Ready for Rishi (again)?

Market Report 24/10/22 - By Sam Balla-Muir

USD

The US dollar slipped back last week, falling by around 1.2% against the British pound, 1.5% against the euro and retreating relative to all other G10 currencies too. The greenback's decline seems to have partly reflected sentiment about the global economy turning a bit less downbeat. US industrial production figures for September on Tuesday showed some encouraging resilience. And a raft of Q3 corporate earnings figures from some of America's largest companies showed that their profits remain fairly robust for now. That better economic news led some safe-haven demand for US dollars to unwind. Friday also saw media reports that the US Federal Reserve may soon slow the pace of its interest rate hikes. Given that rapid Fed rate hikes and the risks to the economy that they entail have been a key factor driving the US currency higher this year those media reports led the dollar to dip.

Some slowdown in the pace of increases in US interest rates was always likely to be signaled soon given just how far and how fast rate expectations have already risen. There are also clear signs that higher rates are putting a lot of pressure on parts of the financial system. But I'm not yet convinced that the Fed is about to change course significantly enough to prompt an end to the USD bull run just yet. Even if the Federal Reserve does slow the pace of its rate hikes soon, the US central bank has already raised its policy rate above 3% and looks set to go well above 4% within its next couple of meetings, a level not seen in more than fifteen years. I suspect that the damage this will do to the economy will yet lead to a lot more safe-haven demand for US dollars. What is more, a sharp fall back in the US dollar would probably require the Fed not only to stop raising rates but to begin actively cutting them. I think that persistently high inflation in the US means that such a move is some way off.

GBP

The British pound's gain of around 1.2% versus the US dollar last week was largely a reflection of broader US dollar weakness (see the USD Section above). By contrast, sterling's roughly 0.2% fall against the euro last week was more telling, indicative of a fairly mixed period for news from the UK. On the political front, sterling was the best-performing G10 currency on Monday, as new Chancellor Jeremy Hunt scrapped the bulk of measures included within Kwasi Kwarteng's doomed "mini-budget" and stated that the government will commit itself to responsible tax and spending at its medium-term fiscal strategy on 31st October. However, the pound was the second worst-performing G10 currency over the rest of the week. The chaotic way in which Liz Truss's government collapsed has made it even clearer that the Conservative Party is deeply divided in a way that makes it far from assured that Truss' successor will manage to establish a stable government either. On the economic front, a very weak set of retail sales figures for September on Friday seem to suggest that the UK has already entered a fairly severe recession.

Where the pound goes over the next few weeks is once again hostage to political events. This is partly a question of whether or not the UK sticks with the fiscal discipline that Jeremy Hunt committed to on Monday, unwinding much of the damage done to the government's credibility under Kwarteng and Truss. The question of whether Hunt remains as Chancellor and retains some autonomy over tax and spending decisions seems key. A second question is whether Liz Truss' successor has enough support to unite a Conservative Party that increasingly seems ungovernable. If they cannot, more erratic policymaking, political uncertainty and perhaps an eventual general election seem likely. Boris Johnson dropping out of the leadership race late on Sunday was been welcomed by the pound on Monday morning, given that Johnson seemed to lack the ability to unite the party. A decisive win by Rishi Sunak would probably be the markets' preferred option, though a lot of uncertainty remains over whether the next PM will find that intra-party divisions undermine their authority.

EUR

The euro had a fairly good week last week, rising by around 1.5% against the US dollar and by some 0.2% versus the British pound. The euro was helped in part by a broader trend towards US dollar weakness and the ongoing political uncertainty weighing on sterling. But some domestic factors seem to have helped too. Giorgia Meloni was sworn in as Italy's Prime Minister last week. While at the head of a coalition that many view as "far-right", Meloni has been clear in recent days that she wants to lead a pro-EU and pro-NATO government, which may have reassured investors. Meanwhile, Eurozone inflation data for September released last week confirmed that underlying price pressures remain very strong, further building the case for the European Central Bank, or ECB, to rapidly hike interest rates, which could boost the euro's appeal.

I suspect that fairly rapid interest rate hikes from the ECB will do a lot to support the euro over the next few months. Even so, this will probably not prevent the euro from slipping further against the US dollar if yet more signs of a sharp slowdown in the global economy prompt a general appreciation in the greenback. The euro's fortunes relative to sterling depend in large part on political events in the UK. But putting those to one side, the economic data in the UK have begun to deteriorate quite markedly. This, along with the government junking its earlier plans for fiscal stimulus, seems to point to less of an increase in UK interest rates relative to those in Europe, and perhaps a weaker pound relative to the euro too.

The Week Ahead

The coming week looks set to be a fairly quiet one in the US, with GDP data for Q3, due on Thursday, likely to be the main event. Political developments will remain key for the pound, but Monday's Flash PMI business activity survey for October will be of interest too. Next week would seem to be a much busier one for the euro. Expect the October Flash PMIs on Monday, an important ECB meeting on Thursday and figures on German inflation, as well as German, French and Spanish GDP, on Friday.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+ 1.18
$ per €	+ 1.45
€ per £	- 0.24

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Mon. 24th	UK	07.00	GBP Flash Manufacturing	Oct.	48.4	47.9
Thu. 27th	EU	19.00	ECB Press Conference & Rate Announcement	Oct.	1.25%	2.0%
Fri. 28th	UK	12.30	Next UK Prime Minister announced	Oct..	-	-