Sterling ends a volatile week bottom of the pack

Market Report 07/11/22 - By Sam Balla-Muir

USD

Last week was an extremely volatile one for FX markets. The US dollar strengthened considerably relative to all other major currencies from Monday through to Thursday. Some weaker economic data, including October ISM business activity surveys for the US manufacturing and services sectors, helped to contribute to a “risk-off” mood in currency markets that spurred some safe-haven demand for US dollars. But the main factor driving the greenback higher in the earlier part of the week was the Federal Reserve’s policy announcement on Wednesday. While the Fed’s decision to raise interest rates by a further 75bp was widely anticipated, Fed Chair Jerome Powell poured cold water on investors’ hopes that the US central bank might soon “pivot” towards looser monetary policy. Powell indicated that interest rates would rise higher than investors had previously thought, will likely remain high for longer, and that the Fed is happy to cause a recession if that is what is required to crush inflation. That supported the twin trends towards expectations for higher US interest rates and fears for the global economy that have been driving the US dollar higher for much of this year.

However, these trends reversed course dramatically on Friday, with the US dollar falling sharply, on speculation that China might soon abandon its “Zero-COVID” policy, and an October nonfarm payrolls report that seems to have been read by some as signaling that the US labour market is cooling down. A softer labour market would ease the pressure on the Fed to raise rates. With the exception of sterling, the US dollar ended last week either roughly flat or lower relative to all other G10 currencies.

In my view, the reaction of currency markets to the news from Monday to Thursday was roughly as I expected and have been calling for over the past few months. It seemed to be dawning on investors that the worst inflation problem that the global economy has faced in over four decades will require a prolonged periods of very high interest rates and probably a deep global recession in order to quash. I think that this will remain the dominant trend driving the US dollar for at least a few months longer.

By contrast, the moves in currency markets on Friday were puzzling and, in my view, will end up being a blip. There seems little chance of China meaningfully moving from its strict COVID policies anytime soon while such a large share of its elderly population remain inadequately unvaccinated. And even if this were to happen, such a move would probably USD positive, given that China’s demand for raw materials would rebound, putting further pressure on inflation and therefore the Fed. What’s more, when it comes to the labour market, one swallow does not make a summer. While slightly softer, last Friday’s data pointed to a labour market that is way too strong for the Fed’s liking.

GBP

Sterling performed very poorly last week, falling by around 2% against both the US dollar and euro, making it the world’s worst-performing major currency. Rather than reflecting political developments, economic factors were mostly responsible for the pound’s drubbing. As I predicated would be the case in last week’s note, the Bank of England surprised investors at its policy meeting on Thursday by indicating that it does not intend to raise UK interest rates by nearly as much as investors have been expecting, citing the weak outlook for the UK economy and its view that faltering growth will do a lot to bring UK inflation down by itself. The prospect of lower interest rates than they had thought, as well as a greater likelihood that the Bank will not do enough to get on top of high inflation led investors to dump the pound.

While I had expected sterling to weaken as the Bank of England failed to raise interest rates by quite as much as many investors had anticipated, I was surprised at just how strongly the Bank pushed back against the high expected path for rates that is priced into financial markets. By assuming that a weaker economy will do most of the work in taking care of inflation, the Bank of England seems to be taking a fundamentally different view of how to deal with high inflation than either the Fed or the European

Central Bank, which see interest rates as doing a large share of the heavy lifting. The pressures in the global economy pushing for a stronger US dollar mean that sterling is very likely, in my view, to trend lower against the greenback from here (see the USD section above). But I suspect that continued disappointments on interest rates from the Bank of England could mean that sterling slips further against the euro as well.

EUR

The euro also experienced a lot of volatility but, on net, it ended last week roughly flat against the US dollar but up by around 2% against sterling. As often seems to have been the case in recent weeks, these weekly numbers seem to largely reflect either the global factors pushing for a stronger US dollar, or UK-specific factors driving down the pound, compared to a relatively quiet period for news on the Eurozone. That said, a couple of data releases last week were arguably euro positive. A much-larger-than-expected jump in the Eurozone's headline inflation rate to 10.7% in October supports the European Central Bank's case that tighter monetary policy is needed to reduce price pressures, as do figures showing that the currency block's unemployment rate fell a bit further in September, to a fresh multi-year low. Meanwhile, speeches for some European Central Bank policy makers indicated that – unlike the Bank of England – they see the risks tilted toward higher interest rates still being necessary to bring inflation back down.

I remain of the view that there is further room for the US dollar to appreciate against the euro, as well as most other major currencies, as the combination of high US interest rates and a very weak global economy continues to drive safe-haven demand for the US currency. However, I also think that the European Central Bank's monetary policy is far more likely to surprise on the upside relative to expectations than policy from the Bank of England. While I expect both currencies to slide further against the US dollar, I suspect that the euro will rise a bit further relative to sterling, as the ECB sticks to its guns, and the Bank of England hesitates from further aggressive rate increases.

The Week Ahead

A couple of mid-level data releases due in the Eurozone and UK might garner the attention of investors this coming week, including German industrial production numbers for September on Monday, Eurozone retail sales figures for the same month on Tuesday, and data that could point to a contraction in the UK economy in September on Friday. But far more important will be Thursday's US CPI inflation numbers for October, probably still the world's most important data release at present, given that their trajectory will determine if and when central banks can change their plans to tighten monetary policy.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	- 1.02
$ per €	- 0.03
€ per £	- 2.04

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 8th	US	All Day	Congressional Elections	Nov.	-	-
Thu. 10th	US	13.30	US CPI Y/Y	Nov.	8.2%	7.9%
Fri. 10th	UK	12.30	GDP M/M	Nov,	-0.3%	-0.4%