. On the other hand, the ECB also disappointed investors who had expected it to announce a tool to prevent the yields of government bonds of some member states with large debt burdens, such as Italy, rising by too much, threatening their solvency. That left some investors less willing to hold euro-denominated assets.

In my view, the euro is likely to struggle from here against both the US dollar and British pound. Given the weakness in the Eurozone economy, and scarcer evidence of strong underlying inflationary pressures there, I do not think that the ECB will raise interest rates by as much as investors expect, diminishing the euro's appeal. What's more, the more that interest rates in Europe rise, the more concerns about the public finances of heavily indebted Eurozone members like Italy and Greece are to grow.

The Week Ahead

There is little economic data of note due in the Eurozone next week, though data on industrial production (Wednesday) and retail sales (Friday) for May will give some early hard evidence on just how well the US economy held up last month. A large of batch activity (Monday) and labour market (Tuesday) data in the UK may also get attention. However, the main two events next week will be the US Federal Reserve's policy meeting on Wednesday, followed by the Bank of England's meeting on Thursday. Both banks look set to raise interest rates and reaffirm plans to continue hiking in the months ahead.

Last Week's Changes In Exchange Rates

Exchange Rate%- change on week

€ per £	+0.46
\$ per £	-1.39
\$ per €	-1.90

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Weds. 15th	US	19.00	Federal Reserve Policy Meeting	June	-	-
Thu. 16th	UK	12.00	Bank of England Policy Meeting	May	+6.1%	+5.9%
Fri. 17th	US	14.15	Industrial Production % (M/M)	May	+1.1%	+0.5%