USD rally not over yet

Market Report 20/09/22 - By Sam Balla-Muir

USD

The US dollar climbed further against all other G10 currencies last week, including a gain of around 1.5% against the British pound, and a smaller rise of about 0.2% against the euro. The main driver of the greenback's jump was yet another set of stronger-than-anticipated inflation figures on Tuesday. The annual rate of headline inflation in the US fell by less than forecast in August and, more importantly, core prices - excluding food and energy - increased sharply again last month. That led investors to double down on bets that the US Federal Reserve will raise interest rates very sharply, squeezing the global economy in the process, in order to bring inflation back down. The further sharp falls in most stock markets last week echo this downbeat view. The combination of higher US interest rates and a worse economic outlook has fuelled further safe-haven demand for USD assets.

There are few signs that the rally in the US dollar is done yet. While the prices of oil and some types of goods disrupted by the pandemic are starting to dip, more persistent inflationary pressures in the labour market and services sector have continued to build. Meanwhile, the US Federal Reserve has signalled very strongly in recent weeks that it is a long way from done with raising interest rates, and will do what it takes to bring inflation back down, even if that means inflicting a lot of economic pain. I see safe-haven demand stemming from a combination of high inflation, higher rates and a global pushing the US dollar up further from here.

GBP

The British pound struggled yet again last week, falling by about 1.5% against the US dollar and by around 1.3% versus the euro. Sterling's struggles were partly a reflection of the US dollar surging on the back of yet more strong US inflation data. But some weak data out of the UK, including figures showing that a smaller 40,000 jobs were created in the three months to July, inflation numbers coming in not as high as expected in August, and other data showing that retail sales fell sharply last month, suggesting that surging energy bills are already prompting consumers to spend less elsewhere. This led investors to judge that the Bank of England might raise interest rates by a bit less relative to other central banks, denting the pound's relative appeal.

That said, while some of the headline figures out of the UK pointed to a weak economy, the details suggest that price pressures remain very strong, with wage growth far higher than is consistent with the Bank of England's 2% inflation target and price pressures in the UK services sector picking up further too. Add in the greater budget deficits that Liz Truss' government plans to run, and all the signs point to the need for much tighter UK monetary policy. Indeed, investors are already pricing in a large number of further rate hikes in the coming months. If the Bank of England disappoints those expectations, the pound might continue to struggle, not just against the US dollar but somewhat against the euro too.

EUR

While the euro fell by around 0.2% against the US dollar last week, it held up better relative to the greenback than most other G10 currencies, rising by around 1.3% relative to the pound. With most currencies falling against the US dollar given the very strong August US inflation report it is not clear why the euro did not slip by more. After all, data released on Wednesday pointed to a sharp fall in Eurozone manufacturing activity in July, and ZEW survey data for Germany on Tuesday were very weak too. Support may have come from a speech from EU Commission President Ursula von der Leyen on Wednesday, announcing substantial windfall taxes on energy companies that will be used to cut consumers' bills, limiting damage to the economy.

Given the tendency for the US dollar to strengthen during tough periods for the global economy, and that Europe faces a particularly trying economic outlook due to its energy crisis, I suspect that the euro has further left to fall against the US currency over the coming months, despite already being at multi-decade lows. The energy crisis has so far seemed to have distracted investors from Italy's upcoming election, which looks set to see the country elect a far-right led government that could raise big questions over the currency block's future, another risk factor. The euro may slip further against sterling too, though this is probably contingent on the Bank of England delivering the rate hikes that due UK economy clearly needs.

The Week Ahead

This Friday will see the release of flash PMI business activity surveys for September for the US, UK and Eurozone, giving the latest read on how each of these economies is faring. But more important for currency markets next week will probably be policy meetings from the US Federal Reserve and Bank of England, on Wednesday and Thursday, respectively. The Fed is expected to raise rates by another 0.75%-pts, though if it opts for a full 1%-pt hike, or raises its projections for further ahead, the dollar could benefit. Anything more than a 0.5%-pt hike from the Bank of England seems like a tall order, though the pound could also slip if the Bank does not signal that it is serious about bringing inflation back down.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	-1.51
$ per €	-0.24
€ per £	-1.27

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Weds 21st.	US	19.00	Federal Reserve Interest Rate Announcement	Aug.	2.25%-2.50%	3.0%-3.25%
Thu. 22nd	UK	13.30	BofE Interest Rate Announcement	Aug.	1.75%	2.25%
Fri 23rd	EU	09.00	Eurozone Flash Services PMI's	Aug.	49.8	48.9
Fri 23rd	UK	09.30	UK Flash Services PMI's	Aug.	50.9	49.9