affinity EXCHANGE

USD bull run remains in tact

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

USD

Last week was a game of two halves in FX markets. The first two days of the week saw the US dollar weaken considerably against most other currencies. The ISM Manufacturing Survey for September, released on Monday, pointed to easing price pressures in the US last month, and other data released on Tuesday revealed a fall in new job openings in August, suggesting that some heat is coming out of the US labour market. Since the trend towards higher interest rates is currently the biggest threat to the global economy, and is therefore prompting strong safe-haven demand for US dollars, signs that inflationary pressures are already easing point to less of a need to hike rates, and a weaker US currency. However, other news later on in the week pushed in the other direction. That included a surprise cut to production by the OPEC oil cartel, which prompted oil prices to surge, and strong US data for September on the services sector and nonfarm payrolls. Those latter two releases suggested that price pressures in the US might not be easing by quite so much after all. In the end, the greenback ended the week 0.7% higher against the pound and up by 0.6% versus the euro.
There are certainly some signs that inflation, at least in the US, will soon start to fall back quite considerably. What’s more, the US Federal Reserve, along with most other major central banks, is already expected to raise interest rates to multi-decade highs in order to get inflation back under control. For those reasons, I think that the bulk of the rise in the US dollar is now behind us. Even so, the Fed seems determined to continue hiking interest rates until inflation is very clearly headed back towards its two percent target, even if this means inflicting a lot of damage on the global economy. Since inflation still has a long way to fall, I do not see these recent trends in FX markets changing for a couple of months at least. I suspect that safe-haven demand for dollars will mean the US currency continues to grind higher for a while yet.

GBP

There was limited economic data of note in the UK last week, nor did we receive much news about the UK governments' plans for fiscal policy, which have hurt sterling considerably in recent months. While Chancellor Kwarteng on Monday scrapped a planned cut to the 45p rate of income tax, this measure made up only a very small share of the tax cuts announced as part of the "mini budget". And the bigger picture as far as investors are concerned has not really changed. We already knew that the Chancellor and Prime Minister would be forced to backtrack to some extent, given their fiscal plans lacked the support of the financial markets, the electorate, and even many of their own MPs. And since it is still unclear what further concessions the government might have to make, the uncertainty over what exactly comes next continues to hang over sterling. While the British pound slid by around 0.7% against the US dollar last week that seemed to largely reflect global factors supporting the US currency (see the USD section above). Sterling was essentially unchanged versus the euro.

I think that the trends towards tighter monetary policy and a deteriorating global economic outlook – both of which point to a stronger US dollar – have further to run, suggesting some additional weakness in the pound versus the greenback. How far sterling falls, and whether it slips back against the euro too, now depends largely on infighting among the Conservative Party. That political dimension is clearly unpredictable, though the government's rumoured plans to lay out a medium-term strategy for how they will keep the public finances on a stable trajectory in late October looks like a potential flashpoint for the pound. Investors are also expecting the Bank of England to raise interest rates very sharply when it meets in early November. If the Bank fails to deliver at this point, sterling might see another sharp decline, prompting further political ructions.

EUR

Compared with the global shifts in the outlook for inflation and interest rates driving the US dollar, and the political turmoil buffeting the British pound, recent events in the Eurozone have been relatively uninteresting as far as FX markets are concerned. Data for August on Eurozone retail sales and German industrial production were both very weak, although largely as expected, and seem consistent with the view that the continent is now entering a deep recession. Meanwhile, minutes from the European Central Bank's last policy meeting hinted that the Bank remains determined to raise interest rates very aggressively, despite the poor economic outlook. But again, that view has already largely been discounted in markets. The euro's 0.7% decline against the US dollar last week seemed to largely reflect global factors supporting the US currency, with the euro little changed relative to the pound.

My base case is that the combination of a deteriorating global economy and especially deep recession in the Eurozone will mean that the euro continues to edge lower against the US currency. Meanwhile, the outlook for the euro relative to sterling seems to depend in large part on whether the UK's current government can avoid another confrontation with the financial markets. That said, I still think that the euro faces a not insignificant risk of another Eurozone debt crisis, given what the combination of surging interest rates and hit to government revenues from a recession means for heavily indebted member states, most notably Italy. While not my central scenario, it might only take one wrong move from politicians in Rome to tip the balance for investors from nervousness to panic.

The Week Ahead

A pivotal moment for FX markets will probably come with the release of September's US CPI inflation report on Thursday. Another strong month for core consumer prices might see the US dollar rise a little further. Otherwise, the minutes from the Federal Reserve's September policy meeting, due Wednesday, may shine some light on the central bank's thinking. There is limited economic data of note due in the Eurozone this week, though figures in the UK for August on the labour market – on Tuesday – and GDP – on Wednesday – may receive some attention.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	- 0.68
$ per €	- 0.59
€ per £	- 0.11

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Wed. 12th	UK	07.00	GDP (%M/M)	Sep.	0.2%	0.1%
Wed. 12th	US	19.00	Fed FOMC September Meeting Minutes	Sep.	-	-
Thu. 13th	US	13.30	US CPI Inflation (%Y/Y)	Sep.	+8.3%	+8.1%