No end in sight for USD rally

Market Report 18/07/22 - By Sam Balla-Muir

USD

The US dollar rose yet further last week, climbing by 1.5% against the British pound and by 1.0% versus the euro. That contributed towards the seventh consecutive weekly rise in the DXY Index, which measures the US dollar's strength against other major currencies. The index has now increased by more than 20% since last summer, to its highest level in over 20 years. One factor contributing to the US dollar's latest rise was data released on Wednesday showing that CPI inflation rose by more than expected yet again, to over 9%, prompting investors to double down on their bets for the US Federal Reserve to raise interest rates by more than other central banks. Another factor appears to have been growing fears of a global recession, with the typical market bellwethers – commodity prices and stock markets – both falling last week. The recession fears were not eased by last week's relatively weak data releases on US retail sales and industrial production for June. Recession worries often boost the US dollar, as global investors seek out the relative safety of USD-denominated assets.

Given how far, fast and consistently the US dollar has risen in recent months, I suspect there is a good chance of a pause in its rally in the near term, as investors take stock of the USD-positive bets that they have already made. However, looking further ahead, I see little chance of the two main USD tailwinds of high inflation prompting US Fed rate hikes, and fears about a sharp slowdown in the global economy, fading. This is reflected in my view that the US dollar will end this year higher than its current level against the British pound, and much higher against the euro.

GBP

The pound struggled last week, falling by 1.5% against the US dollar and by about 0.5% against the euro. It is hard to pin that weakness in sterling on last week's economic data, with the main release on UK GDP for May showing a small expansion, better than many analysts had expected. In part, the pound's fall against the US dollar probably reflected certain US-specific and global factors (see the USD section above), but its decline may have also been due to political developments. Rishi Sunak, the one candidate to be the next Prime Minister who is not proposing the kind of large unfunded tax cuts that might force the Bank of England to raise interest rates, has remained the bookies' favourite.

I expect the pound's fortunes to be somewhat mixed from here. If the global economy continues to weaken, as I expect, sterling is likely to struggle by a bit more against the US dollar, as will most other currencies too. That said, I suspect that investors are also underestimating the extent to which the Bank of England will have to raise interest rates if it is to bring UK inflation back under control. As it becomes clear that the Bank of England has more to do on this front, I think that the pound will strengthen against many other major currencies, including the euro.

EUR

The euro fell by around 0.9% against the US dollar last week, but rose by about 0.5% against the British pound. The euro's decline against the US currency mainly reflected US and global-related factors, rather than events on the continent. (See the USD section above.) If anything, it is surprising that the euro did not fall by more, given that last week saw political infighting threaten to bring down Italy's coalition government, risking new elections that could see Eurosceptic and populist parties take power in what is arguably the Eurozone's weakest link. If such a collapse happens, investors would probably take fright, and the European Central Bank – ECB – may be less inclined to raise interest rates too, both euro negatives. Perhaps the euro was helped by the roughly 10% fall in European natural gas prices last week, a helpful development for a continent facing an energy crisis.

Although the euro might see a near term bounce given just how far and fast it has fallen in recent months, I suspect that it will end this year lower against both the US dollar and British pound. Europe's energy crisis and ongoing structural problems mean that its economy is in a very difficult position, and that the ECB is unable to raise interest rates by nearly as much as investors still expect. As this becomes clear, I see the euro falling further.

The Week Ahead

The coming week looks set to be a quieter one, with few economic data releases of note due in the US, and Federal Reserve officials entering their customary "blackout" period ahead of their policy meeting at the end of this month. In the UK, Tuesday's figures on the labour market, and Wednesday on inflation, may garner some interest. But the main event will be the European Central Bank's policy meeting on Thursday. The ECB is all but certain to raise its policy interest rate for the first time in over a decade, though there is a risk that the Bank disappoints if it does not signal more rate hikes further ahead, or fails to lay out the detail of its planned tool to stop Eurozone government bond markets from fragmenting.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	-0.46
$ per £	-1.46
$ per €	-0.94

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue 19th	UK	07.00	Unemployment Rate (%)	June	+3.8%	+3.8%
Wed 20th	UK	07.00	CPI Inflation (%Y/Y)	June	+9.1%	+9.3%
Thu 21st	EZ	12.45	ECB Interest Rate Decision	July	-0.5%	-0.25%