Hopes for Goldilocks slowdown interrupt USD rally

Market Report 25/07/22 - By Sam Balla-Muir

USD

After rising relentlessly over recent months, the US dollar fell back last week against every other G10 currency, including declines of around 1.3% against the British pound and 1.2% against the euro. The US currency's decline mainly reflects nuances in investors' shifting view of the global economic outlook. Data released early on last week suggested that US interest rate hikes are already leading to a sharp slowdown in the housing sector. Meanwhile, investors also seem to have latched onto S&P Global PMI survey figures pointing to a slight easing of price pressures as an indication that global inflation may now have peaked. Arguably, investors are increasingly hoping for what might be termed a "goldilocks slowdown" – a scenario where the interest rate hikes which have already been priced into financial markets weaken rate-sensitive sectors such as housing by enough to curb inflation, but not by enough to cause the type of deep economic damage that leads to safe-haven demand for the US dollar.

As I have discussed in previous reports in recent weeks, the US dollar had risen so far and so fast that some reversal in its upward climb was becoming likely. And I would not be surprised to see the US dollar weaken by a little more in the near term if this so called "goldilocks slowdown" narrative gains some further traction in global markets. However, I suspect that this narrative is built on weak foundations, and see the same trend which have boosted the US dollar sharply over 2022 resuming before long. While some "global" inflationary pressures seem to be easing, such as in goods prices and for commodities such as oil, "domestic" price pressures, such as in wage growth and labour markets, still appear very strong. That suggests to me that much further US interest rate hikes are likely. If that leads to fears about a sharper economic slowdown returning, safe-haven inflows into the US dollar would probably resume too.

GBP

The British pound rose by around 1.3% against the US dollar last week, but was essentially unchanged against the euro. In my view, sterling's rise against the US dollar mainly reflected global trends leading to a broad-based softening in the US currency. After all, the economic news from the UK was fairly mixed. UK inflation was revealed to have risen by more than expected last month, but core price pressures – excluding food and energy prices – slipped back, and figures for retail sales in June were fairly weak, as was the UK's S&P Global/CIPS Flash PMI activity survey for July. On the other hand, other data pointed to the labour market holding up well, with jobs growth still strong. Meanwhile, Liz Truss' emergence as the front runner to be the next Prime Minister also suggests that the Bank of England might have to raise UK interest rates further, given that Truss favours tax cuts that could increase demand and therefore inflationary pressures.

Where sterling goes from here, especially against the US dollar, will hinge more on global than UK-specific factors, and I generally expect the global macroeconomic backdrop to favour a bit more US dollar appreciation between now and the end of this year. However, I also suspect that sterling will appreciate against the euro, since I think the Bank of England will end up raising interest rates by more from here than the ECB, the European Central Bank. That reflects how the UK economy appears to be in a much stronger position, with more persistent inflationary pressures, particularly in the labour market.

EUR

The euro was more or less unchanged against the pound last week, and although it rose by around 1.2% against the US dollar, that appears to have mainly reflected US and global-specific factors (see the USD section above), rather than developments on the continent. Last week's news from Europe itself was rather mixed for the euro. The ECB's decision last Thursday to raise interest rates by 50bp, and to announce a supposedly unlimited program meant to contain the risk of another Eurozone debt crisis, should have been euro-positive. However, the collapse of Italy's coalition government, which looks set to lead to elections in which Italy's Eurosceptic right will gain power, pushed in the other direction, as did the ECB's refusal to say whether it would use its anti-debt crisis tool to counter investors concerns about political stability. Meanwhile, business activity surveys for the currency block for July were consistent with a recession.

As with sterling, where the euro goes against the US dollar from here will depend on global factors as much as European ones, but it seems hard to built a strong case for the euro based on the Eurozone's own domestic fundamentals. The Eurozone economy is very weak and facing a deep energy crisis, political uncertainty is high and seems unlikely to fade, and inflationary pressures on the continent appear to be much softer than in either the US or UK. That suggests to me that the euro will slip back against both the US dollar and euro from here, as the ECB struggles to raise interest rates by very much.

The Week Ahead

This coming week, a raft of data and events which could tell us more about the outlook for growth, inflation and interest rates look set to be the main driver of currency markets. The US Federal Reserve is very likely to raise interest rates by at least 75bp when its meeting concludes on Wednesday, but what the central bank signals about additional increases further down the line will be key. US Q2 GDP data due on Thursday will also receive a lot of attention, given worries about a recession there. Data on Eurozone GDP for last quarter at the end of this week will also garner some attention, though figures on inflation in July are probably more important in terms of the outlook for European interest rates and therefore the euro. Meanwhile, the calendar for the UK is fairly sparse.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+1.27
$ per €	+1.22
€ per £	-0.17

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Wed. 27th	US	19.00	Fed Interest Rate Announcement	Jul'	1.5%- 1.75%	2.25% - 2.5%
Thu. 28th	US	13.30	GDP (% Q/Q Annualised)	Q2	-1.6%	+0.9%
Fri. 29th	EZ	10.00	Flash HICP Inflation (%Y/Y)	Jul	+8.6%	+8.8%