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Weekly Report

G10 Weekly FX Update

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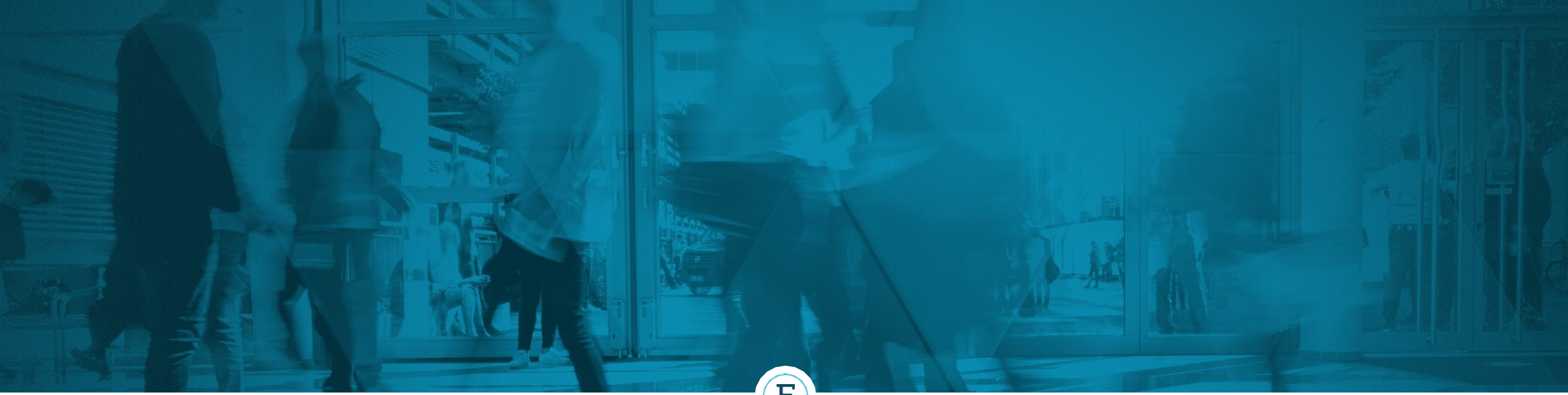
7th August 2023



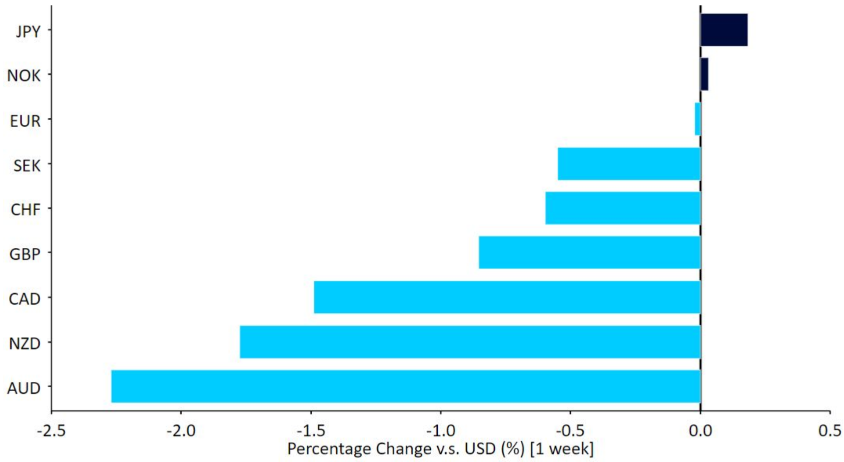
Spike in US Treasury yields buoys dollar

An unsettling updrift in US government bond yields, particularly long-term ones, continued to hobble the performance of both European and emerging market currencies.

The market had perhaps become too complacent about the move lower in the dollar after the Fed suggested that it may be done hiking rates. Short dollar positions are stretched, and the year's popular FX trades (long emerging markets, long the euro, short the dollar) are having a difficult time. Fitch's downgrade of the US credit rating is being blamed, although we are very sceptical that a single report really added significant information to the most analysed economy and market in the world.

The relatively light data calendar this week is dominated by the July CPI inflation report in the US out on Thursday. The spike higher in US yields (with the rest of the world's rates following suit, as usual) seems to us so far a technical phenomenon, somewhat disconnected from the good news we have been receiving on US inflation. The July report, and its potential validation of the disinflationary trend in the US, takes on added importance. Thin holiday markets may amplify any market moves after the report is released.

Figure 1: G10 FX Performance Tracker [base: USD] (1 week)



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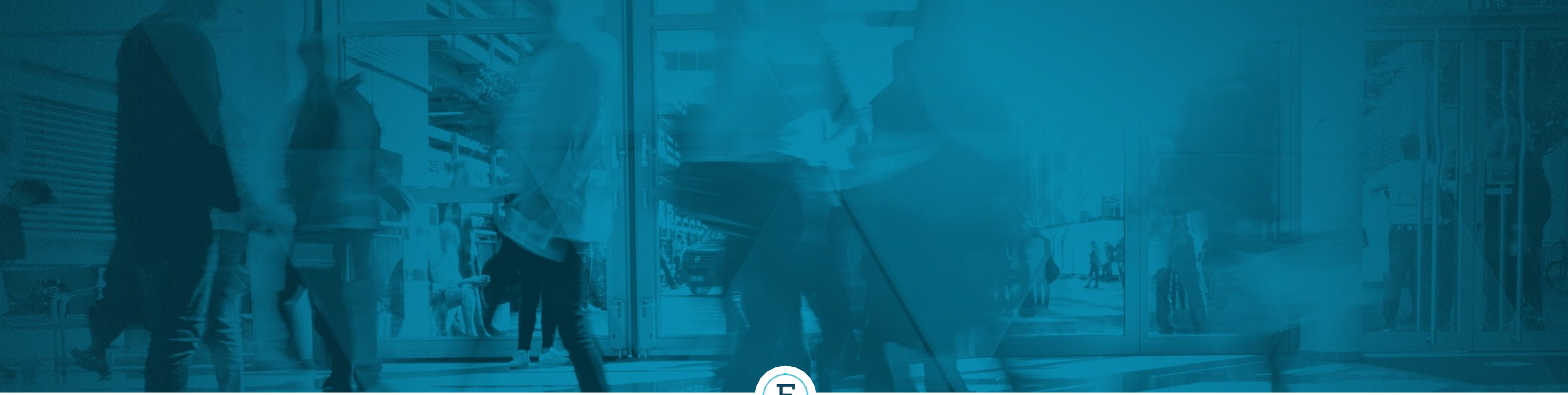


GBP

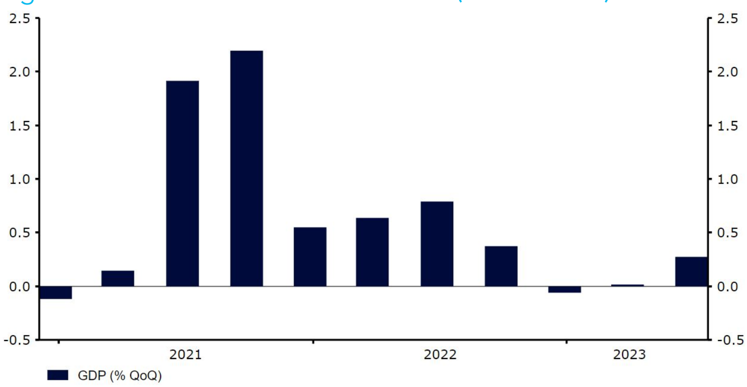
The August meeting of the Bank of England was unhelpful to Sterling. The MPC opted for a small interest rate hike of 25 basis points, in line with our expectations, albeit there were three dissents, with two members favouring a 50bp hike and one voting in favour of no change. The guidance in the statement was unaltered from the previous meeting, hinting that more hikes may be needed should inflation be ‘persistent’. That said, there is now a general consensus that the end to hikes may not be too far away, with the MPC stating that rates are already at ‘restrictive’ levels.

As market expectations for the terminal rate recede from the 6% level, the pound is suffering. However, the BoE has also suggested that rates will stay elevated for a long time. Given that the terminal rate is very likely to be the highest among G10 countries, we remain optimistic on sterling, and stick by our bullish forecasts for the pound. This week, the GDP growth report out on Friday will give a lagged read on the health of the UK economy.

EUR

The ECB received mixed news from the second-quarter GDP and July flash inflation reports. The former showed that the bloc economy emerged from a technical recession in the three months to the end of June, albeit growth is at anaemic levels. Meanwhile, the latter showed no signs of a disinflation trend, at least in the core subindex, which modestly beat expectations and remains just shy of record highs.

Figure 2: Euro Area GDP Growth Rate (2021 - 2023)



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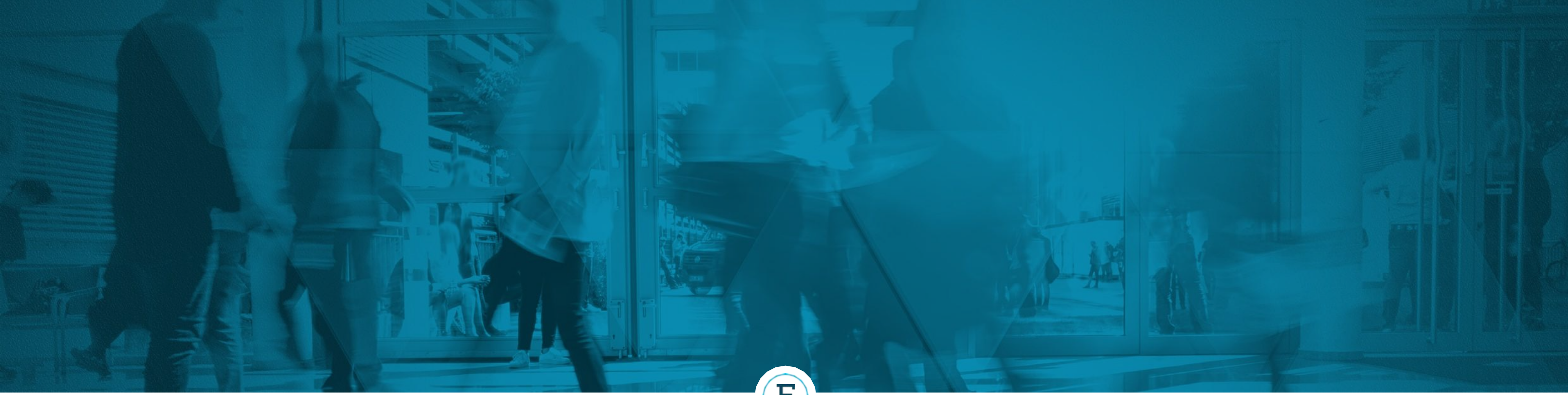


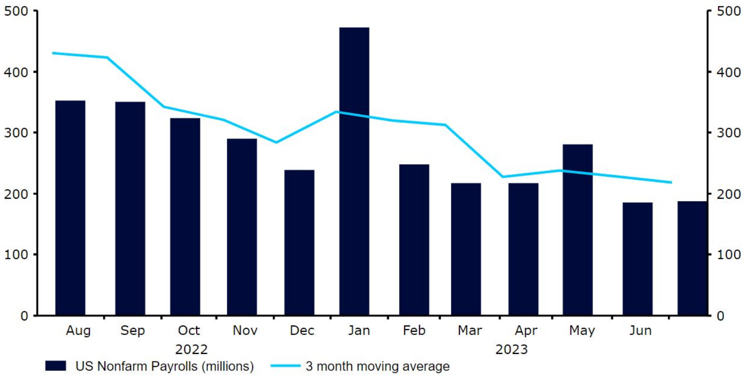
The euro remains dependent on European Central Bank policy, which itself is now dependent on future economic data. It is not clear to us how the dichotomy between weak Eurozone activity and stubbornly high core inflation in the Eurozone will be resolved, although we think that the quarterly wage report out of Germany later in the month, followed by the Euro Area data in mid-September, will be unusually important here. Any signs of a further acceleration in earnings could raise concerns over a wage-price spiral, and support bets in favour of additional ECB policy tightening.

USD

The Federal Reserve received mixed news from the July US payrolls report. The headline number was consistent with a gradual loosening in the US labour market, as job creation eased below 200k and missed expectations for the second straight month (following fourteen consecutive upside surprises). On the flip side, unemployment remained near record lows, and unexpectedly dropped back to 3.5%, while wage growth, more importantly, surprised to the upside.

Of greater significance to the Fed than last week's payrolls report will be this Thursday's inflation numbers. Markets are optimistic that the critical monthly core inflation number will be consistent with the recent disinflationary trend, printing at levels consistent with 2-3% annual inflation. A disappointment on this front could create significant volatility given the fragile technical state the bond market appears to be in.

Figure 3: US Nonfarm Payrolls (2022 - 2023)



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JPY

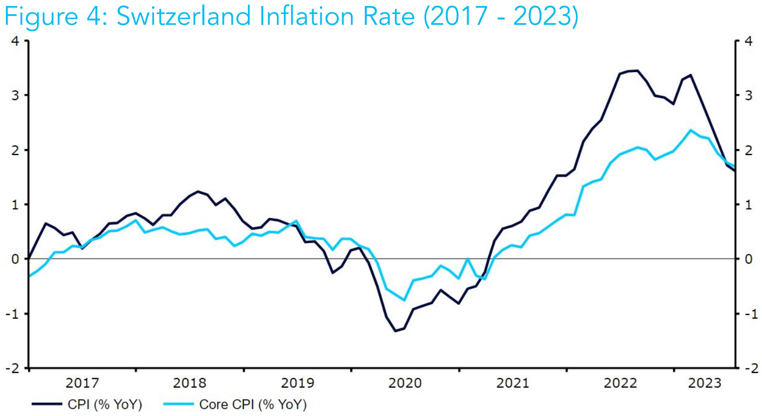
The yen was among the better performing currencies in the G10 last week, albeit continues to trade just shy of June's seven month lows against the US dollar. The recent yield curve policy adjustment from the Bank of Japan is keeping the yen relatively well bid, though not to the extent that we are yet witnessing a sustained and strong rebound in the currency. Policymakers have insisted that this YCC tweak is not the start of monetary tightening, even if much of the market, ourselves included, do not entirely buy into this rhetoric.

The BoJ's July meeting minutes, released during Asian trading on Monday, were somewhat more hawkish than expected, noting that rate-setters debated the prospect of sustained inflation at a rate 'not seen in the past'. While it is still too soon for the bank to provide any clear clues as to the timing of hikes, we contest that the latest policy tweak, and the tone of communications in the minutes, are a prelude to modest and gradual rate increases, to potentially begin in early-2024.

CHF

EUR/CHF traded sideways last week, hovering around the 0.96 mark. Attention among market participants was primarily on the latest CPI data, with both the headline and core rates extending their decline to 1.6% and 1.7% respectively in July. The headline rate has remained within the SNB's target of less than 2% for two months in a row, and is now the lowest in a year and a half.

Figure 4: Switzerland Inflation Rate (2017 - 2023)



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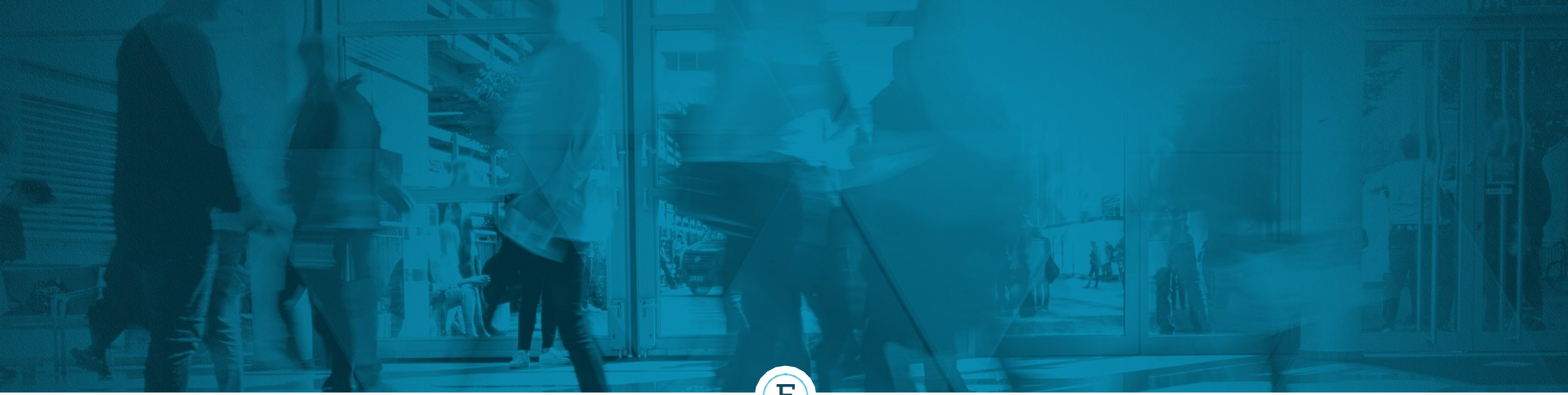


This should provide some comfort for the central bank and adds weight to the argument for ending rate increases with a final hike in September. Recent business activity data also supports this argument, with both the manufacturing and services indices falling in July and in line with a contraction in overall activity. Unlike last week, domestic newsflow is set to be light this week as the economic calendar is nearly empty, and attention is likely to be on developments elsewhere.

AUD

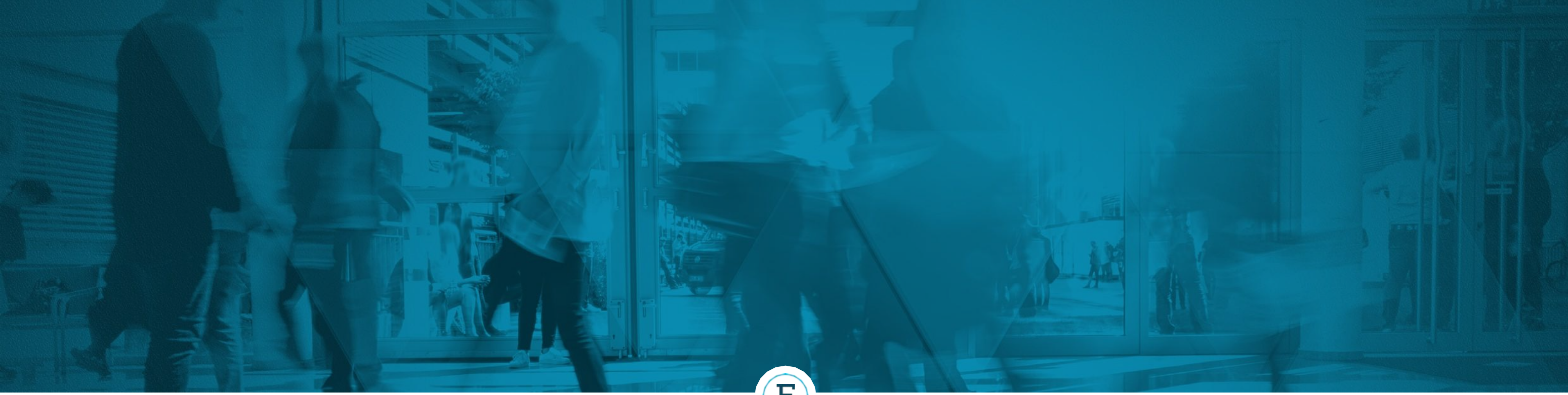
Last week's Reserve Bank of Australia policy announcement provided little assistance to AUD, which ended the week right at the foot of the G10 performance tracker, down more than 2% versus the US dollar. The RBA held rates for the second consecutive meeting, maintaining its tightening bias, although warning that growth was set to slow during the remainder of the year. Policymakers also appear increasingly confident that inflation will return towards the 2-3% target, with the statement notion that risks to inflation are now 'broadly balanced'.

All in all, these communications suggest that the bank has little appetite for additional tightening, and that the hiking cycle may already be over. This will, of course, be dependent on incoming data, but at the very least it appears as though the RBA is happy to stand pat for a little while, before potentially delivering one final hike later in the year. This less hawkish approach is clearly weighing on AUD, which is now trading back below the 0.66 level on the USD.

NZD

A mixed second quarter labour report, perhaps also coupled with the RBA's dovish turn, ensured that the New Zealand dollar ended as one of the worst performing major currencies last week. The latest labour data was far from devoid of optimism, as the rate of change in new jobs added came in double economists' estimates (+1% vs. +0.5% consensus). The unemployment rate did, however, edge up on the first quarter, rising to 3.6% from 3.4%. Realistically, this changes little for the RBNZ, which already appears to have ended its hiking cycle.

Focus this week will be on both the central bank's measure of inflation expectations (Wednesday), and the latest business activity PMI for July (Thursday). The latter looks likely to once again print below the level of 50 for the fifth straight month that, if confirmed, may heighten concerns over the growth outlook for the rest of the year.



CAD

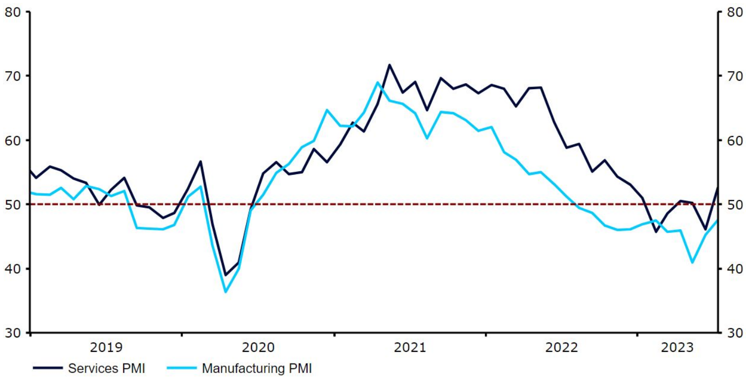
Canadian labour market data out last week was surprisingly soft, and CAD subsequently struggled, registering an uncharacteristically bad performance relative to its major peers. According to Friday's data, 6.4k net jobs were shed in the Canadian economy in July, after economists had penciled in growth of more than 20k. Wages are growing at a very steady clip, although the jobless rate ticked upwards again, and is now at its highest level since January 2022. This soft data, combined with a sharp drop below 50 in the Ivey business activity PMI, has sent CAD to arounds its lowest level in almost two months.

The economic calendar is very light on the ground in Canada this week, so the USD/CAD pair is likely to be driven almost entirely by developments out of the US, notably the upcoming inflation report. Ahead of the next BoC meeting in September, the latest CPI data (15/08) and GDP report (01/09) will be closely monitored by market participants, and could be key for Canadian dollar in the next couple of weeks.

SEK

The Swedish krona depreciated slightly against the euro last week, as better than expected PMIs for July were not enough to ease investors' concerns about the weak Swedish economy. Both the services and manufacturing indices beat expectations in July and increased from the previous month. The manufacturing index remained in contractionary territory, albeit rose to 47.6, its highest level in six months. The news on the services front was even better, with the PMI moving back into expansionary territory and rising to its highest level since December 2022 (52.7).

Figure 5: Sweden PMIs (2019 - 2023)



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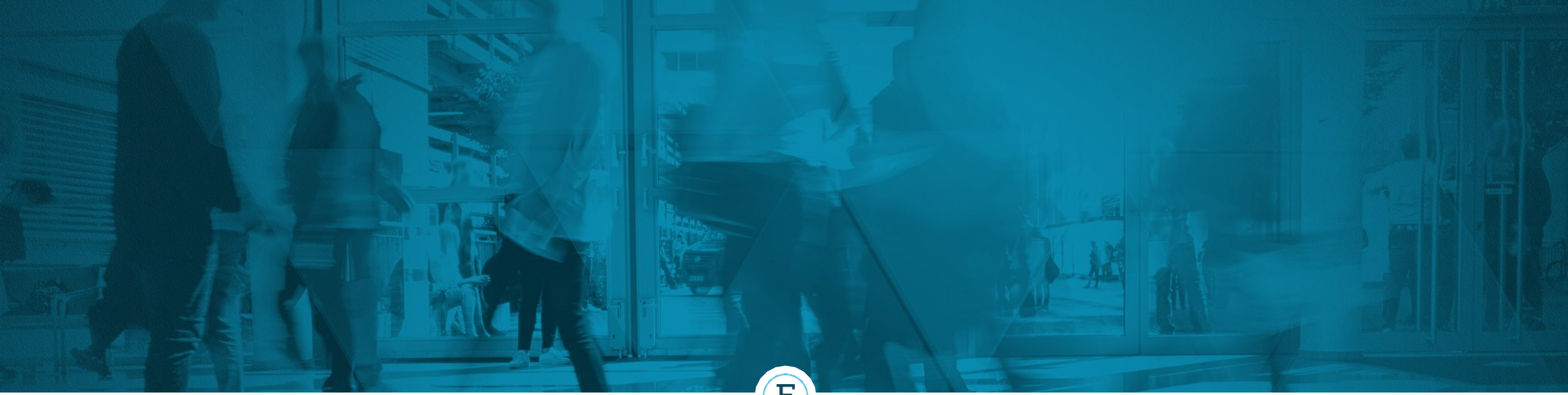


Despite the encouraging PMI news, the latest hard data points to a deterioration in macroeconomic conditions, which could influence the Riksbank's future monetary policy decisions. Markets are largely pricing in a 25bp rate hike from the Riksbank at its next meeting in September, with another in November also possible. However, further signs of a slowdown in activity could reduce the need for further tightening beyond next month’s meeting, and an additional hike by year-end is by no means guaranteed.

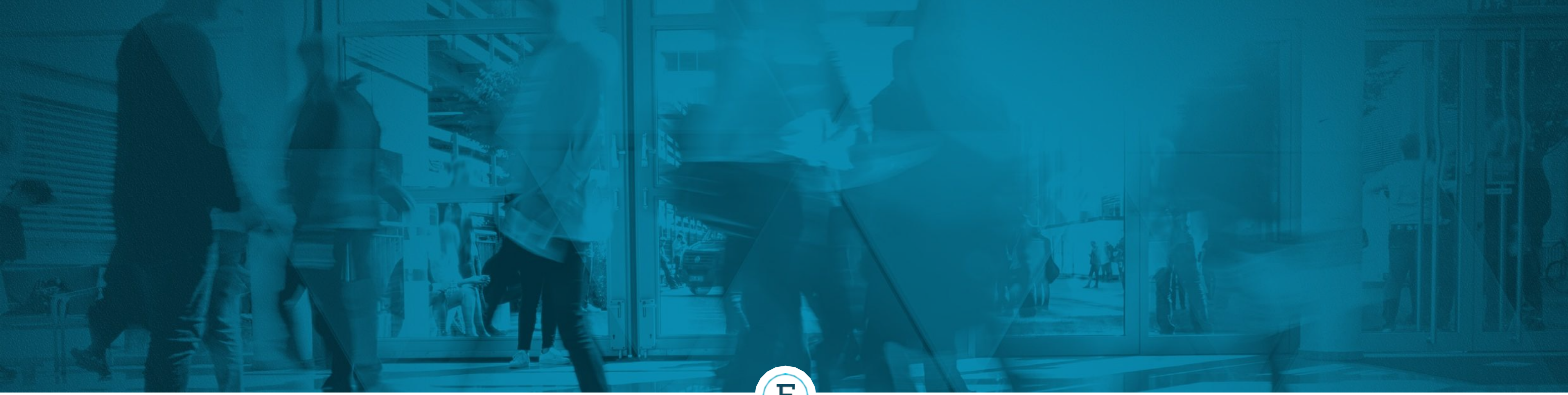
NOK

Rising oil prices, which are currently at their highest level in four months, and better than expected PMI data for July, boosted the Norwegian krone last week, which appreciated slightly against the euro. The manufacturing PMI returned to expansionary territory in July, increasing to 56.7, comfortably above even the top end of estimates. This is its highest level since April 2022, and in line with robust expansion in the sector.

This week will be crucial for NOK, as inflation data for July will be released on Thursday. Both the headline and core indices are expected to moderate from the previous month, albeit are set to remain at elevated levels. After delivering a hawkish pivot at its June meeting, Norges Bank now looks likely to continue raising rates in August, and this week's inflation data could be key in determining whether the hike will be 50 basis points or 25 basis points.

CNY

In a difficult week for emerging market currencies, the yuan performed well, selling off only modestly against the US dollar and rising sharply in trade-weighted terms. Investors’ newfound optimism about Chinese stimulus efforts is helping the yuan withstand external headwinds. Authorities are bombarding investors with new headlines indicating a willingness to support the economy and, thus far, it appears to be working. We’re cautiously optimistic that an improvement in sentiment toward China can be sustained if announcements, such as these from the provincial capital of Henan, Zhengzhou (focused primarily on aiding the property market), keep coming.



PMI data out last week was mixed - the composite indices from both NBS and Caixin fell, although overall the data was not overly weak. Sometime ago we mentioned that economic data from the country was becoming more nuanced. It now appears that there is light at the end of the tunnel. It's worth noting that China's economic surprise index from Citi has edged up since mid-July. Looking ahead, the domestic economic calendar for this week is quite rich. Particularly important will be the data on prices, out on Wednesday. For the first time in more than two years, China is expected to experience consumer deflation.

Economic Calendar (07/07/2023 - 11/08/2023)

Economic Calendar	Country	Day	Date	Time (GMT)
Unemployment Rate (Jul.)	SWI	Monday	07/08	06:45
Inflation (Jul.)	CHN	Wednesday	09/08	02:30
Inflation (Jul.)	NOR	Thursday	10/08	07:00
Inflation (Jul.)	US	Thursday	10/08	13:30
GDP (Q2)	UK	Friday	11/08	07:00

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