Market Report 28/02/22

A flight to safety strengthens the US dollar - By Sam Balla-Muir

USD

The US dollar ended last week stronger against most other major currencies. Admittedly, it fell slightly against the currencies of some advanced economies which are major exporters of raw materials, such as the Norwegian krone and Australian dollar, reflecting how commodity prices jumped on concerns that the Russia-Ukraine conflict will disrupt supply. But the US currency rose by around 1.2% against the British pound on the week, and by roughly 0.5% against the euro.

With few major data releases on the US economy last week, comments from Christopher Waller – a key decision maker at the Federal Reserve, the US central bank – suggesting that the Fed should raise its policy interest rate by 100 basis point by the middle of this year may have helped the US dollar's rise. Higher interest rates in the US relative to elsewhere boost the dollar's appeal to investors.

However, the far more important factor last week was probably Russia's outright invasion of Ukraine. Given the US dollar's role as the world's de facto reserve currency, it often rises during times of geopolitical stress, where international investors seek out financial safe-havens.

That said, rising by only 0.5% against the euro, and just over 1% against the pound, the upward move in the US dollar so far during the conflict has been remarkably small. That may reflect how many investors on Friday appear to have wrongly assumed that the heaviest forms of sanctions on Russia's economy – such as cutting Russia off from the Western financial system might be avoided. Many also appear to have anticipated a fairly swift end to the conflict, apparently not anticipating the remarkable strength of the Ukrainian resistance which has become clear over the weekend.

The near-term outlook for exchange rates is especially uncertain, and will depend on the course of the conflict, the extent of further sanctions on Russia, and the collateral damage to Western economies. I expect FX markets to be particularly volatile for at least the next few weeks, and a stronger dollar is probably likely over the coming months. After all, a prolonged period of heightened geopolitical tensions would probably lift the US currency higher. What's more, the euro-zone and British economies would likely suffer more than the US should trade with Russia halt, given their dependence on their Eastern neighbour for energy commodities. What's more, if it cleared the runway for the US Federal Reserve to begin aggressively raising interest rates in order to combat high inflation, an easing of tensions would not necessarily be all that bad for the US dollar either.

GBP

The British pound struggled last week, falling by just over 1% against the US dollar, and by about 0.4% against the euro. As discussed in the *USD* section above, the dip in the pound against the dollar probably reflects both greater safe-haven demand for the US currency, and how the UK's reliance on energy imports leaves its economy more exposed. However, the slight dip in pound against the euro is more puzzling. After all, the euro-zone's reliance on imports of Russian energy is even greater, and its economy is arguably even more exposed to the conflict than that of Britain's. Instead, the dip in pound against the euro appears to be due to investors paring back their expectations for interest rate hikes by more in the UK than in the euro-zone (investors were expecting much less in the way of interest rate hikes in the euro-zone to begin with).

While, in my view, the British pound might continue to struggle against the US dollar, I doubt that it will continue to fare as badly against the euro. With inflation in the UK already very high, and its domestic economy in better condition than that of the euro-zone, I think that expectations for higher interest rates could move in favour of the pound before long. And even if severe disruption to the UK's imports of Russian gas and oil starts to harm the British economy, I would warn against concluding that the Bank of England will completely abandon its plans to hike interest rates. Bank Governor Andrew Bailey has repeatedly made clear that he is already concerned about high inflation in the UK becoming longer-lasting, as price rises lead to workers demanding higher wages. Much higher energy prices might reinforce this dynamic.

EUR

The euro made a small gain of around 0.4% against the pound last week, as investors' expectations for interest rates moved in the euro's favour – see the *GBP section* for a fuller explanation. Even so, the euro fell by around 0.5% against the US dollar, probably reflecting safe-haven demand for the dollar, and the greater exposure of the euro-zone economy to the Russia-Ukraine crisis.

Although a lot clearly depends on the course of events over the coming weeks, I suspect that the euro could weaken against the US dollar and pound from here, in large part because of the euro-zone's closer economic ties to Russia, and its dependence on Russia for energy imports. How severely these energy imports are disrupted will be key. But, unlike in the UK and the US, the current high levels of inflation do not yet seem to be leading to workers on the continent bargaining for higher wages, or at least not to the same extent. That seems to reflect how the euro-zone economy is less robust. Even if a big shock to energy markets pushes prices in Europe even higher, the European Central Bank will probably be in less of a rush to raise interest rates than either the Bank of England or Federal Reserve.

The Week Ahead

Next week will see quite a few economic data releases and events which, on a more normal week, would usually be of key interest to currency markets. That includes the Wednesday's euro-zone inflation data for February, Friday's US non-farm payrolls release for this month, and Federal Reserve Chair Jerome Powell's testimony before Congress. However, the main driver of exchange rates for some time yet will probably continue to be the Russia-Ukraine crisis. Of key importance will be the course of the war itself, Russia's reaction to the tighter Western sanctions announced over the weekend, and news on how severely trade between Russia and the West will be disrupted. Whatever happens, expect the coming weeks in currency markets to be especially volatile.

Currency Moves

Exchange Rate	%- change on week
€ per £	-0.38
$ per £	-1.22
$ per €	-0.48

Key Events

Date	**Market**	**Time (GMT)**	**Release/Event**	**Period**	**Previous**	**Analysts' Expectation**
Wed 2nd	EZ	10.00	Euro-zone CPI Inflation (% y/y)	Feb.	5.1%	5.3%
Wed 2nd	US	15.00	Fed Chair Powell's Testimony	-	-	-
Fri 4th	US	13.30	US Non-farm Payrolls	Feb.	467,000	350,000