Sterling welcomes Kwarteng's departure

Market Report 17/10/22 - By Sam Balla-Muir

USD

The US dollar had a fairly good week last week. While it slipped by around 0.8% against the British pound and gained only around 0.2% versus the euro those two currencies had domestic factors working in their favour. And last week saw reasonably big gains in the greenback against most other major currencies. In retrospect, it is somewhat surprising that the US dollar did not appreciate by more. After all, a raft of releases last week gave further fuel to the narrative that has pushed up the US currency by so much over the past few months – that very strong inflationary pressures mean a very aggressive tightening cycle from the Federal Reserve and probably a global recession. The minutes from the Fed's September meeting, released on Wednesday, confirmed that the central bank is more concerned with inflation remaining very high than it is with causing a sharp economic downturn. What's more, data on Thursday showed a new peak in the annual rate of US core inflation, while figures on Friday showed that US consumers' expectations for inflation in the years ahead have continued to climb. In other words, the Fed still seems to have a lot of work to do.

That the US dollar did not rise by more last week may reflect a view that interest rates in the US are already expected to rise to such heights, that it will be hard for the Fed to tighten by much more than this without prompting either a financial crisis, or a very deep economic downturn. Recent dislocation in the UK government bond market, which has required the Bank of England to step in to fix things, is a reminder of the risks here. While I would not write off the risks of such a financial accident taking place in the US, I do not think that the mere risk of this alone will convince the Fed to significantly change course. Meanwhile, severe strains in the global financial system typically mean a stronger, not a weaker, US dollar, as investors seek out "safer" currencies. In other words, I suspect that the same trends which have pushed up the US dollar further in recent months mean that it has a bit further left to climb.

GBP

The pound staged a further recovery last week, rising by around 0.8% against the US dollar and gaining roughly 1% versus the euro. The economic data in the UK continued to take a back seat last week, with UK politics and policymaking remaining the main driver of sterling. Further ructions in the UK gilt market, which required the Bank of England to step up its intervention, led the pound to slip during the early part of the week. But sterling rallied on Wednesday and Thursday as it became clear that Kwasi Kwarteng's time as chancellor was nearing its end. The pound took a bit of a knock on Friday, as Liz Truss struck a more defiant tone at a press conference, suggesting that she still wants to implement much of her "pro-growth" policy agenda. But the news that a large hike to the UK's headline rate of corporation tax will go ahead after all, and comments from Truss' new Chancellor Jeremy Hunt over the weekend suggesting that further tax changes will be pushed back, suggests that the government has, for the meantime at least, given up on most of the policy changes which had spooked markets around the time of the "mini budget". That explains much of sterling's recovery.

Even so, I would be wary of declaring that the pound is now out of the woods. A lot of political uncertainty remains, including over what the government will announce as part of its next fiscal event at the end of October and whether Truss has enough support among her own MPs to remain Prime Minister for much longer. Meanwhile, further troubles in the UK gilt market could hurt the pound yet again as the Bank of England's support for the market is wound down, and I also see a risk that the Bank fails to raise interest rates by quite as much as investors expect. Global factors also seem likely to continue to weigh on the pound relative to the US dollar (see the USD section above). I suspect that the pound will fall a bit further against the US dollar over the rest of this year, and there is a risk that it slides by a bit more against the euro too.

EUR

The euro had a reasonably good week last week. It fell by only around 0.2% against the US dollar, much less than most other major currencies. And while it dipped by around 1.0% against the pound, that mainly reflected the UK government's further retreat on fiscal policy rather than developments on the continent. In the Eurozone, a more resilient release on industrial production in the currency block in August probably provided the euro with some support, as did some very strong German inflation numbers for last month. Both releases underlined the case for the European Central Bank to continue hiking interest rates quite aggressively, with the prospect of higher rates boosting the euro's appeal.

I think that the global trend towards higher interest rates and a worse outlook for economic growth will mean that the euro continues to slip against the US dollar in the near term, even if the bulk of the euro's declines are now behind us. While I had thought that the euro would slip by a bit against the pound I am now much less sure of that, given the multiple headwinds that sterling faces (see the GBP Section above). That being said, I do still think that the euro faces some risk of another big blow up in its government debt markets, as the combination of a very weak economy and very high interest rates puts a great deal of pressure on some governments' finances. While not my base case, events in the UK gilt market of late show how easy it is for investors to flip from nervousness to panic.

The Week Ahead

The calendar next week looks like a quieter one for currency markets, with few data releases of note due in the US or Eurozone other than US industrial production data for September and the German ZEW investor sentiment survey for October, with both releases due on Tuesday. In the UK, data on inflation for September on Wednesday will grab headlines, especially if it creeps higher, as is expected. But more important for the pound will probably be the UK's ongoing political drama, and the question of how the gilt market fares as the Bank of England dials back its support.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+ 0.78
$ per €	- 0.23
€ per £	+ 0.96

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 18th	EU	07.00	ZEW Investor Sentiment Survey	Oct.	-61.9	-66
Tue. 18th	US	19.00	Industrial Production (%M/M)	Sep.	-0.2%	-0.1%
Wed. 19th	UK	13.30	CPI Inflation (%Y/Y)	Sep.	+9.9%	+10.0%