How long will US Dollar weakness last?

Market Report 23/05/22 - By Sam Balla-Muir

USD

After six consecutive weeks of gains the US dollar finally slipped back last week, ending the week lower against all other G10 currencies, including 1.8% lower against the British pound and down 1.4% against the euro. The dip in the US dollar was all the more notable given that last week's data on US industrial production and retail sales in April pointed to continued resilience, pouring cold water on the idea that the US economy is slipping into recession. The US currency's decline was also at odds with the further sharp fall in global stock markets last week, as periods of turmoil in financial markets typically lead to "safe-haven demand" for dollar-denominated assets. Part of the US dollar's decline last week may have been prompted by data suggesting that the UK and Eurozone economies remain healthier than many investors may had thought.

However, more simply, periods of rapid appreciation in currencies are nearly always punctuated, on occasion, by pauses and reversals. As I suggested would be the case in my previous note, it was always likely that the recent rally in the US dollar would soon pause for breath following such a remarkably consistent period of strength. While this pause in the US dollar's climb might not be done yet, I still suspect that the US currency will be meaningfully higher against both the pound and euro six months from now. That is because I expect two factors which had until recently been fuelling the US dollar's rise – weak global stock markets and a relatively resilient US economy – to remain in place.

GBP

The British pound was one of the FX world's top performers last week, rising by around 1.8% against the US dollar, and by around 0.4% versus the euro. Partly, sterling received a boost from the broad-based decline in the US dollar (see the USD section above), following a very pronounced recent period of dollar appreciation. However, on top of this, a raft of economic data suggested that the case for the Bank of England to keep on raising interest rates remains strong. This data showed that the UK unemployment rate fell even further in March, while UK inflation hit a 40-year high of 9% in April, at the same time as retail sales rebounded.

I suspect that last week's recovery in the British pound may have further to run over the next few weeks – and especially against the euro – in part because I think that investors are underappreciating the extent to which the Bank of England will need to raise interest rates to bring inflation back under control. Indeed, with investors' expectations for interest rates rising by more in the UK than elsewhere last week, this already appears to be happening. However, further ahead, I expect the pound to slip back again against the US dollar, if not the euro, given that the US economy appears to be in a fundamentally stronger position than that of the UK.

EUR

While the euro slipped back by around 0.4% against the British pound last week, it finally regained some ground relative to the US dollar, gaining about 1.4%. In some way, a reversal in the EUR/USD exchange rate was overdue, given just how far and fast the euro had fallen. But the euro perhaps also received some support from data showing upward revisions to the second estimate of Eurozone GDP in Q1, and a further improvement in the labour market. More important still was probably signs in the minutes from the ECB's April policy meeting that the central bank is considering raising interest rate imminently. That message was strengthened by comments from key ECB policymaker Klass Knot last week that the bank may begin raising interest rates in 0.5%-pt increments, implying an even faster path of interest rate hikes than investors had expected.

The euro might strengthen a little further in the near term if the ECB follows through with plans to begin raising interest rates within the next month or two. However, I doubt that it will continue to rise beyond then. The hit to the Eurozone economy from the loss of imports of Russian energy has left it in a weak position, and I suspect that it will soon become clear that this economic weakness means that the ECB is unlikely to have to raise interest rates by very much in order to squash inflation. As this dawns on investors, I suspect that the euro will fall below parity against the US dollar by the end of this year.

The Week Ahead

The coming week looks set to be a relatively quiet one in terms of major data releases and events. The Flash PMI business activity surveys for May due in the US, UK and Eurozone may give some sense of how these three economies are faring relative to one another when released on Tuesday. Otherwise, the main release to watch will be the minutes from the Federal Reserve's policy meeting in early May, which should reveal how committed the US central bank was to plans to aggressively raise interest rates and shrink the money supply in order to bring inflation back under control.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	+0.39
$ per £	+1.84
$ per €	+1.43

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 24th	EZ	08.30	Flash Manufacturing PMI	May	55.5	55.0
Tue. 24th	UK	09.30	Flash Manufacturing PMI	May	55.8	55.0
Wed. 18th	US	19.00	FOMC Meeting Minutes	May	-	-
Thu. 26th	US	13.30	Prelim GDP q/q	-	-1.4%	-1.3%
Fri. 27th	US	13.30	Core PCE Price Index m/m	May	+0.3%	+0.3%