
**Kwarteng sends sterling to record lows**

Market Report 26/09/22 - By Sam Balla-Muir

**USD**

The US dollar rose sharply last week against every other G10 currency, including a gain of around 3.2% against the euro and of nearly 5% against the British pound. This was driven by a raft of meetings from the world's major central banks, including the US Federal Reserve, where policy makers raised interest rates much further and indicated that they plan to tighten policy very aggressively in order to bring inflation rates back to acceptable levels, even if this means causing a lot of damage to economies. This has taken a heavy toll on financial markets, with the S&P 500 index of US stocks falling by 4% last week, on the back of a 5% decline the week before. As is often the case during periods of stress in global markets, international investors have flocked to buy US dollars, given their role as the world's de facto reserve currency and that US government bonds are seen as the ultimate safe-haven asset.

The size of this single-week move in the US dollar is quite rare, and only usually seen during periods where global financial markets are creaking, such as the onset of the COVID-19 pandemic, or the global financial crisis. If policymakers change their tune to show a bit more moderation in their fight against inflation, the US dollar could retreat. However, for the time being, their determination to bring down inflation at nearly any cost points to a lot more pain for economies and markets. That suggests to me that safe-haven inflows into USD-denominated assets will continue to push the US dollar higher for some time yet.

## GBP

While nearly all currencies fell sharply against the US dollar last week (see the USD section above), sterling's decline was especially steep, dropping by almost 5% against the greenback and by around 1.2% against the euro. As I have flagged as a risk in recent weeks, the pound's plunge appears to reflect international investors losing confidence in British policy making, which is dangerous given the UK economy runs a large current account deficit. This piece of jargon essentially means that Britain as a whole spends more than it earns, so must rely on selling assets to foreigners to fund the difference. That leaves the pound vulnerable to sharp falls if international investors decide that they are less interested in what the UK has to offer. Chancellor Kwarteng's announcement of the largest tax cuts in many decades – which threatens to put the public finances on an unsustainable footing and pour further fuel on the UK's inflationary bonfire – seemed to scared many investors off.

Where the pound goes from here depends largely on whether UK policymakers do what is necessary to restore economic credibility. And those policymakers may be forced to deliver on this front sooner rather than later as a "flash crash" in sterling, to only around $1.03/£ in Asian trading on Monday morning, has drawn yet more media attention onto the UK's plunging exchange rate, as well as the sharp sell-off in the UK's government bond market. Sterling has drifted back to Friday's close at the time of writing on Monday afternoon, but largely because investors have moved to bet that the Bank of England will hike interest rates very sharply in near future in order to prop the pound up. Investors now expect the Bank's base rate to reach over 6% early next year, versus 2.25% at present. The Bank of England failing to deliver those interest rate hikes would probably mean further weakens in the pound. But actually delivering would also mean a great deal of harm to the British economy. That suggests mammoth rate hikes to support the currency are far from a done deal. The UK – and by extension sterling – appears to be in a very vulnerable position.

## EUR

Compared to events in many other economies, last week was a relatively quiet one for the Eurozone. While a weak set of flash PMI business activity surveys for the currency block on Friday may have contributed a little to the euro's roughly 3.2% decline against the US dollar last week, its fall mainly reflected a broad-based surge in the US currency as aggressive central bank interest rate hikes threatened to break global markets and the economy. (See the USD section above). The euro actually appreciated against some other currencies, including a gain of around 1.2% against the British pound.

So long as a global push by central banks to raise interest rates aggressively in order to bring down inflation is still in full swing, I suspect that most other major currencies, the euro included, will continue to depreciate against the US dollar. Whether the euro continues to gain relative to the pound depends in large part on whether UK policy makers can retain the confidence of international investors (see the GBP section above), which is in doubt. That said, I remain of the view that investors are underestimating the risk that a further climb in Eurozone interest rates prompts another sovereign debt crisis on the continent.

## The Week Ahead

Rather than any particular event or data release, of key interest for currencies early this week will be whether global financial markets stabilise following the chaos seen at the back end of last week. Otherwise, there are few particularly important data releases due in either the US or UK, though there is more news on the agenda in the Eurozone. That includes results, from Italy's general election early in the week, some business activity surveys for September on Thursday, as well as data on last month's Eurozone inflation on Friday.

## Last Week's Changes In Exchange Rates

| Exchange Rate | %- change on week |
|---|---|
| $ per £ | -4.87 |
| $ per € | -3.25 |
| € per £ | -1.69 |

## Key Events

| Date | Market | Time (GMT) | Release/Event | Period | Previous | Analysts' Expectation |
|---|---|---|---|---|---|---|
| Tue. 27th | US | 13.00 | Durable Goods % M/M | Aug. | -0.1% | -0.1% |
| Fri. 30th | EZ | 10.00 | Flash HICP Inflation % Y/Y | Sep. | 9.1% | 9.6% |
| Fri. 30th | EZ | 10.00 | Unemployment Rate | Aug. | 6.6% | 6.6% |