US dollar struggles as central banks brace for a turning point

Market Report 31/10/22 - By Sam Balla-Muir

USD

The US dollar faltered last week, falling by around 2.7% against the British pound, by about 1.0% versus the euro and ending the week lower relative to every other G10 currency too. One of the main reasons behind the US dollar's decline is the more cautious tone on interest rate rises struck by many of the world's major policymakers. Following hints from the Federal Reserve on Friday of the week before last that the US central bank may start raising rates at a slower pace, the Bank of Canada hiked by a smaller-than-expected 50bp last Wednesday and the European Central Bank sounded more dovish at its meeting last Thursday too (see the EUR section below). A raft of weaker data on the world's major economies last week, including some very poor Flash PMI business activity surveys for October out of the US, Eurozone and UK, among other poor releases, helped to underline the case that a struggling global economy means fewer rate hikes are warranted.

That being said, while many of the world's major central banks seem to be shifting to a slower pace of rate hikes, they do not appear to be considering halting these increases altogether, and interest rate cuts seem a very long way off. While weaker economic growth calls for lower interest rates, this has to be balanced against the strength of inflation in most places, which has continued to surprise on the upside. What is more, I remain of the view that central banks will probably have to induce a fairly severe global recession in order to bring inflation back down. In that scenario, even if higher interest rates, and the strains on global markets that they cause, stop supporting the US dollar, safe-haven demand due to a faltering global economy will probably continue to push the greenback higher.

GBP

The British pound was the best-performing major currency last week, rising by around 2.7% against the US dollar and by about 1.7% versus the euro. There was little in the way of economic data pointing to a stronger pound last week, with the main data release, the Flash PMI business activity survey for October, pointing to the onset of recession in the UK. And part of sterling's gains against the dollar reflected broad-based weakness in the US currency (see the USD section above). However, the other factor pushing the pound higher last week was clearly politics. Rishi Sunak's victory in the Conservative leadership race, his choice to retain Jeremy Hunt as Chancellor and – for the time being at least – his broad support among the parliamentary party all helped to assuage investors concerns about both irresponsible fiscal policy and volatile UK politics more generally.

At the risk of tempting fate, Sunak's appointment as PM seems to mark the end of politics as the dominant driver of the pound's fortunes. This turns the spotlight back on the UK economy, the extent to which the Bank of England raises rates, and how this fits into the global picture. For the reasons I explain in the USD section above, I suspect that global factors will mean that the pound resumes its slide against the US dollar. Just how far it slides, and how it fares against the euro would seem to hinge on how far the Bank of England raises interest rates relative to investors' already high expectations in the coming months. My view is that the Bank of England will disappoint on this front, putting pressure on the pound and causing it to slip relative to the euro, as the Bank puts more weight on a floundering UK economy. The recent data all point to the UK slipping into the early stages of a fairly deep recession, and the boost to demand from looser fiscal policy under Truss and Kwarteng now seems to be flipping to a hit to demand due to tighter policy under Sunak and Hunt.

EUR

Last week was a bit mixed for the euro, which gained by around 1.0% against the US dollar but fell by around 1.7% against sterling. The euro's rise against the US dollar seems to be due in large part to global factors pushing the greenback lower against most currencies. And although the euro's drop against the pound was partly due to political uncertainty in the UK lifting, developments on the continent seemed to point to a weaker euro too. A raft of data released for the Eurozone last week continued to paint a picture of very weak activity. Partly reflecting this weaker economic outlook, the European Central Bank raises rates by 75bp at its meeting last Thursday, but also sounded much more cautious about tightening monetary policy by more further ahead, causing investors to dial back their expectations.

While it makes sense, all else equal, for a weaker economy to mean fewer hikes to interest rates, this arguably misses the bigger picture. I think that investors may have gone too far in paring back their expectations for ECB interest rates last week. After all, while the data on economic activity in the Eurozone have been very poor, the data on inflation have continued to point to very strong price pressures. This showed up last week in several business surveys, as well as stronger-than-expected German inflation figures for October. With inflation so high, I suspect that the ECB will feel compelled to raise rates much further, despite faltering growth. While the euro will probably continue to slip against the US dollar in the near term, given the strength of global forces pushing up the greenback, I think that a fairly hawkish ECB could mean that the euro gains relative to sterling in the coming months.

The Week Ahead

Next week looks set to be a busy one in terms of scheduled data and events. Activity and labour market data in the Eurozone and US next week, including the US ISM surveys for October – on Tuesday and Thursday – and this month's nonfarm payrolls figures – due Friday – will provide some insight on just how quickly major economies are deteriorating. But of more importance will be two major central bank meetings, which should give a clearer sign on whether policymakers really are reaching a turning point in terms of their plans for interest rates. The US Federal Reserve will announce the decisions of its meeting on Wednesday, followed by the Bank of England on Thursday.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	+ 2.73
$ per €	+ 1.04
€ per £	+ 1.69

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts' Expectation
Wed. 2nd	US	18.00	FOMC Meeting & Fed Funds Rate	Oct.	3.25%	4.0%
Thu. 3rd	UK	12.00	MPC Meeting & Bank rate	Oct.	2.25%	3.0%
Fri. 4th	US	12.30	Non-Farm Employment Change	Oct.	263k	200k