



## **Hawkish Powell helps US dollar edge higher**

Market Report 29/08/22 - By Sam Balla-Muir

### **USD**

The US dollar rose a little further against most other major currencies this week, including by around 0.7% against both the British pound and euro, with the DXY index of the US currency's strength reaching a fresh twenty-year high. Three main factors explain the US dollar's gains. First, some poor economic data, including a surprise plunge in the US Flash Services PMI business activity survey for August. Second, European natural gas prices surged by another 40% last week, suggesting that the continent probably now faces an even deeper recession. And third, as I suggested would be the case in last week's note, Fed Chair Jerome Powell used his keynote speech at Jackson Hole on Friday to underline that the US central bank will do whatever it takes to bring US inflation back down to the 2% target. These developments all bolstered the view that an already struggling global economy will also have to bear the weight of much further increases in interest rates. That rather gloomy backdrop appears to have encouraged safe-haven flows into US dollar assets.

The fact that the US dollar did not climb even further last week on the back of the tough economic developments probably partly reflects how the US dollar has already risen to multi-decade highs against the euro and pound, with a lot of bad news already expected by investors. Even so, I suspect that the US dollar will generally continue to creep higher as the bad economic news keeps on coming thick and fast. European economies now face fairly deep

recessions, China is failing to pull itself out of its current slump, and the recent resilience of the US economy now also appears to be faltering.

### **GBP**

The British pound was more or less flat against the euro last week, but slipped further, by around 0.7% against the US dollar. Aside for some general US dollar strength on the back of safe-haven demand (see the USD section above), sterling's struggles seem to have reflected further bad news about the UK's energy crisis. Not only did we learn that the Ofgem utility price cap will rise by around 80% from October, an additional 40% surge in European natural gas prices last week suggests that much more pain is yet to come between now and the middle of next year. While the UK Flash PMI activity survey for August, released on Tuesday, suggests that the UK economy is not yet in recession, the huge hit to consumer's real incomes from higher energy prices suggests that a fairly deep slump in the UK is now only a matter of time.

For the time being, it seems hard to see where sterling might find some support. There seems limited chance of the energy crisis abating before the winter is over, and the economic news over the coming months is likely to be grim. Bank of England interest rate hikes might provide some support for the pound, but insofar as they come due to high inflation rather than stronger growth, that support will be limited. Some further sterling depreciation against the US dollar seems likely. That said, I remain of the view that the pound will at least make small gains against the euro. Germany and Italy both face a tougher energy backdrop than Britain does, and the Eurozone's structural flaws – which raise the risk of another debt crisis on the continent if government borrowing costs rise too far – will limit the extent to which the European Central Bank can defend the euro with rate hikes of its own.

### **EUR**

While the euro was more or less unchanged against the British pound last week, it slipped by a further 0.7% against the US dollar, falling below parity with the US currency once again. As mentioned in the USD & GBP sections above, the euro's decline partly reflected a darkening outlook for the global economy, but also a further intensification of the continent's energy crisis. Though the euro was also probably not helped by some poor economic data, including weak Eurozone Flash PMIs for August, as well as minutes from the European Central Bank's last policy meeting that pointed to the reluctance of some policymakers to help to keep borrowing costs low for heavily indebted member states like Italy. So long as that reluctance persists, it will be hard for the ECB to raise interest rates to tackle high inflation without risking another Eurozone debt crisis.

As also mentioned above, I suspect that a continued deterioration in the global economy, and with European economies suffering especially badly due to their energy crisis, will mean that

the US dollar continues to grind higher for a little while yet, including against the euro. What is more, the fragility of certain Eurozone member states with large debt burdens could yet again prove to be the currency area's Achilles heel. Given that the current combination of very high inflation and weak growth makes these issues for the Eurozone even more pressing than usual, I anticipate that the euro will drop back against the British pound over the coming months too.

### **The Week Ahead**

As has continued to be the case over recent weeks, the ongoing energy crisis, and particularly shifts in wholesale European natural gas prices, will probably continue to have a strong influence on exchange rates. There is limited economic data of note due in the UK this week, though investors will be watching US non-farm payrolls figures on Friday for any sign that jobs growth there is slowing from its strong recent rates. The US ISM Manufacturing survey for August, due on Thursday, may also garner some attention. Finally, key in the Eurozone will be the first estimate of inflation in August for Germany – due on Monday – as well as for the currency block as a whole – due on Wednesday.

### **Last Week's Changes In Exchange Rates**

Exchange Rate%- change on week

\$ per £	-0.68
\$ per €	-0.73
€ per £	+0.04

### **Key Events**

<b>Date</b>	<b>Market</b>	<b>Time (GMT)</b>	<b>Release/Event</b>	<b>Period</b>	<b>Previous</b>	<b>Analysts' Expectation</b>
Wed. 31st	EZ	10.00	Headline HICP Inflation (% Y/Y)	Aug'	+8.9%	+9.0%
Thu. 1st	US	15.00	ISM Manufacturing Survey	Aug'	52.8	52.1
Fri. 2nd	US	13.30	Change In Non-Farm Payrolls	Aug'	+528,000	+300,000