Sterling just can't catch a break

Market Report 20/06/22 - By Sam Balla-Muir

USD

The US dollar had a good run yet again last week, rising against every other G10 currency bar the Swiss franc, including a gain of around 0.2% against the euro and of just over 0.8% against the British pound. Two factors appear to explain the US dollar's rise on net. First, the very strong recent data on inflation convinced the Federal Reserve to raise its policy rate by 0.75% at its policy meeting last Wednesday, rather than the 0.5% rise that many analysts had expected. All else equal, higher US interest rates boost the dollar's appeal to investors. Second, last week was a volatile one not only for FX markets, but also for financial markets more generally, with the S&P 500 Index of US equities falling by around 6%, its worst week since the onset of the COVID-19 pandemic in March 2020. Such periods of turmoil in global financial markets often lead global investors to seek out the safety of dollar-denominated assets, given the US dollar's status as the world's de facto reserve currency.

By and large, I suspect that a similar set of factors will mean that the US dollar continues to climb from here. A relatively robust US economy, plus strong underlying inflationary pressures, mean that I think expectations for US interest rates will continue to edge up relative to those for other major economies. Meanwhile, ongoing fears about the health of the global economy, and volatility in global financial markets mean that "safe-haven demand" for the US dollar remains elevated.

GBP

The British pound had another difficult week, falling by around 0.8% against the US dollar, and also by around 0.5% against the euro. Sterling's travails appear to partly reflect some poor economic data, with figures released on Monday showing – unexpectedly – that the UK economy shrunk by around 0.3% in April. Data on Tuesday also hinted that the labour market – up until now a bright spot for the UK economy – may be beginning to soften too. However, another key factor behind sterling's decline was the Bank of England's decision last Thursday to hike its policy rate by only 0.25%, less than the 0.5% rise analysts had expected, and a fraction of the 0.75% increase enacted by the US Federal Reserve last week. Concerns about the UK growth outlook still appear to be dissuading the Bank of England from hiking interest rates more aggressively in order to get on top of very high UK inflation.

I am unconvinced that the gradualist approach to fighting inflation that the Bank currently favours can last. Although the UK economy remains in a fairly weak position, inflation in the UK is so high and show such limited signs of falling back that interest rates will probably need to rise a great deal further in the UK even if the economy remains weak. As a pivot towards heftier interest rate rises is "priced in" in the UK, I suspect that the pound will make gains against the euro, and stop falling quite so sharply against the US dollar.

EUR

Although the euro's fall of around 0.2% against the US dollar might not seem particularly impressive, the euro actually held up better against the US dollar last week than all other G10 currencies except the Swiss franc. It is hard to pin the euro's relative resilience on good news about the Eurozone economy. The main data release last week showed only a meagre gain in Eurozone industrial production in April, following its sharp decline in March. Meanwhile, wholesale European natural gas prices shot up by around 40% last week, on the back of ongoing supply disruption, another big headwind for Europe's flagging industrial sector. Instead, the euro's better performance probably reflects an emergency announcement from the European Central Bank – or "ECB" – that it will soon assemble a new "policy tool" intended to ensure that borrowing costs for heavily indebted Eurozone economies such as Italy do not rise by too much relative to those for "core" Eurozone economies, such as Germany. While this may seem like an arcane technical point, the upshot is that such a tool would sharply reduce the risk of another Eurozone debt crisis, making euro-denominated assets more attractive to investors.

While that policy announcement by the ECB seems to have boosted sentiment towards the euro for now, it is unclear whether this can last, given that the details of the new program have so far been minimal, and European policy makers have a track record of only implementing partial solutions, until a deeper crisis pushes them to more decisive action. I also remain of the view that the European Central Bank is unlikely to raise interest rates by nearly as much as investors anticipate over the next year or so, given the underlying weakness in the Eurozone economy. As that dawns on investors, I expect the euro to come under renewed pressure against most other currencies.

The Week Ahead

The main event in the US next week will probably be the testimony to Congress that Federal Reserve chair Jerome Powell is due to deliver, which may provide further clues on whether the US central bank favours another 0.75%-pt rate hike in July. Otherwise, although May data on UK retail sales due on Friday will likely point to deteriorating economic activity in the UK, another batch of very strong UK inflation data for the same month – due on Wednesday – will probably indicate that the Bank of England needs to raise interest rates aggressively anyway. Otherwise, there Is limited economic data due in the Eurozone next week, though Monday morning may see some market reaction to the result of Sunday's French parliamentary elections, which showed that President Emanuel Macron's Ensemble party failed to win an outright majority, potentially holding back his policy agenda

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	-0.52
$ per £	-0.81
$ per €	-0.23

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Weds. 22nd	UK	07.00	CPI Inflation (%Y/Y)	May	+9.0%	+9.2%
Weds. 22nd	US	14.30	Fed Chair Powell's Testimony	June	-	-
Fri. 24th	UK	07.00	Retail Sales % (M/M)	May	+1.4%	-0.7%