US dollar's relentless rise continues

Market Report 16/05/22 - By Sam Balla-Muir

USD

The US dollar had another solid week, with the DXY index of the US currency's strength rising for a sixth consecutive week. This included a gain of roughly 0.6% against the British pound, and more than 1.3% against the euro. This may have partly reflected recent volatility in stock markets prompting the "flight to safety" into US dollar that is typical during panics. But the US dollar's gains were probably also due to a clear divergence in the week's economic data. While a strong US inflation report showed a hefty 0.6% rise in core consumer prices on the month in April, pointing to robust US demand, data from the UK and Eurozone was weak.

It seems unlikely that the US dollar will continue to climb quite so rapidly against either the pound or euro over the next few weeks, given how far and quickly the dollar has already risen lately, rising to levels not seen in twenty years. However, I still suspect that the balance of risks favour the US dollar gradually grinding higher against both the pound and euro over the coming months, as the US economy remains robust relative to its peers, the US Federal Reserve hikes interest rates by more than central banks elsewhere, and concerns about the growth of the global economic recovery climb.

GBP

The pound had a mixed week last week, rising against the euro, but falling by about 0.6% against the US dollar. Sterling's drop against the US currency was partly due to data which showed that the UK economy stagnated in February and contracted slightly in March, as the cost of living crisis started to bite. This suggests that the UK economy is at risk of a minor recession this year. The government's plans to make unilateral changes to parts of the Northern Ireland protocol, risking a showdown with the EU, also means that Brexit worries are weighing on the pound once again.

The reemergence of Brexit risks has darkened the near-term outlook for sterling, and the UK economy is in a difficult position. However, I doubt that the pound will continue to fare quite so badly. The strength of the UK economy mostly matters for the pound insofar as it influences the Bank of England's interest rate decisions, the main determinant of the relative appeal of the pound to short-term traders. But with inflation so high in the UK, the Bank of England may need to raise interest rates much further to counter it, even if the UK economy remains weak. Indeed, investors' recognition of this fact may partly explain why the British pound made gains against the euro last week.

EUR

The euro's falls of roughly 0.7% and 1.3% against the pound and US dollar, respectively, were slightly at odds with comments from a raft of European Central Bank officials who strongly hinted that the ECB will begin hiking interest rates in July. That would typically boost the euro's appeal. Set against this was a host of news confirming the Eurozone economy's weak position. Data for March showed that industrial production on the continent fell by nearly 2% in the month following Russia's invasion of Ukraine. What's more, news that the transit of Russian gas to the Eurozone via certain Ukrainian pipelines may be disrupted by the conflict highlighted that its economy is very vulnerable to a hit to energy supplies.

With these factors in mind, I still suspect that the euro will lose value against both the pound and US dollar over the coming months. Admittedly, given just how sharply it has fallen of late, the euro's declines may take a breather over the next few weeks, particularly if the ECB follows through with plans to raise rates in July. But further ahead, I suspect that an underperforming economy will mean that the ECB raises rates by less than investors expect, prompting the euro to weaken. With underlying inflation much softer in the Eurozone, the ECB is unlikely to need to raises rates aggressively amid a weak economy in the same way the Bank of England might be.

The Week Ahead

With limited data on the Eurozone next week, attention will be on data releases due in the US and UK. In the US, Tuesday's data on industrial production and retail sales in April look set to reveal that its economy has remained in good health, though housing starts data may point to the housing market – often the first part of the economy to falter as interest rates rise – starting to struggle. Otherwise, UK data will probably highlight the British economy's current "stagflationary" problems, with retail sales – due Friday – falling again last month and CPI inflation – due Wednesday – perhaps rising to nearly 9% as the utility price cap was lifted. With Tuesday's data also likely to reveal that the labour market remains healthy, the pressure of the Bank of England to raise interest rates is unlikely to ease by much.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	+0.69
$ per £	-0.62
$ per €	-1.33

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tues. 17th	US	13.30	Retail Sales (%M/M)	Apr.	+0.5%	+0.7%
Tues. 17th	US	14.15	Industrial Production (%M/M)	Apr.	+0.9%	+0.4%
Weds. 18th	EZ	07.00	CPI Inflation (%Y/Y)	Apr.	+7.0%	+8.9%