Softer US inflation figures sends the dollar plunging

Market Report 14/11/22 - By Sam Balla-Muir

USD

The USD dollar plunged last week, with the DXY index measuring its strength versus other currencies falling by more than 4%. Besides the panic in markets at the onset of the pandemic this was the largest weekly decline in the US dollar since 1985. The markets seemed to shrug off the results of the US mid-term elections. Split or narrow control of Congress will limit what either party can do, meaning that US politics looks likely to take a back seat as a driver of currencies. The plunge in the greenback instead reflected Thursday's softer US inflation figures for October. A smaller monthly rise in prices meant that the annual rate of core inflation in the US dropped back to 6.3%, from 6.6% in September. Expectations for US interest rate fell back very sharply in response, as investors judged that softer inflation would reduce some of the pressure on the Federal Reserve to keep on raising rates. Lower US interest rates would undermine the dollar's appeal. They would also limit some of the downside risks to the global economy, causing some of the recent safe-haven demand for US dollars to unwind.

Weaker US inflation numbers should reduce some of the pressure on the Fed to keep on raising interest rates, though my view is that markets have overreacted to a single month's figures. Inflation seems set to come down further in the coming months as pandemic- and war-related surges in goods and commodity prices continue to unwind. But there is a strong case that more underlying price pressures, especially from the labour market, will mean that US inflation remains too high for comfort for some time. If so, the Fed might not slow down its rate hikes by as much as investors now hope. What's more, if I am right that the monetary tightening that is already in the pipeline will do significant damage to the global economy, the US dollar will probably receive some boost from safe-haven demand even if the Fed relented. I remain cautiously bullish on the US dollar's near-term prospects.

GBP

While the British pound rose by around 4.0% against the US dollar last week that seemed to largely reflect US inflation figures pushing for a weaker greenback, rather than UK-specific developments. After all, sterling was essentially flat against the euro last week. That said, the few more interesting bits of news we did receive on the UK economy last week arguably support a downbeat view on the pound's prospects. GDP data for Q3 released on Friday suggested that the UK economy is already in recession. Meanwhile, media reports suggest that Chancellor Jeremy Hunt is still planning both some fairly large increases in taxes alongside substantial spending cuts at this coming Thursday's fiscal statement. Tighter fiscal policy at a time of surging energy bills and higher interest rates will further sap demand from an already spluttering UK economy.

As I have made clear in recent notes, I think that the same global and US-specific factors which have pushed the US dollar higher this year will mean that it will soon resume its ascent against most other currencies, including the British pound, over the coming months. However, I think that there is a strong case that the mounting headwinds to the UK economy will also mean that the Bank of England fails to deliver the extent of interest rate hikes that is currently discounted in financial markets. If so, that would further undermine sterling, and probably lead it to decline against the euro over the coming months too.

EUR

As with most other major currencies, the euro rallied against the US dollar by nearly 4% last week, though this mainly reflected a weaker batch of US inflation data sending the US dollar lower, rather than developments on the continent pushing the euro higher. After all, the euro ended last week down by around 0.2% against the British pound. More generally, last week was a quieter one for key data and events in the Eurozone, though a couple of data releases from last week should arguably have been euro-positive, at least at the margin. Figures released last Monday and Tuesday, respectively, revealed unexpected increases in both German industrial production and Eurozone retail sales in September, indicating that the Eurozone economy may be holding up slightly better than many had feared. Otherwise, another very strong set of German inflation figures for October released on Friday also supported the case for the European Central Bank to continue raising interest rates.

Notwithstanding the jump in the euro against the US dollar last week, I expect the euro to resume its slide against the US dollar over the coming months, as the Federal Reserve remains much more hawkish than investors expect and a faltering global economy fuels continued safe-haven demand for the US currency. That said, I suspect that continued interest rate hikes from the European Central Bank, beyond what is discounted in financial markets, will provide some support to the euro, a view arguably backed up by last week's data releases. If so, the euro might make gains against sterling, particularly if the Bank of England disappoints investors expectations.

The Week Ahead

A raft of data released due in the US this week should give the latest read on how the world's largest economy is holding up, including retail sales and industrial production figures for October on Wednesday, and numbers on strength of the US housing market on both Wednesday and Thursday. Other than the Chancellor's Autumn Statement on Thursday, sterling may also be moved by numbers on the UK labour market on Tuesday, inflation on Wednesday, and retail sales on Friday. Few data releases of note are due in the Eurozone.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+ 4.04
$ per €	+ 3.94
€ per £	+ 0.18

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Tue. 15th	UK	07.00	Claimant Count Change	Oct.	1.6%	1.2%
Wed. 16th	US	07.00	CPI Inflation Y/Y	Nov.	10.1%	10.7%
Thu. 17th	UK	TBC	Autumn Forecast Statement	-	-	-