US dollar at a crossroads

Market Report 21/11/22 - By Sam Balla-Muir

USD

Last week was a quieter one for currency markets, but the US dollar generally steadied following the sharp falls prompted by a batch of softer US inflation figures in the week before. While the US currency dropped back by around 0.4% against the British pound last week, it rose by around 0.3% versus the euro, and regained a bit of ground against most other major currencies too. That better outturn for the US dollar may have been prompted by data released last Wednesday showing that US industrial production and retail sales were both fairly resilient in October. But more important were probably a raft of speeches from key policymakers at the Federal Reserve indicating that the US central bank still favours tighter monetary policy. Christopher Waller pointed out that one weaker inflation report does not make a trend, while several others, including Vice Chair Lael Brainard and St. Louis Fed chief James Bullard, suggested that US interest rates still have much further to rise.

That said, the hawkish rhetoric trotted out by the Fed only had so much of an effect on investors' expectations for US interest rates, explaining why the US dollar made only limited gains last week too. Investors still seem to suspect that – despite Fed policymakers' insistence – hikes to interest rates will soon give way to cuts as inflation drops back and the global economy continues to slow. However, while I expect inflation to continue to retreat from its current highs, I suspect that it will remain far too elevated for the Fed to consider ending its tightening cycle for quite some time. As this realisation dawns on investors, I suspect that revisions to their expectations for interest rates will give a renewed boost to the US dollar. And as the global economy continues to turn south, I suspect that safe-haven demand will give a meaningful boost to the greenback too.

GBP

The British pound was one of the best-performing major currencies last week, rising by around 0.4% against the US dollar and by about 0.3% versus the euro. The pound's better performance probably mainly reflects the Autumn Statement that Chancellor Jeremy Hunt delivered last Thursday. By announcing substantial tax rises and spending cuts, but in a package that only really starts to bite from around 2024 onwards, Hunt has managed to walk a fine line between retaining the confidence of investors but also delaying most of the fiscal pain until later on, when the economy will presumably be stronger. Sterling may have also been supported by some of last week's economic data. While figures released last Tuesday showed that employment in the UK fell by around 53,000 in the three months to September, wage growth remains very strong, supporting the case for Bank of England rate hikes. Data on Wednesday showing another sharp rise in UK inflation, to over 11% in October, gave a similar message.

As explained in the USD section above, I suspect that the combination of a very hawkish US Federal Reserve and safe-haven demand linked to a faltering global economy will mean that most major currencies, including sterling, will slip against the US dollar in the coming months. All else equal, the very strong price pressures that are evident in the UK would point to the need for very aggressive further interest rate hikes from the Bank of England. If so, that would provide sterling some support against the euro. However, compared to other central banks, including the ECB, the Bank of England has put far greater emphasis on the downside risks to economic activity, than on the strength of inflation. That could lead the Bank to disappoint investors' expectations for rate hikes, prompting the pound to slip against the euro too.

EUR

The euro struggled a little last week, falling by around 0.3% against the US dollar and dropping by about 0.6% versus sterling. Those falls seem to largely reflect a fairly broad-based uptick in the US dollar on the back of some more hawkish comments from Federal Reserve officials (see the USD section) and the fiscal package announced in the UK by Jeremy Hunt (see the GBP section), rather than bad news about the Eurozone economy. In fact, Eurozone industrial production data published on Monday showed a surprise jump in September, the German ZEW investment sentiment survey for November released on Tuesday rebounded by more than expected, while figures from Thursday showed that underlying inflation on the continent remains very strong. All three of those data points arguably support the case for further interest rate hikes from the ECB, and are therefore arguably euro positive.

If I am right about the US Federal Reserve remaining hawkish for some time, and in my expectation for the global economy to take a turn for the worse, it seems like a tall order for the euro to make any headway against the US dollar over the coming months. However, I do think that the euro could make gains relative to sterling. While the UK and Eurozone face a similar combination of cratering economic growth and very high inflation the European Central Bank appears to be much more concerned about high inflation than the Bank of England is, with the latter stressing the downside risks to economic growth. As this difference in approach is borne out in monetary policy decisions over the coming months, I expect the euro to rise relative to the pound.

The Week Ahead

The main events of note in the US for currency markets over the coming week will be the release of the minutes from the Fed’s fairly hawkish October policy meeting and last month’s data on durable goods orders, both due on Wednesday. Beside from a raft of speeches from key Bank of England policymakers throughout the week, Wednesday’s UK flash PMIs for November will give the latest read on how the British economy is holding up. Finally, in the Eurozone next week we will also get the minutes from the ECB’s October policy meeting on Wednesday, November flash PMIs for the currency block on the same day, and perhaps Italy’s government submitting a draft budget to the European Commission too.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+ 0.41
$ per €	- 0.27
€ per £	+ 0.61

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts’ Expectation
Wed. 23rd	EU	08.15 - 08.30	French & German PMI's	Oct.	-	-
Wed. 23rd	UK	09.30	UK PMI's	Oct.	-	-

Wed. 23rd	US	14.45	US PMI's	Oct.	48.0	47.8