A pause in the USD rally

Market Report 12/09/22 - By Sam Balla-Muir

USD

The US dollar slipped back last week against most other major currencies, including a fall of around 0.7% against the British pound and of about 0.9% versus the euro. With few other major economic data releases of note, the main driver of the retreat in the US currency last week was probably the ISM Services Index for August. The small uptick in the survey suggested that the largest sector of the US economy remains a long way from recession for the time being. While it may sound counter-intuitive for a strong data release on the US economy to prompt its currency to weaken, a key trend pushing the US dollar higher in recent months has been the safe-haven demand for USD assets prompted by fears for a global recession. Data suggesting that the world's largest economy is holding up well for now has eased those fears.

Even so, I suspect that the flow of news about the US economy in the coming weeks and months will be less positive, as inflation there remains elevated, and the higher interest rates required to tackle it induce a recession eventually. While both the pound and euro have their own issues working against them, I suspect that the safe-haven demand for the US dollar linked to a cratering global economy will be the main driver of the further gains that I expect from the dollar from here.

GBP

The easing of political uncertainty following Liz Truss' appointment as Prime Minister has provided only limited support to sterling. Although the pound rose by around 0.7% against the US dollar last week, that largely reflected USD-specific factors. Meanwhile, sterling slipped by around 0.2% against the euro. The energy support package announced by Truss last week seems necessary. But her governments' plans for extensive tax cuts has probably undermined investor confidence in UK policy making, given they risk making the UK's inflation problem worse and will be difficult to fund given the UK economy's already large current account deficit. This latter term essentially means that the UK consistently imports more than it exports and therefore must rely on foreigners to fund the difference, leaving it vulnerable to shifts in investor confidence. The weakness of the pound in recent weeks has been a symptom of this.

What happens next will depend in large part on how the Bank of England responds. With inflation high and foreign investors effectively being asked to fund the UK economy's growing budget deficits, higher interest rates are probably needed to restore confidence and ensure the capital inflows required to support sterling. If the Bank of England proves too timid with its interest rate hikes from here, a further depreciation in the pound will probably be needed to make UK assets appear sufficiently attractive again. While I had already expected the pound to lose ground against the US dollar from here, the Bank's choices will determine how much ground is lost, and whether sterling will slip further against the euro.

EUR

The euro fared reasonably well last week, rising by around 0.9% against the US dollar and by 0.2% relative to the pound. While partly reflecting better news about the global economy, the euro's gains were also the result of a fairly hawkish monetary policy meeting from the European Central Bank, which saw policymakers raise rates by 0.75%-pts and indicate that they will probably continue hiking even in the now rather likely scenario of a European recession. All else equal, higher rates lift the euro by boosting the returns available from EUR-denominated assets.

That said, as much as the ECB's determination to raise interest rates appears genuine, I suspect that this will provide only limited support to demand for European assets, and therefore the euro, given the grim economic outlook on the continent. Meanwhile, the ECB's ability to raise rates particularly far will hinge on avoiding a blow-up in markets for European government debt. Given the tricky economic backdrop, and that Italy looks set to elect a fairly Eurosceptic government at elections due later this month, this looks far from assured. I envisage further weakness in the euro from here against the US dollar, although the euro's fortune's relative to the pound will depend on the extent of the Bank of England's policy response to high inflation and greater government spending in the UK (see the GBP section above).

The Week Ahead

While August data on industrial production and retail sales in the US – both due on Thursday – will receive some attention from investors, more important for the US dollar will be the CPI inflation report for last month – due on Tuesday. With the Bank of England's next policy meeting moved from 15th to 22nd September as a mark of respect for HM Elizabeth II, the main news for the pound next week will probably be Wednesday's UK CPI report for August, as well as a raft of activity data due during the week. Little major data is due in the Eurozone, though a speech from EU Commission President Ursula von der Leyen due on Wednesday may tell us something about how Europe's response to its energy crisis is evolving.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+0.70
$ per €	+0.88
€ per £	-0.16

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 13th	US	13.30	CPI Inflation (%Y/Y)	Aug.	8.5%	8.1%
Wed. 14th	UK	07.00	CPI Inflation (%Y/Y)	Aug.	10.1%	10.2%
Wed. 14th	EZ	-	EU's Von der Leyen State of Union Speech	-	-	-