Market Report 21/03/22

Hopes for a peace deal provide respite for GBP and EUR - By Sam Balla-Muir

USD

After making strong gains throughout February and early March, the US dollar lost some ground against most other major currencies last week, slipping by around 1.3% against the euro, and by only a bit less against the British pound. That dollar weakness was not a result of the latest economic data, as last week's figures on US retail sales and industrial production for February were reasonably good. Meanwhile, the US Federal Reserve hiked its main policy interest rate by 25bp on Wednesday, and announced more aggressive-than-expected plans to tighten monetary policy over the next couple of years, in order to combat high inflation. Since relative shifts in interest rates between economies tend to be a key driver of currency markets in the short term, that kind of policy shift from the Federal Reserve would usually have been a significant US dollar positive.

The main factor offsetting the impact of a more hawkish shift from the US Fed has probably been growing hopes over the course of last week for some sort of peace deal between Russia and Ukraine, following reports earlier on in the week that the two countries had made progress in negotiations. That appears to have prompted some unwinding of the safe-haven inflows that typically support the US dollar in times of global crisis. Indeed, those currencies which have fallen by most during the course of the war so far – such as the Norwegian krone, Swedish krona and Polish zloty – rose by most against the

US dollar last week. The Russian ruble rebounded by around 20%, and the price of oil – the global supply of which has been threatened by the war – slipped back too.

As has been the case for the better part of a month now, the near-term outlook for the US dollar – and currency markets more generally – hinges on the course of the conflict in Ukraine. If efforts towards a peace deal fail to yield progress, this would be a US dollar positive. On the other hand, the US Federal Reserve has now indicated that it intends to raise interest rates at every one of its six remaining policy meetings this year. That means that there is probably now less scope for growing expectations for interest rate hikes to support the US dollar, at least over the next couple of months. Looking through the fog, however, very high and rising rates of US inflation appear to call for a strong response from monetary policy. I suspect that the balance of risks to points further dollar strength over the rest of this year, as it becomes clear that US interest rates need to be raised even more aggressively to bring inflation under control.

GBP

Last week was a mixed one for the British pound. It rose by a little over 1% against the US dollar, but fell by around 0.2% against the euro. As mentioned in the *USD section* above, the pound's gains against the dollar can probably be put down to the broad-based decline in the US currency due to an easing in safe-haven demand.

When it comes to explaining the pound's decline against the euro, sterling may have received a bit of support from data showing that the UK unemployment rate dipped to 3.9% in January, not far off its pre-COVID-19 low. However, this boost seems to have been more than offset by the signals on monetary policy provided by the Bank of England at its meeting on Thursday. While the Bank raised interest rates for a third time in this cycle it indicated that it might temper the pace of its further planned rate hikes, if sharply rising energy prices start to have a more significant impact on the economy.

As with the US dollar, developments in the UK will be key to the near-term outlook for the pound. But the other key factor for sterling will be how recent economic events influence the Bank of England's plans to raise interest rates. There now appears to be some risk that the potential hit to the economy from rising costs means that the Bank of England dials back its plans to raise rates, which would likely lead to some weakness in sterling, especially against the US dollar. The pound seems much less likely to slip back against the euro, however, given that the euro-zone economy is much more exposed to the negative effects of rising energy costs than the UK economy.

EUR

The past week was a fairly good one for the euro, which rose by just over 1.3% against the US dollar, and by roughly 0.2% against the British pound. There was little in the way of policy announcements of economic data on the euro-zone economy that could explain its recent gains, with the most high-level data released being wage growth data from Q4, which is by now old news. Instead, the euro's gains probably reflect growing hopes for some sort of peace accord between Russia and Ukraine (see the *USD section* above), which seems to have prompted an unwinding of safe-haven demand for the US dollar, and led investors to become less concerned about the potential risks to the euro-zone economy.

As mentioned above in the context of the US dollar and British pound, developments between Russia and Ukraine will probably be a key near-term driver of the euro, with some of its recent strength likely to reverse if peace talks fail to progress. Looking further ahead the euro's fortunes will depend critically on how much the European Central Bank moves to raise interest rates relative to other major central banks, such as the Federal Reserve and Bank of England. I suspect that the balance of risks is still tilted towards the weaker starting position of the euro-zone economy meaning that the amount of rate hikes there underwhelms, prompting the euro to weaken relative to the British pound and US dollar.

The Week Ahead

Developments in eastern Europe will probably remain a key driver of currency markets for some time, but otherwise this coming week appears to be a relatively quiet one for market-moving data and events. In the US, durable goods orders data for February may garner passing attention. More pressing will probably be the Markit Flash PMIs for March, business surveys which will give an early indication of how economies are coping with supply disruptions due to the war in Ukraine. Depending on what those data show, signs of economic damage may prompt weakness in the pound and euro. Finally, UK inflation data for February – due on Wednesday – may strengthen the case for the Bank of England to raise interest rates, especially if rising price pressures increasingly appear to be the result of a strong UK labour market, rather than mainly issues related to global supply chains and energy markets.

Currency Moves

Exchange Rate	%- change on week
€ per £	-0.20
$ per £	+1.10
$ per €	+1.34

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Wed. 23rd	UK	07.00	CPI Inflation (%Y/Y)	Feb.	+5.5%	+5.9%
Thu. 24th	EZ	09.00	Markit Flash Composite PMI	Mar.	55.5	54.0
Thu. 24th	US	12.30	Durable Good Orders (%Y/Y)	Mar.	0.50%	0.75%