Ebury What borders?®

Weekly Report

# G10 Weekly FX Update

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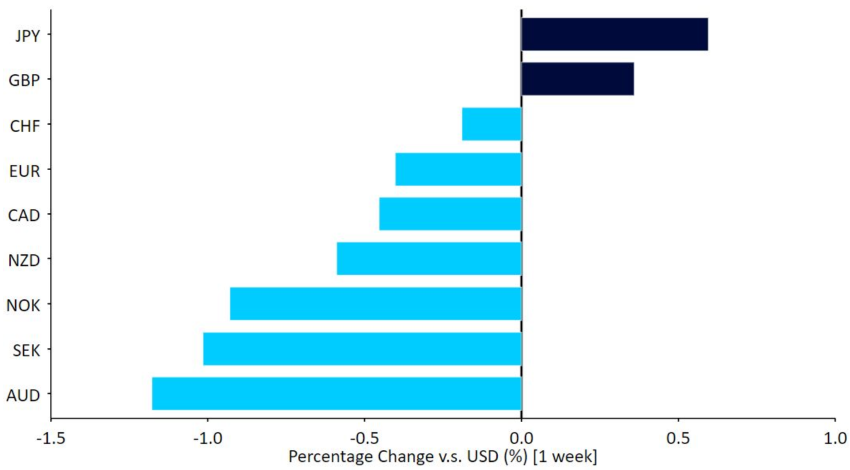
# European Central Bank stops euro rally in its tracks

The worsening economic data out of the Eurozone didn't help, but what finally did the euro in last week was a surprisingly dovish European Central Bank meeting.

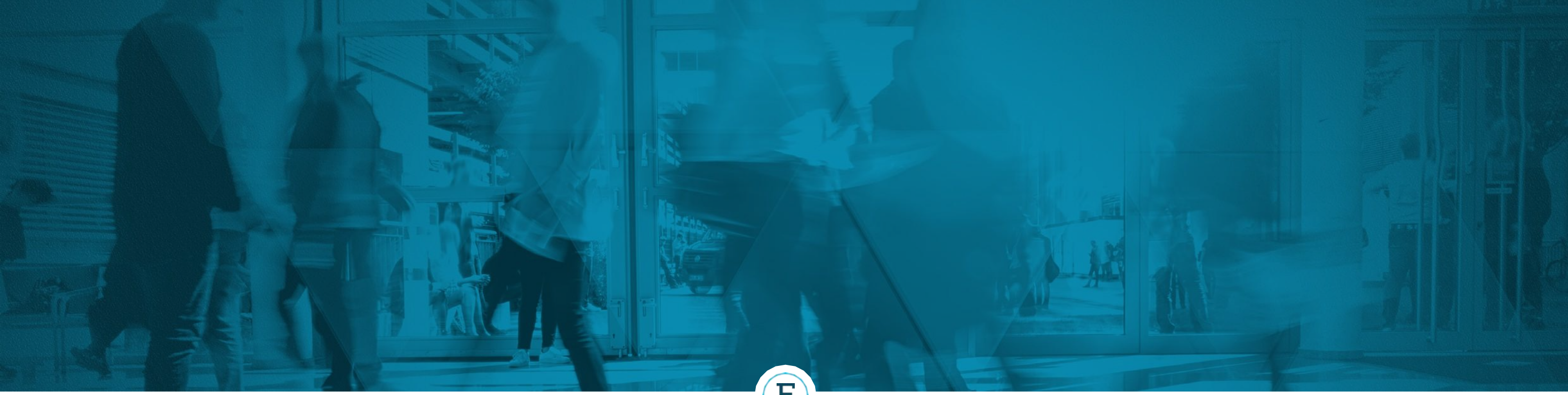
At its meeting last week, the ECB raised rates as expected, although surprisingly hinted that this could be the final one in the current tightening cycle. The euro had been wobbly all week, but the prospect of rates peaking below 4%, without any clear signs that core inflation is trending down, sent the currency reeling. Most G10 currencies followed the euro down against the dollar, despite the likelihood that last week's rate hike from the Federal Reserve was the last. Emerging market currencies withstood the dollar rally very well, and the week's performance table was headed by the South African rand, the Mexican peso and the Brazilian real.The latter two added to their scorching performance so far this year.

This week will be data-packed. On Monday, we'll receive the Eurozone second-quarter GDP growth and July flash inflation reports. It will be key to see whether these two validate the ECB dovish turn - should core inflation surprise to the upside, things could get interesting in FX markets. The Bank of England meets on Thursday. Friday is payrolls day in the US, a key data point that comes after a run of positive economic surprises in the US that speak to the surprising resilience of the American economy in spite of higher rates. August is traditionally a quiet trading month in FX markets, but 2023 could easily prove the exception given the accumulation of uncertainties.

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



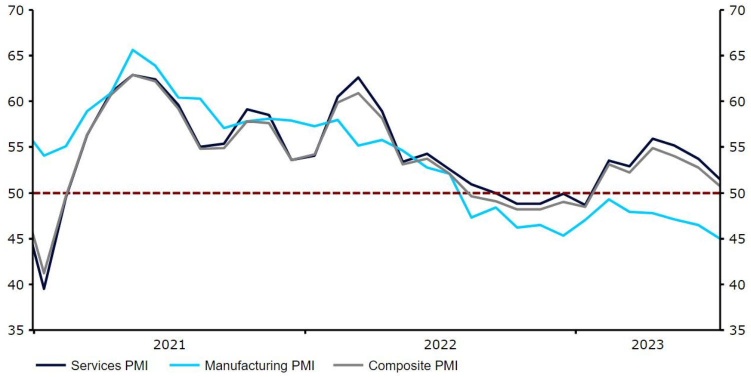

Source: Refinitiv Datastream Date: 31/07/2023



# GBP

Sterling reacted surprisingly well to the poor PMIs of business activity published last week. However, a gap is developing between these business surveys and actual economic data, which continues to show resilience and is consistent with a tight labour market and plenty of consumer firepower.

Figure 2: UK PMIs (2021 - 2023)

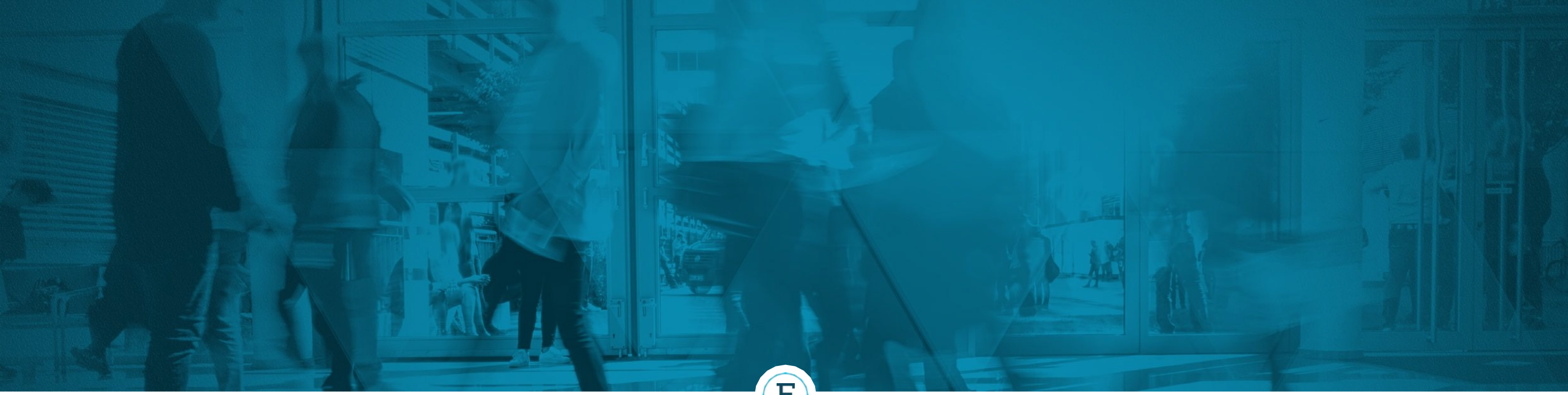



Source: Refinitiv Datastream Date: 31/07/2023

Expectations for the Bank of England meeting this week have cooled ever since the recent positive surprise on inflation, although markets are still pricing in a small chance of a 50bp hike, with the certainty that we will get at least a 25bp one. As usual, the key to the reaction in the pound will be the voting pattern among MPC members. We are eying a three-way split vote, whereby at least one member (Dhingra) votes in favour of no change, while a handful, though not enough for a majority, potentially side with a 50bp hike. Either way, the pound continues to trade strongly and is now back as the best performing G10 currency of 2023.

# EUR

Dismal sentiment in the manufacturing sector dragged down the PMI surveys to a level consistent with a recession. This no doubt weighed on the minds of ECB members, which decided to hike rates as expected, but made it clear that the September meeting was wide open. Lagarde's tone in the press conference reinforced the sense of caution, and she explicitly indicated that the bank was open to pausing the tightening cycle at the next meeting in September. We think that this is now the mostly likely option, with a final hike possible in October, should data warrant.



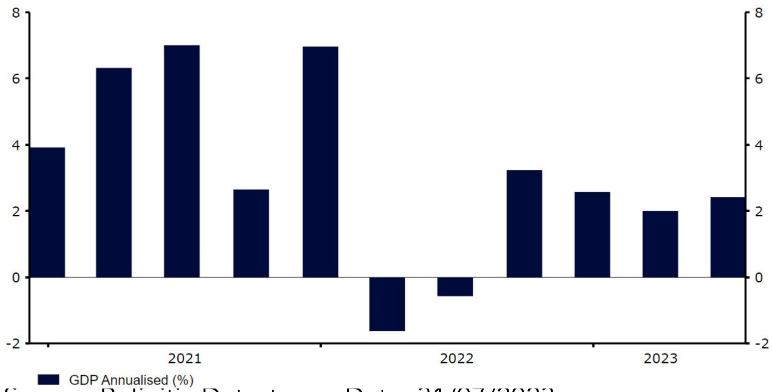
The prospect of a terminal rate of not even 4% sent the euro sharply lower. The ECB seems to be betting that inflation is a lagging indicator that cannot fail to come down given weakness in the economy and the disinflationary trend clearly visible in the US and most emerging markets. Monday's flash inflation numbers will provide a key test of this view.

## USD

The Federal Reserve hiked rates again last week and left the door open to additional rate increases, although only if the incoming data warrants it. Powell's communications suggest that the FOMC is very much taking a wait-and-see approach, and will assess upcoming inflation and jobs market reports before deciding whether another rate hike is necessary before the end of the year. With inflation seemingly on the way down, this could well mean that the hiking cycle is over, but the US economy continues to outperform expectations and the hot labour market refuses to budge.

Last week's GDP number surprised to the upside, led by a surge in business investment. This week's labour market report is expected to show a still tight jobs market with unemployment well below 4% and wage rises finally outpacing inflation. The contrast with the stagnating European economy may prevent EUR/USD from continuing its 2023 rally in the short-term.

Figure 3: US GDP Growth Rate (2021 - 2023)

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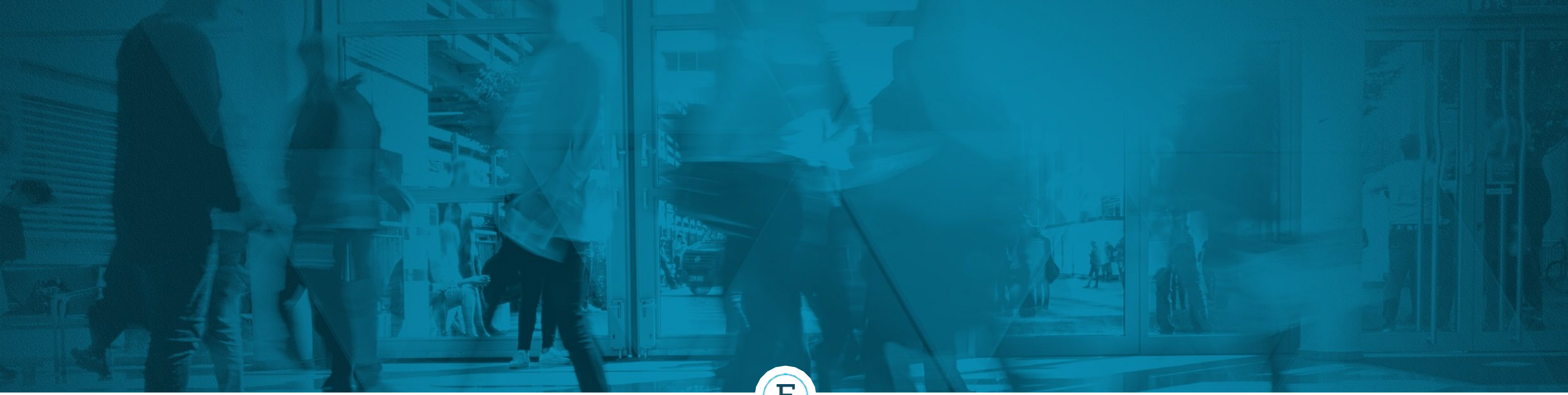


## JPY

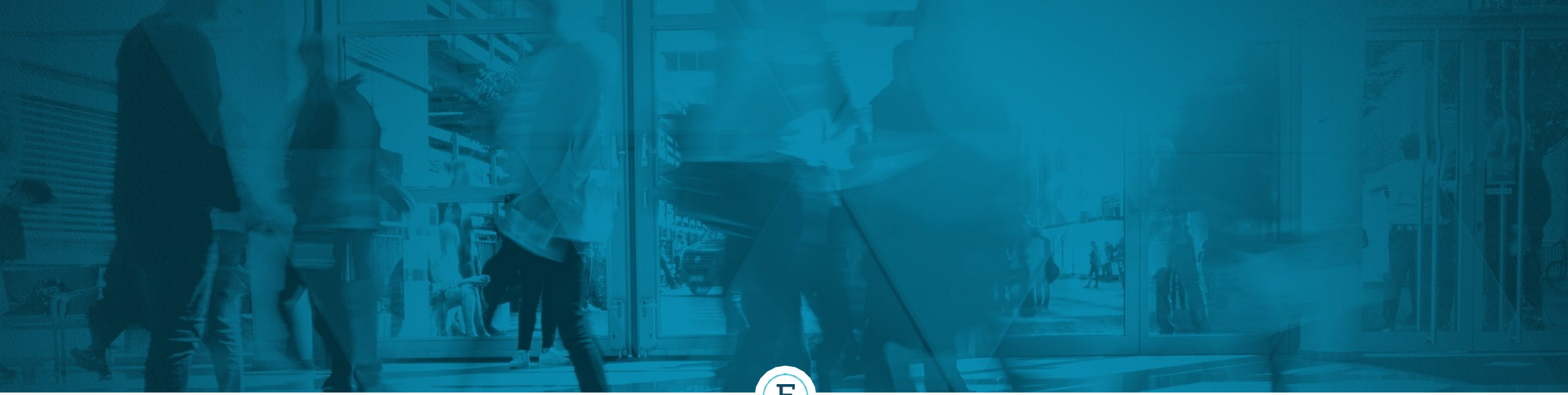
The Bank of Japan's new leadership took its first baby step on the road towards tighter monetary policy on Friday, delivering a minor tweak to the yield curve control (YCC) policy. The bank will continue to allow 10-year government bond yields to fluctuate between 0-0.5%, although it will now buy these bonds (JGBs) at 1% on a daily basis. This was not described by the bank as policy tightening, and governor Ueda was quick to keep expectations in check, though this does constitute somewhat of a change in approach, and an acknowledgement that high inflation, particularly in the 'core core' index, is becoming a greater concern.

The yen was unable to post any meaningful advances following Friday's announcement, although the possibility of FX intervention and a change in tact from the BoJ does present room for longer-term upside. We expect the YCC policy to be abandoned by year-end, which should open the door to a first rate hike in early-2024.

## CHF

The Swiss franc took another leg up against the euro last week. The EUR/CHF pair fell to another low just above the 0.95 level following Thursday's dovish signal from the ECB, although it managed to recover some of its losses before the end of the week. Last week's data from Switzerland was quite positive. Retail sales posted the first year-on-year increase since September in June (+1.8%). Sentiment data were mixed, but the key KOF index surprised to the upside, rising to 92.2 in July after several months of declines. While still at a low level, suggesting limited economic activity ahead, the improvement is a welcome sign.

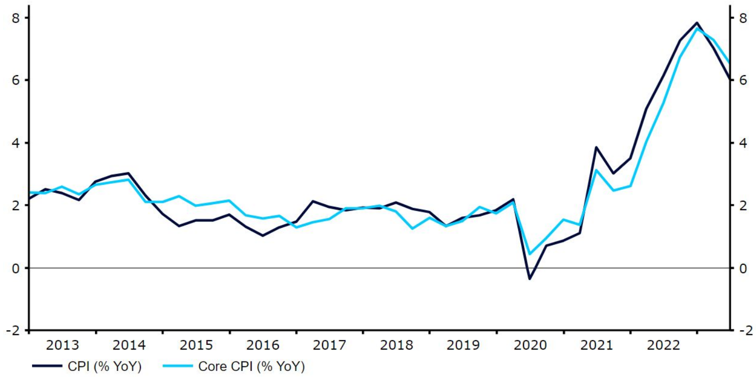
In addition to changes in global risk sentiment, attention in markets this week should focus on domestic data, including Thursday's July inflation data, which is expected to show another decline in the headline number. Regardless, we believe that the SNB will deliver another rate increase in September, although the medium-term rate outlook is less clear, and could be influenced by both this week's CPI and PMI data. Given the recent downward surprises in Eurozone data, which cast a shadow over the continent's economic outlook, the often-overlooked business activity data from Switzerland could take on added significance.



# AUD

This week's Reserve Bank of Australia meeting will be governor Lowe's last at the helm, so we don't expect any major fireworks. Rates are set to remain unchanged, with the bank's communications unlikely to rock the boat too much. On the one hand, we have seen misses in recent inflation and PMI reports in Australia, although jobs data has held up rather well. Last week's second quarter CPI print showed that inflationary pressures are easing more than expected, albeit only modestly, so the bank won't rule out additional policy tightening altogether.

Figure 4: Australia Inflation Rate (2013 - 2023)

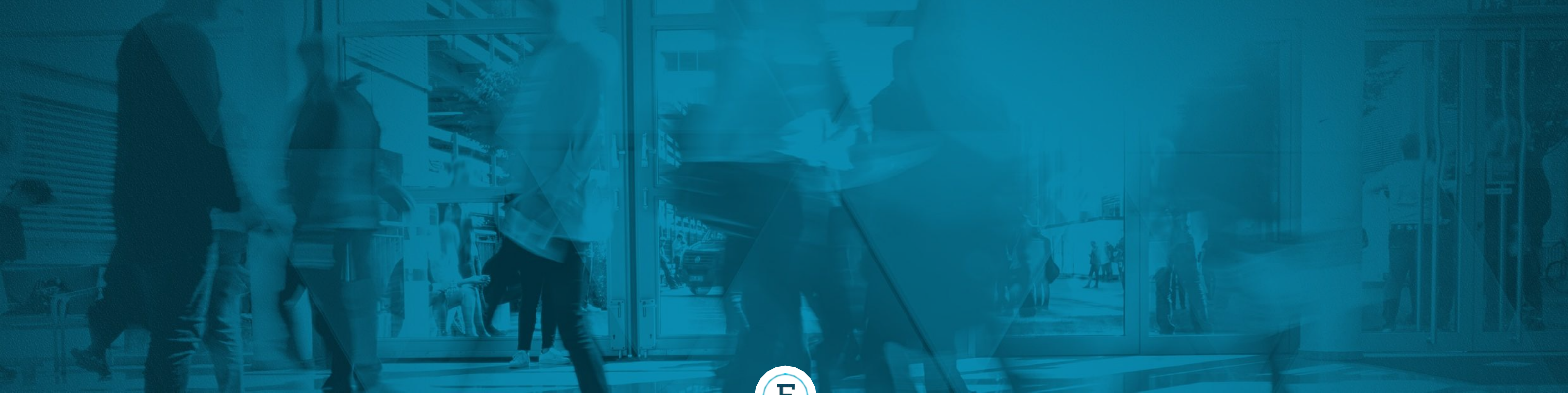



Source: Refinitiv Datastream Date: 31/07/2023

We think that the RBA will stay the course, and keep the door ajar to further hikes, although it will stress that this remains dependent on economic data. Markets are pricing in less than a 50/50 chance of another 25bp hike through the September meeting, so there is room for some upside in AUD should the RBA strike a hawkish note.

# NZD

Renewed optimism surrounding fiscal stimulus in China contributed to a rebound in both the Aussie and New Zealand dollars last week. NZD slightly outperformed its antipodean counterpart, although there was not a clear catalyst. The second quarter labour report will be released out of New Zealand on Tuesday this week, and will likely be very closely watched by market participants. Perhaps the most important data point will be the employment change number, although expectations for additional RBNZ policy tightening is so low, that even a big upside surprise here is unlikely to bring additional central bank rate hikes into view.



## CAD

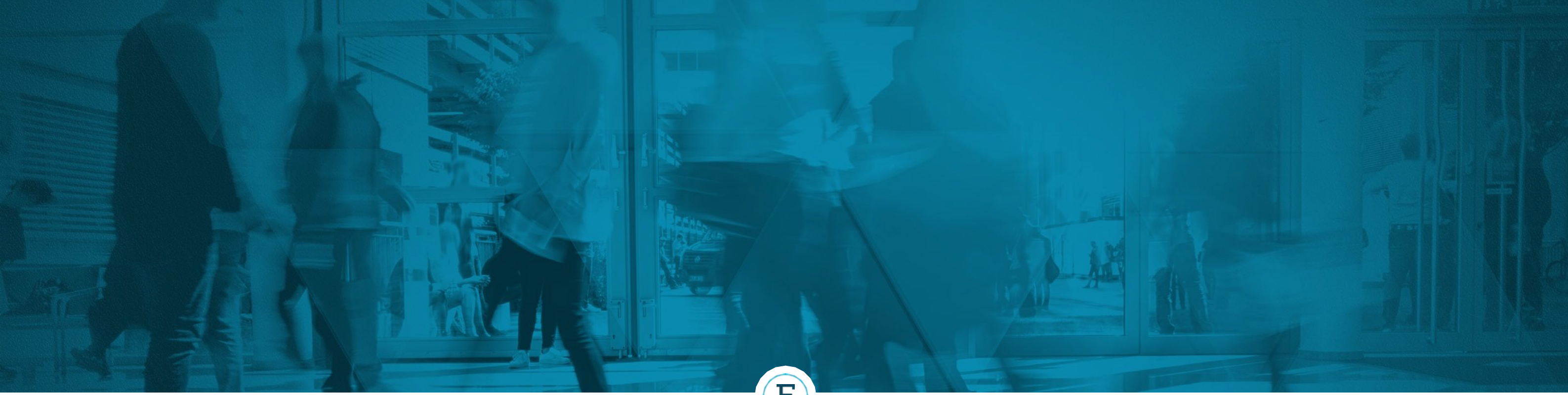
The Bank of Canada's latest meeting minutes provided little clues as to the bank's future policy plans, emphasising data-dependence. Last week's GDP report was slightly mixed, as it showed decent monthly growth for May, but a slightly weaker flash print for June, which puts Q2 growth on course to miss the BoC's projections. This can perhaps partly explain to slight underpermance in CAD, which somewhat broke out of its recent tight range on the US dollar.

Given the priority that the BoC is placing on upcoming economic data, this week's employment report could prove important. Investors are expecting a moderation in the net employment change number and a modest uptick in the jobless rate. This does, however, tend to be overshadowed by the US nonfarm payrolls data, released at the same time, and this week is unlikely to be too much different.

## SEK

The Swedish krona edged lower against the euro last week, with the EUR/SEK hitting a low above the 11.62 level. This sell-off was partly due to yet another disappointment in domestic activity data. After two consecutive months of expansion, retail sales fell by 0.3% in June. More worryingly, the unemployment rate unexpectedly rose to 9.2% in June from 7.9% in the previous month. This is the highest reading since June 2021, and well above consensus, which expected the jobless rate to fall to 7.6%.

This deterioration in macroeconomic conditions could influence the Riksbank's future monetary policy decisions. Markets are now fully pricing in a 25bp rate hike from the Riksbank at its next meeting in September and another in November is on the cards, particularly should upcoming inflation prints once again beat expectations. However, further signs of a slowdown in activity could reduce the need for further tightening.



## NOK

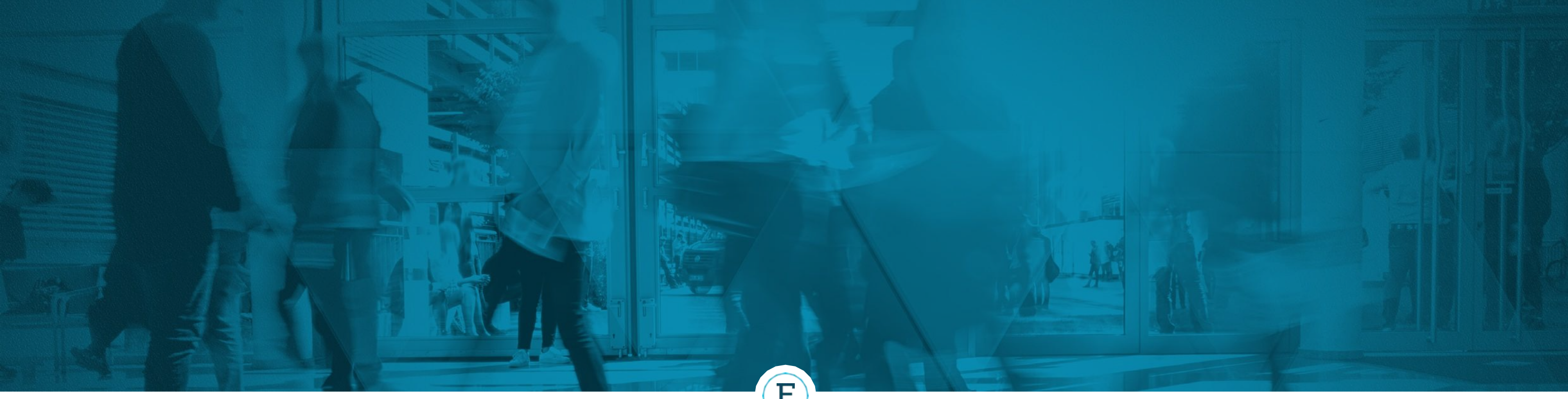
EUR/NOK continued to trade around the 11.2 level last week. The krone has recovered in the last month, and is set to end July more than 4% higher against the euro. Rising oil prices, which are on track to end the month up more than 11%, and expectations of a more aggressive Norges Bank are behind the Norwegian currency's rally.

The surprise to the upside in the latest Norwegian inflation data suggests that Norges Bank now looks likely to continue raising rates in August, after delivering a hawkish pivot at its June meeting. The prospect of another hawkish shift from Norway's central bank, and high oil prices, should continue to boost the currency.

## CNY

The yuan sprouted wings last week, outperforming all other Asian currencies, except the Thai baht. It was also among the minority of currencies that appreciated against the US dollar. One of the key reasons for the rebound in the yuan was the supportive tone of the Politburo meeting. The language of the communication suggested that investors should expect further accommodation and measures to lift up the struggling property market. Furthermore, state banks were seen intervening in the FX market again, which is yet another indication that Chinese authorities started caring about the exchange rate.

After the Politburo meeting, China provided more detail on its plans, including Friday's announcement focusing on the support of the consumer-facing light industry. Further initiatives were announced today. Investors will be awaiting additional steps, which are expected to be rolled out in the coming months. In the meantime, they'll keep an eye on economic activity data. Last week's industrial profits data confirmed an extension of double-digit declines. This week's NBS manufacturing PMI edged up marginally from 49.0 to 49.3, but the non-manufacturing index plunged to 51.5 from 53.2. Tuesday will see the release of the Caixin manufacturing PMI, with services on Thursday. Thus far, the data supports the argument in favour of further policy support.



## Economic Calendar (31/07/2023 - 04/08/2023)

| Economic Calendar | Country | Day | Date | Time (GMT) |
|---|---|---|---|---|
| NBS PMIs (Jul.) | CHN | Monday | 31/07 | 02:30 |
| Inflation (Jul.) | EZ | Monday | 31/07 | 10:00 |
| GDP (Q2) | EZ | Monday | 31/07 | 10:00 |
| Unemployment Rate (Jun.) | JPN | Tuesday | 01/08 | 00:30 |
| Caixin Manufacturing PMI (Jul.) | CHN | Tuesday | 01/08 | 02:45 |
| RBA Monetary Policy Meeting | AUS | Tuesday | 01/08 | 05:30 |
| Employment Report (Q2) | NZ | Tuesday | 01/08 | 23:45 |
| Caixin Services PMI (Jul.) | CHN | Thursday | 03/08 | 02:45 |
| Inflation (Jul.) | SWI | Thursday | 03/08 | 07:30 |
| BoE Monetary Policy Meeting | UK | Thursday | 03/08 | 12:00 |
| Employment Report (Jul.) | US | Friday | 04/08 | 13:30 |
| Employment Report (Jul.) | CAN | Friday | 04/08 | 13:30 |

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