Market Report 13/03/22

Higher interest rates to combat inflation? By Sam Balla-Muir

USD

The steady appreciation in the US dollar against most other major currencies has continued. One factor supporting dollar strength has been investors' ongoing safe-haven demand for the world's de facto reserve currency, against a backdrop of continued conflict. A second factor has been growing expectations that – the war in Ukraine notwithstanding – the US Federal Reserve will continue with its plans to raise interest rates quite rapidly from here.

Typically, higher interest rates prompt a currency to strengthen. The pressure on the Federal Reserve to raise rates was underlined by data released last week showing that US inflation rose to almost 8% in February, before the latest surge in global oil prices had even been fully felt. These two factors help to explain why the US dollar last week appreciated by about 2.0% against the Japanese yen, roughly 1.8% against the Swiss Franc and by around 1.4% relative to the British pound. Admittedly, the US dollar gained less than 0.2% against the euro. But the resilience of euro seems to reflect a handful of developments specific to the euro-zone economy. (See the *EUR section* below.)

Although the war in Ukraine has made the outlook for currency markets even more uncertain than usual, I suspect that the balance of risks suggests that the US dollar will probably continue to strengthen against most other major currencies, including the euro and pound, from here. Ongoing conflict may continue to prompt investors to seek out the relative safe-haven of dollar-denominated assets.

What's more, while an easing of geopolitical tensions, or move towards ending the war might lead to an unwinding of some safe-haven flows which causes the US dollar to weaken in the near term, I suspect that the US dollar would nonetheless resume its climb before long. After all, that would give the Federal Reserve freer reign to tackle high inflation by rapidly tightening monetary policy, which would be a strong US dollar positive.

GBP

The British pound struggled last week, falling by around 1.4% against the US dollar, and by roughly the same amount against the euro. That weakness does not appear to be down to any UK-specific events but rather a strengthening of both the euro and dollar. Indeed, the main data release in the UK on Friday showed that the British economy grew by a stronger-than-expected 0.8% in January.

As with the US dollar, and to a large extent the euro, the two most important factors for the pound over the coming months will be both how the conflict in Ukraine evolves – especially when it comes to disrupting trade in energy commodities – plus how far the Bank of England goes in raising interest rates relative to elsewhere. The UK economy is more dependent on Russia for its energy needs than the US, but much less so than the euro-zone. Meanwhile, I suspect that the Bank of England will ultimately end up raising interest rates by a bit less over the next year or so than the US Federal Reserve, but by significantly more than the European Central Bank. On both counts then - exposure to conflict, and prospects for monetary policy, it seems possible to me that the British pound could fare worse against the US dollar from here, but better than the euro.

EUR

The roughly 0.2% fall in the euro relative to the US dollar last week appears far from impressive on the surface. However, it is worth noting that this took place during a week in which the US dollar was on a broad-based upward trend against most other currencies. (See the *USD section* above.) Indeed, the euro rose by around 1.4% against the British pound last week, and against many other major currencies too. With limited economic data on the schedule last week, the euro's resilience appears to have reflected a raft of policy announcements on the continent.

On Tuesday the European Commissions announced a detailed plan to slowly wean the EU off from imports of Russian gas, which appears to have somewhat ease concerns about a sharp drop in gas supplies doing heavy damage to the euro-zone economy. That was followed by news that the EU is also considering issuing new government as a block in order to fund new energy and defence projects, another positive, given that worries about the large debts of some members, such as Italy, have in the past led to prolonged periods of euro weakness.

But perhaps most important was the European Central Bank's announcement that, despite the war, it will reduce its government bond purchases more quickly than had been expected. That has led to speculation that European interest rates will rise sooner rather than later too, boosting the euro's appeal to investors.

Even so, while a couple of risk factors for the euro have diminished over the past week, I find it hard to be upbeat about the currency from here. So long as the conflict in Ukraine continues, the euro-zone economy remains very vulnerable to disruptions to energy supplies. Meanwhile, although the European Central Bank may have surprised many with its announcements last week, it is very hard to see it hiking interest rates by quite nearly as much as either the Bank of England or Federal Reserve. I would not be surprised to see further euro weakness over the coming weeks and months.

The Week Ahead

Other than further developments in Russia and Ukraine, there are a few economic data releases due next week that may influence currency markets. Data on US industrial production and retail sales in February might support the US dollar if they reveal that the US economy remained in good health last month. UK labour market data on Tuesday may influence the pound, though given that these cover only up to January, they are arguably now old news.

Potentially much more important for currency markets will be the policy meetings of the US Federal Reserve – on Wednesday – and of the Bank of England – on Thursday. The US central bank is widely expected to deliver its first rate hike in over three years, while most analysts suspect that the Bank of England will further raise its policy rate to 0.75%. If either central bank reaffirms its intentions to tighten monetary policy quite rapidly, despite the conflict in Ukraine, that might be a catalyst for gains in either the US dollar or British pound.

Currency Moves

Exchange Rate	%- change on week
€ per £	-1.37
$ per £	-1.43
$ per €	-0.16

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Wed 16th	US	12.30	Industrial Production (%Y/Y)	Feb.	+1.4%	+0.5%
Wed 16th	US	18.00	Federal Reserve Policy Announcement	Mar.	0.00% - 0.25%	0.25% - 0.50%
Thu. 17th	UK	12.00	Bank of England Policy Announcement	Mar.	0.50%	0.75%