Fed slows down pace of rate hikes

Market Report 19/12/22 - By Sam Balla-Muir

USD

The US consumer inflation data released to the markets last week showed that the hard-hitting interest rate hikes by the Fed are now having the desired effect of lowering the pace of inflation. The Fed also followed up with its promise to slow down the pace of rate increases with a 50 basis points rate hike. This is a dovish move away from its last four rate hikes, which had been of the order of 75 basis points each. With consumer inflation slowing and the Fed becoming slightly less hawkish, the US Dollar lost ground against its peers in the first three trading days of last week. However, the Fed statement that followed the moderated rate hike was not as dovish as the markets had expected, with FOMC Chair Jerome Powell confirming that further rate hikes were still on the cards.

The Fed's indication that the hawks would remain around for some time stoked some risk aversion in the markets on Thursday and Friday, allowing the greenback to pare some losses sustained earlier in the week. Thus the US Dollar index closed slightly lower, reflecting slightly lower weekly closes in the greenback's pairings with the Euro, British Pound, and the Yen.

As risk aversion ploughed through the markets, the US stock markets gave away earlier gains for the week as markets feared that the Fed's elongated hawkishness could still provoke a recession in 2023. The S&P 500 index and risk-associated Nasdaq ended the week lower to extend their losing run to the second week in a row.

A radical drop in US Retail Sales from a 1.2% growth in October to a 0.2% decline in November also helped to trigger risk aversion due to concerns that an economic recession was already underway and negatively impacting consumer spending at retail outlets. This risk aversion could extend into the new week, pushing further strength into the greenback.

GBP

Despite a lower-than-expected growth in the UK's annualised consumer inflation number, the sharp uptick in the number of persons seeking employment benefits and some BoE board members no longer in support of a hawkish outlook to monetary policy were enough to halt the pound's advance against the US Dollar and the Yen.

This week's absence of high-impact news from the UK leaves the pound vulnerable to ongoing risk aversion and potential correction from recent highs, which had not been seen since 10 June. There is room for further correction on the GBP/USD and GBP/JPY pairs if the news releases from Japan and the US strengthen the risk-averse sentiment.

Last week, we cited aggressive action from the BoE and a drop in the Claimant Count as being supportive of the Pound's further ascent. These two parameters were unmet, hence the decline. This was because the vote for a 50bp hike was not unanimous and unemployments claims increased. However, I suspect any increases in the UK 2-year bond yields may moderate any further corrections on the pound.

EUR

The European Central Bank raised interest rates by 2.5%, as expected. However, the single currency failed to build on earlier gains last week despite encouraging manufacturing and services PMI numbers from Germany and France. This was due to the impact of recessionary fears and the attendant risk aversion, which made the greenback and the Yen more attractive to traders. But unlike the Pound, the Euro was able to hold on to some gains against the US Dollar, with the EUR/USD ending the week in positive territory.

However, ECB President Christine Lagarde made it clear in the 15 December press conference that interest rates would "still have to rise significantly at a steady pace" to attain levels needed to bring down Eurozone inflation to its 2% target. She also said that inflation in the Eurozone remained "far too high" and was projected to remain above the 2% target "for too long", indicating that the bank expects to raise rates significantly further. However, the ECB Chair says the bank would adopt a data-dependent, meeting-by-meeting approach.

Despite hitting the "minimum needed" mark (citing ECB Governing Council member Gabriel Makhouf), it is clear that a minimum still leaves room for more hawkish action. But the data-dependent approach means the ECB is treading a more cautious pathway than its US counterparts. This could leave the Euro vulnerable if US data for the week and the risk climate support the greenback.

The Week Ahead

As the markets prepare for the upcoming Christmas holidays, which fall on a weekend, there remains a few days of trading where some price volatility is expected. On Monday, 19 December, the Bank of Japan will release its last monetary policy statement for the year. Wednesday, 21 December will see the consumer inflation data from Canada, while the Conference Board's Consumer Confidence Index will be released ninety minutes later. The only other news events of note come up on Friday with the release of the Fed's inflation barometer, the Core PCE Price Index. Canada's GDP data will also be released on the same day.

Last Week's Changes In Exchange Rates

Exchange Rate	%- change on week
$ per £	- 0.60
$ per €	+ 0.60
€ per £	- 1.20

Key Events

Date	Market	Time (GMT)	Release/Event	Period	Previous	Analysts’ Expectation
Wed. 21st	US	15.00	US Consumer Confidence	Nov.	100.2	101
Fri. 23rd	US	13.30	Core PCE Price Index M/M	Nov.	0.2%	0.2%