Sterling's rebound may not last

Market Report 03/10/22 - By Sam Balla-Muir

USD

The US dollar slipped back last week, falling by around 2.7% against the British pound and by about 1.1% versus the euro. While the US currency's decline against the pound partly reflected UK-specific factors, its broader weakness last week, including that against the euro, seems to reflect currency traders questioning just how much longer this bull market in the US dollar can continue. For much of this year the world's major central banks, chief among them the US Federal Reserve, have been tightening conditions in global financial markets considerably in order to weaken economies and thereby bring inflation back under control. As sentiment in markets turns, the perceived safety offered to global investors by the US dollar means that it typically surges relative to other currencies.

This can only go on so long as financial markets remain fairly orderly and continue to function roughly as normal. The need for the Bank of England to heavily intervene in the market for UK government bonds last Wednesday (see the GBP section below), and China's central bank becoming the latest to heavily intervene in its currency markets last week too, seems to have fueled a perception that certain parts of the global financial system are close to breaking point. If so, central banks may soon have to reverse course, potentially prompting a turning point in the US dollar in time too.

There is certainly a risk that we are nearing such a turning point, given just how far and

how fast the US dollar has strengthened over the past year or so. However, I remain of the view that the determination of most major central banks to see clear evidence that inflation is falling back considerably before they change tack means that the global economy, along with global financial markets, still has some pain left to come. That suggests to me that ongoing safe-haven demand for US dollar assets will mean the US currency strengthens a little further over the coming months.

GBP

To say that the British pound was volatile last week is a gross understatement. After a "flash crash" in Asian trading on Monday morning, to only $1.03/£, sterling staged a rebound in the following days, ending the week up by 2.8% against the US dollar and 1.7% higher against the euro, stronger than before the Chancellor's ill-fated budget announcement on Friday 23rd September.

The pound's recovery can partly be pinned on the response of the Bank of England. Investors, encouraged by the Bank's Chief Economist Huw Pill in a speech last week, now expect UK interest rates to be raised very sharply, in part to reinforce sterling's appeal to investors. Meanwhile, the Bank's decision to heavily intervene in the UK government bond market last week in order to prevent a financial crisis breaking out among British pension funds – on the back of market moves caused by the governments recent announcements – seems to have fueled a perception that the Bank will do whatever it takes to steer UK financial markets through their current turmoil. That seems to have helped to partly restore investors' confidence in UK assets, which had been severely dented by the government's decision to announce large unfunded tax cuts at a very ill-timed moment for the UK economy.

However, political factors also helped the pound. Given that the earlier turmoil in UK markets seems to have heaped such a great deal of pressure on both Chancellor Kwarteng and PM Truss, investors seemed to be anticipating some sort of political U-turn, either dialing back on tax cuts or accompanying them with cuts to spending in order to lessen the impact on the UK's public finances. And the pound did recover further against both the euro and US dollar on Monday on news that the planned cut to the 45p income tax band, a small but especially controversial part of the chancellor's programme, would be scrapped. Looking ahead, there now seems to be clear limits on how far Kwarteng and Truss can push their agenda. Whether their plans are hampered by the markets, by their own MPs threatening to eject them, or – if recent opinion polls are taken at face value – by their replacement by a Labour government at a general election, only matters so much.

The risk of another sharp and disorderly fall in the value of the pound seems to have diminished given the change in the political weather, but sterling is not out of the woods yet. The government's promise to set out plans in November for how they will

ensure the public finances remain on a stable long-term trajectory looks like an accident waiting to happen. And there is a high risk that the Bank of England fails to raise interest rates by quite as much as the financial markets are anticipating, given the damage that this would do to Britain's housing market. The Bank disappointing on that front could yet put renewed downward pressure on the pound. While the near-term outlook for sterling remains extremely uncertain, I suspect that a little further weakness against both the US dollar and euro is the most likely outcome.

EUR

Last week was a fairly quiet one for the euro, at least compared to the big moves seen in sterling and some other major currencies. The victory of right-wing populist, and somewhat Eurosceptic, political parties in Italy's general election seems to have left currency markets more or less unruffled, partly because that outcome was already expected. Strong Eurozone inflation data for September appeared to reinforce the pressure on the European Central Bank – ECB – to raise interest rates, though this is hardly news for the euro either. In the end, the euro's rise of around 1.1% against the US dollar seems to mainly reflect global, rather than euro-specific, factors. (See the USD section). Meanwhile, it's decline of around 1.7% against sterling seemed to mainly reflect the pound bouncing back from its own crisis. (See the GBP Section).

I remain of the view that the global forces pushing for a stronger US dollar will mean that the euro continues to slide against the US currency. Meanwhile, although very uncertain, I suspect that the euro could gain a little against sterling as the Bank of England fails to deliver quite as many interest rate hikes as investors currently expect. However, this is all contingent on the ECB managing to steer the eurozone through its current monetary tightening cycle without a blow up in the currency block's sovereign debt markets. That is a key downside risk for the euro, and one that hinges in large part on political decisions taken in Rome.

The Week Ahead

Key for currency markets next week will be the ISM business activity surveys for September due on Monday and Wednesday, as well as Friday's nonfarm payroll figures for last month. Little notable data is due in the UK next week, though media comments from both the government and Bank of England will probably both continue to have a strong influence on sterling. Data on Eurozone retail sales on Thursday and German industrial production on Friday are the key releases due for the euro.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+2.80
$ per €	+1.12
€ per £	+1.71

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Mon. 3rd	US	13.00	ISM Manufacturing Survey	Sep.	52.8	52.4
Wed. 5th	EZ	10.00	ISM Services Survey	Sep.	56.9	56.5
Fri. 7th	EZ	10.00	Change in Nonfarm Payrolls	Sep.	+315,000	+275,000