Euro's rebound seems unlikely to last

Market Report 30/05/22 - By Sam Balla-Muir

USD

The US dollar weakened against every other G10 currency last week, including a decline of 1.0% against the British pound and 1.6% against the euro. This weakness seems to be partly due to investors regaining their appetite for risk, in a week where the US stock market's S&P 500 Index rebounded by nearly 7%. That has presumably meant a reversal of some of the safe-haven flows into US dollar assets typical during times of financial turmoil. Another factor behind the US dollar's weakness was probably some less-than-impressive economic data, including an April new home sales report which pointed to a sharp slowdown in the housing market, and a durable goods orders report for the same month suggesting that investment spending might be slowing too.

If data on the US economy deteriorates sharply from here, that may prompt some near-term US dollar weakness, especially if it leads the Federal Reserve to reconsider its plans to rapidly raise US interest rates over the coming months. However, with US price pressures still very strong, and many other indicators pointing to the US economy remaining in very good health, I suspect that the Fed is more likely to double down on its plans to squash inflation with aggressive interest rate hikes. If so, the US dollar would probably resume its climb.

GBP

The British pound had a mixed week last week, climbing by 1.0% against the US dollar, but weakening by 0.4% against the euro. The pound's gains against the US dollar partly reflected an improvement in investor risk appetite (see the USD section), but the Chancellor's support package for households probably played a role too. After all, the hit to real incomes from the "cost of living crisis" has been a key factor dissuading the Bank of England from raising interest rates more forcefully to counter high inflation. In terms of the pound's decline against the euro, the widely tracked May Flash PMI activity survey for the UK was relatively weak, while the European Central Bank has also published guidance suggesting that it will accelerate its plans to tighten policy, a move not yet made by the Bank of England.

Therefore, one possible scenario is for sterling to weaken slightly against the US dollar, but to strength against the euro. This is reinforced by my view of the relative strength of UK, US and Eurozone economies, and what this implies for relative paths of interest rates, since relative expectations for rates are the main determinant of exchange rate moves in the short term. Although the Bank of England is unlikely to tighten monetary policy by nearly as much as the US Federal Reserve, I suspect that it will raises rates by significantly more than the European Central Bank, given that the Eurozone economy remains very fragile.

EUR

The euro fared well last week, rising by 1.6% against the US dollar, and by 0.4% against the British pound. An improvement in investor risk sentiment probably helped the euro (see the USD section), as did business activity surveys for May which pointed to a smaller economic slowdown than many had fared. But the main factor behind the euro's stronger gains seems to have been comments from European Central Bank chief Christine Lagarde, who laid out plans to raise the ECB's main interest rate out of negative territory by the end of Q3, pointing to a faster path of interest rate hikes in Europe than many had expected.

In my view, that reassessment of the path for interest rate hikes in Europe that has taken place in recent months is built on flimsy foundations. Although high inflation appears to have left the ECB determined to lift its deposit rate, from minus 0.5% at present, to 0.0% within the next few months, I doubt that the ECB will raise interest rates by nearly as much as investors currently anticipate thereafter. That is because a structurally weak labour market, sky-high energy prices, and geopolitical uncertainty linked to Ukraine on its doorstep have left the Eurozone economy in a weak position. As the ECB's resolve to raise interest rates further deteriorates, I suspect that the euro will weaken again against both the US dollar and British pound.

The Week Ahead

Key for currency markets next week will be data on the balance of growth and inflation in the US and Eurozone economies, and what this implies for the central banks plans to tighten monetary policy. In the US, May ISM business activity surveys on the manufacturing sector – on Wednesday – and services sector – Friday – will give the latest read on the strength of the economy, and extent of price prices faced by firms. Friday also sees the release of May's US non-farm payrolls employment data. Key in the Eurozone will be Tuesday's report on inflation this month, though data on unemployment and retail sales in April – due on Wednesday and Friday, respectively – may also receive attention. And in a bank holiday shortened week, there is little in the way of key data and events due in the UK.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
€ per £	-0.43
$ per £	+1.03
$ per €	+1.58

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 31st	EZ	10:00	Flash HICP Inflation (% Y/Y)	May	+7.4%	+7.6%
Wed. 1st	US	15:00	ISM Manufacturing Survey	May	55.4	55.0
Fri. 3rd	US	13:30	Change in Non Farm payrolls	May	+428,000	+329,000