



US dollar wanes in an incoherent week

Market Report 27/06/22 - By Sam Balla-Muir

USD

The US dollar depreciated against almost every other G10 currency last week. Admittedly, the moves in most cases were rather small, including a decline of only around 0.3% against the British pound and by 0.5% against the euro. But the rationale behind those moves is hard to fathom. One key trend in financial markets last week was investors growing more concerned about the risk of a recession, particularly in the US, partly on the back of a weak US Flash PMI business activity survey for June. That led investors to pare back their expectations for interest rate hikes globally. Since worries about interest rate hikes have been a key factor prompting volatility in global financial markets this, in turn, seems to have boosted investor sentiment. The key S&P 500 index of blue chip US stocks, for example, rose by about 7% last week. One consequence of this appears to have been a reversal in the safe-haven flows into US dollar-denominated assets which typically occur in times of financial turmoil.

While that might initially make some sense, investors appear to be overlooking the inconsistencies in their own argument. While fewer interest rate hikes would be good for investors sentiment, all else equal, this is unlikely to be the case if expectations for interest rates are being dampened by a growing likelihood of recession, which could cause its own problems for financial markets. I suspect that the US dollar will begin rising again in due course. One reason for this is that there are growing downside risks

to economic growth in the US, with a recession within the next year a real possibility. That could prompt a renewed flight to safety into US dollar assets. Meanwhile, even if growth is weak, the US Federal Reserve seems likely to continue to hike interest rates aggressively, boosting the US dollar's appeal. That was essentially the message of Fed Chairman Jerome Powell in his testimonies to the US Congress last week. Through either channel – weak growth hurting investor sentiment, or even more hikes to US interest rates – the US dollar seems likely to climb.

GBP

Last week was a mixed one for the pound, which appreciated against the US dollar by around 0.3% – on the back of an improvement in global investor sentiment pushing down the dollar in general (see the USD section above) – but depreciated against the euro by around 0.2%. The pound's decline against the euro was probably driven by some underwhelming economic data, including figures showing that UK retail sales fell significantly in May. Other data also showed that UK inflation rose last month, but by less than many had expected, partially undermining the Bank of England's plans to raise interest rates and thereby denting the pound's appeal.

That said, looking more closely at some of last week's data, some economists have put forward an alternative view which I find convincing. The UK Flash PMI business activity surveys for June suggested that the UK economy continued to hold up fairly well last month, and the survey also suggested that price pressures remain very strong. While UK inflation did not rise by as much as many expected last month, it still remains uncomfortably high. The Bank of England has sounded fairly cautious about raising interest rates in recent months for fear of harming the economy, apparently hoping that UK inflation will come down quite significantly on its own accord. As this optimism eventually proves misplaced, I expect the Bank of England to begin raising rates more aggressively, boosting the pound's fortunes. Indeed, the demands for higher pay which have prompted recent rail strikes could prove to be merely the tip of a fresh inflationary iceberg. I see the pound only losing a fairly small amount of ground against the US dollar, and rising against the euro.

EUR

The euro's reasonably good run last week – rising by 0.5% versus the US dollar and by 0.2% against the pound – is hard to square with the recent economic data, which has been decisively poor. The Eurozone Flash PMI business activity survey for the services sector pointed to a slowdown in June, while the manufacturing PMI for the same month pointed to an ongoing recession in industry on the continent. The German Ifo business survey, also for June, remained at a level consistent with a recession in the Eurozone's largest economy. The fuel for the euro's gain against the US dollar probably laid in a questionable recovery in global investor sentiment (see the USD section above), while its climb against the pound might reflect some underwhelming UK inflation data (see the GBP section above).

For reasons I describe above, I do not see either of these two sets of trends continuing to support the euro relative to either the US dollar or British pound. I remain of the view that the Eurozone economy

remains too weak to handle a substantial degree of interest rate hikes, even if inflation there remains too high, for the time being, for policymakers' liking. As it becomes clear that a weak economy means the European Central Bank will not deliver on the rate hikes that investors expect, I suspect that the euro will depreciate against both the US dollar and British pound.

The Week Ahead

The coming week looks set to be a quieter one in terms of obvious triggers for meaningful moves in exchange rates. Limited economic data of note is due in the UK, though economic data in the US on durable goods orders for May – due Monday – personal income and spending – due Thursday – and the ISM Manufacturing Survey – due Friday – will be closely watched for signs of weakness given recent US recession fears. Otherwise, the Eurozone ESI survey for June – due Wednesday – will probably also point to a weak continental economy. German and Eurozone inflation data for June are also due, on Wednesday and Friday, respectively.

Last Week's Changes In Exchange Rates

Exchange Rate%- change on week

€ per £	-0.20
\$ per £	+0.31
\$ per €	+0.53

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Mon. 27th	US	13.30	Durable Goods Orders (%M/M)	May	+0.5%	+0.1%
Fri. 1st	EZ	10.00	Flash Headline Inflation (%Y/Y)	June	+8.1%	+8.3%
Fri. 1st	US	15.00	ISM Manufacturing Survey	June	56.1	55.4