Ebury What borders?®

Weekly Report

G10 Weekly FX Update

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18th September 2023

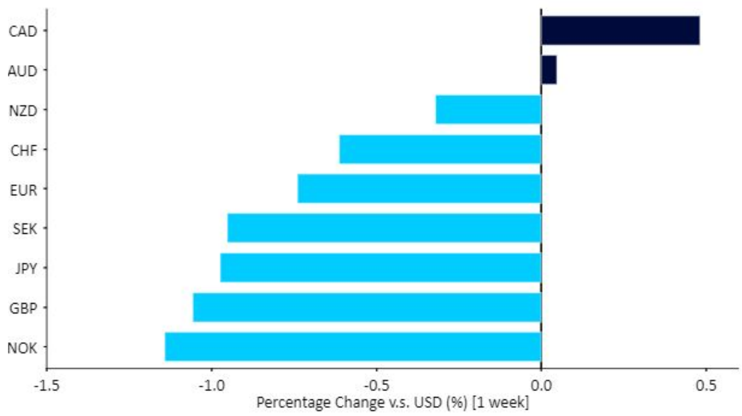
US dollar and commodity currencies rally on dovish ECB rate hike

The main event last week was the European Central Bank's decision to hike interest rates, but suggest that it may be the last one for now, in an apparent compromise between the hawks and the doves.

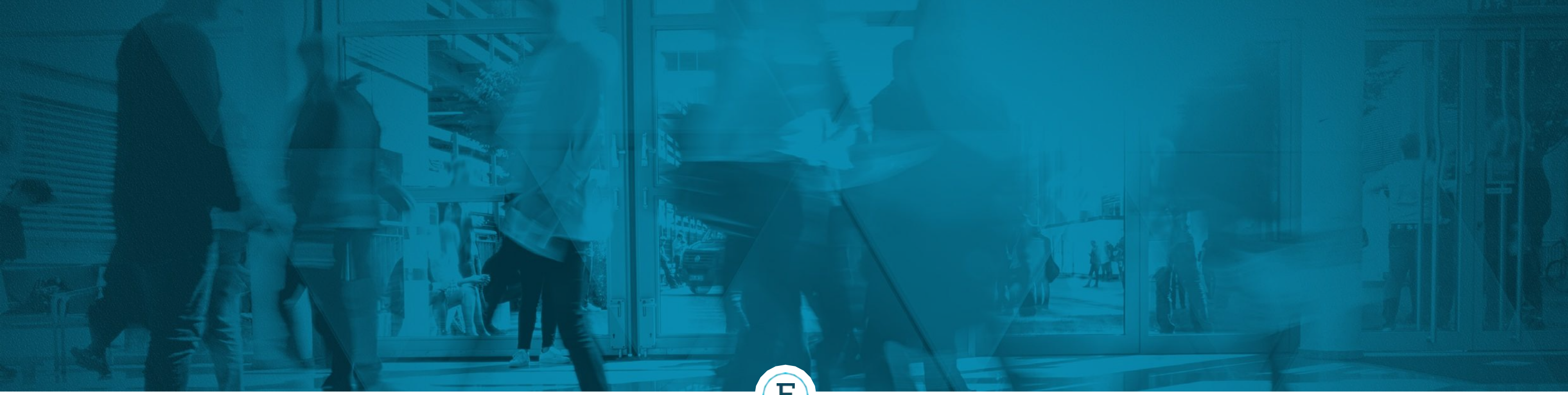
Commodity prices and interest rates continue to march higher, as investors start pricing in a world of persistent deficit spending and inflationary pressures. The key 10-year US Treasury rate flirted with fresh 18-year highs at weekly close on Friday. The dollar and commodity-exporting emerging market currencies benefited from this backdrop. Latin American currencies continue to shine in 2023, and the week's rankings were topped by the Colombian, Mexican and Chilean pesos, together with the Brazilian real.

The big events this week will be the September meetings of the Federal Reserve on Wednesday, and the Bank of England on Thursday. Unlike the ECB, there is a market consensus that the Fed will leave rates unchanged. The Bank of England looks set to raise rates, and is perhaps the G10 central bank that is furthest away from the end of the cycle, albeit there is now a clear possibility that this week's hike could be the last. The August inflation report out of the UK on Wednesday, and the key PMI indices of business activity in all the main economic areas on Friday, will round up an unusually data-packed week.

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



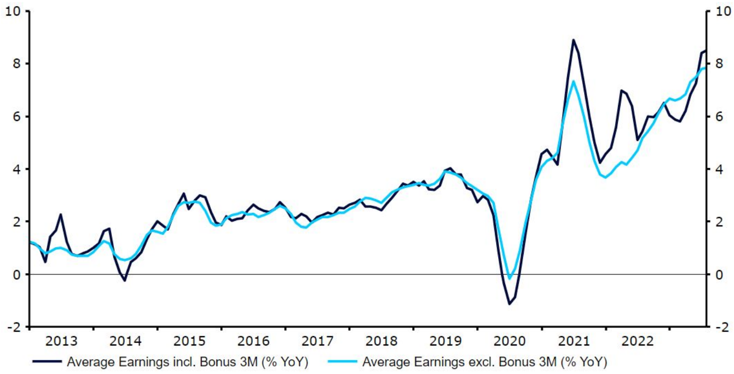
Source: LSEG Datastream Date: 18/09/2023



GBP

The UK labour report for July showed wages rising at an astounding 8.5% annual rate that, in our view, all but cements the case for another rate increase at this week's Bank of England meeting. Bank expectations will be key, of course, but we expect to see an MPC that is increasingly alarmed by the signs of second-round effects driving inflationary pressures in the UK.

Figure 2: UK Average Earnings Growth (2013 - 2023)



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We think that current expectations for a terminal UK rate of about 5.5%, followed by cuts early in 2024, are out of touch with reality. The MPC could push back against this on Thursday, although communications from committee members have been a touch on the dovish side of late, notably from governor Bailey, who recently warned that rates were nearing a peak. We could, therefore, see additional dissents in favour of no change this week, and rhetoric that raises heightened concerns over the UK growth outlook. We don't expect the BoE to indicate that it is done raising rates just yet, but they may not commit to further hikes either.

EUR

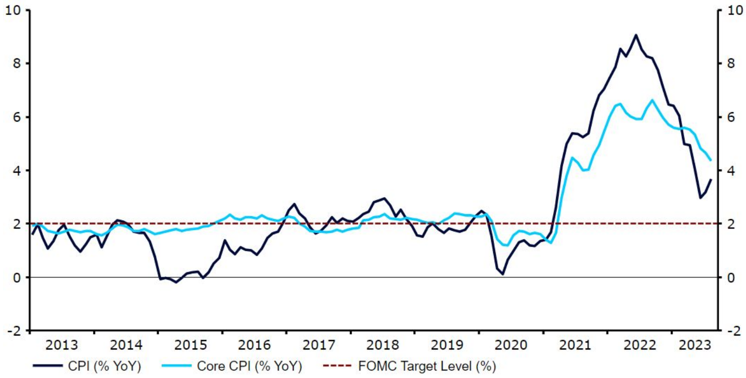
The European Central Bank opted for a compromise between the hawks and the doves at its September meeting. The former got a 25 basis point rate hike, and the latter a suggestion that the ECB thinks it has raised rates high enough for now. We think that the ECB may be too optimistic, as signs of stagflation accumulate, such as the increase in labour costs on the one hand and the falling PMIs on the other. Markets have not completely ruled out the possibility of additional rate increases, although swaps are now only assigning around a one-in-three shot of another 25bp hike by year-end, with cuts now expected to commence in June 2024.

We'll get the latest read on Euro Area business activity this week. Expectations for these are quite dismal already, which leads us to believe that the common currency may be pricing in too much gloom at these levels, particularly as the first positive signs in a while begin to emerge from China.

USD

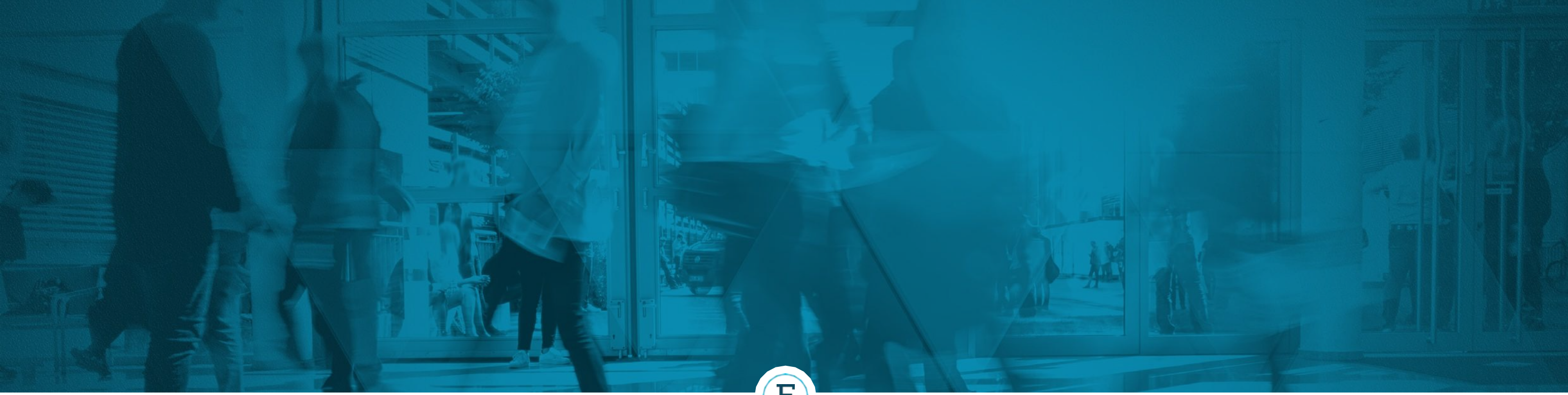
The July US inflation report delivered some modestly negative surprises last week. The rebound in headline inflation on the back of higher energy prices was expected, but the more important core subindex surprised to the upside with a 0.3% monthly increase, equivalent to around 3.5% annualised. This latter number is the first break in the disinflationary trend in the US in six months.

Figure 3: US Inflation Rate (2013 - 2023)



Source: LSEG Datastream Date: 18/09/2023

However, it is probably not enough to change the Fed's course, and so we expect unchanged rates this week, in line with the consensus of the market and economists. The key to the meeting will be whether the central bank officially calls time on the tightening cycle, and pushes back against market expectations that the cutting cycle will begin in the middle of next year. We suspect that the Fed will keep its options open for the November meeting, and once again stress that rate cuts are some way off. This could provide some upside support for the dollar in the second half of the week.



JPY

Rising expectations that the Bank of Japan could deliver a sooner-than-expected interest rate hike are still yet to be reflected in a meaningful way i the Japanese yen, which continues to trade around the 148 level against the US dollar. Speaking last week, BoJ governor Ueda noted that volatility in the yen exchange rate, and the impact of a weaker yen on domestic inflation, could encourage the bank to shift its stance on the yield-curve control (YCC) policy, and ditch its negative interest rates.

This sets up Friday's BoJ policy announcement to be an incredibly important one. We certainly don't expect any change in rates this week, though we are bracing for a hawkish pivot that could tee-up an end to the YCC from the next meeting, and a first 10 basis point rate hike at some stage in the coming few meetings. For the first time, swaps are now fully pricing in this first rate increase as soon as January that, if alluded to by policymakers, could trigger a sharp rebound in the yen towards the end of the week.

CHF

We saw some volatility in the franc after Thursday's ECB meeting, although EUR/CHF ended the week effectively unchanged, trading slightly below the 0.96 mark. Domestic newsflow was light. Deflation in producer and import prices deepened to -0.8% in August, marginally boosting the case for disinflation in consumer prices. This week promises to be far more important for the franc than the previous one, given that the quarterly SNB meeting will take place on Thursday. Most economists, including ourselves, expect another 25bp rate increase. Markets are not as convinced, and see the decision as a coin flip, despite recently raising their bets in favour of another hike.

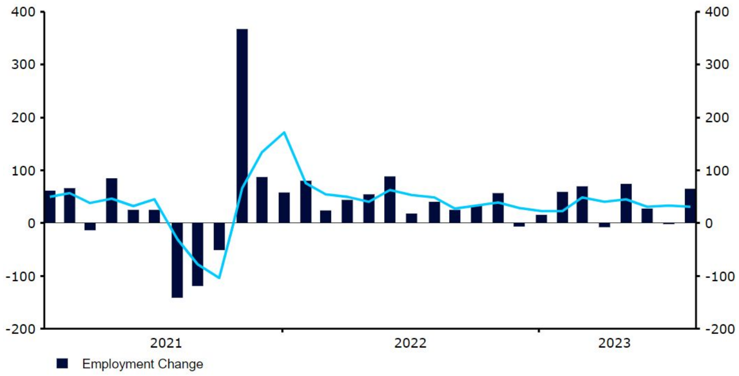
Given current market pricing, we should see a reaction in the exchange rate regardless of the rate decision. Beyond that, the bank's communications, notably the language on the franc, and the updated inflation forecasts will be under scrutiny. Any hike after September now appears a stretch, and markets will be looking for confirmation that this is, indeed, likely to be the case. We believe that the peak SNB hawkishness is behind us, and we see the bank turning its focus towards faltering growth, particularly as inflation has subsided.

AUD

The Australian dollar remained one of the outperformers in the G10 last week, and has been one of only two major currencies, including the Canadian dollar, to trade higher on the US dollar in the past month. This can be partly attributed to valuation, as the recent sell-off has left the currency languishing around its lowest level since November. Some slightly more encouraging newsflow out of China in the past few weeks has also supported AUD, as has recent labour market data, which has kept alive hopes for another RBA rate hike at upcoming policy meetings.

Last Thursday's labour data showed that the Australian economy added 65k net jobs in August, well above the 23k consensus, while there was also an upward revision to the July number. Both the latest jobs data and the strong Q2 GDP report were released after the September RBA meeting, so this Tuesday's RBA meeting minutes will not reflect this optimism, and could be overlooked by investors. We will be paying closer attention to Friday's PMI numbers, as further signs of reliance here could extend the recent AUD rally.

Figure 4: Australia Employment Change (2021 - 2023)



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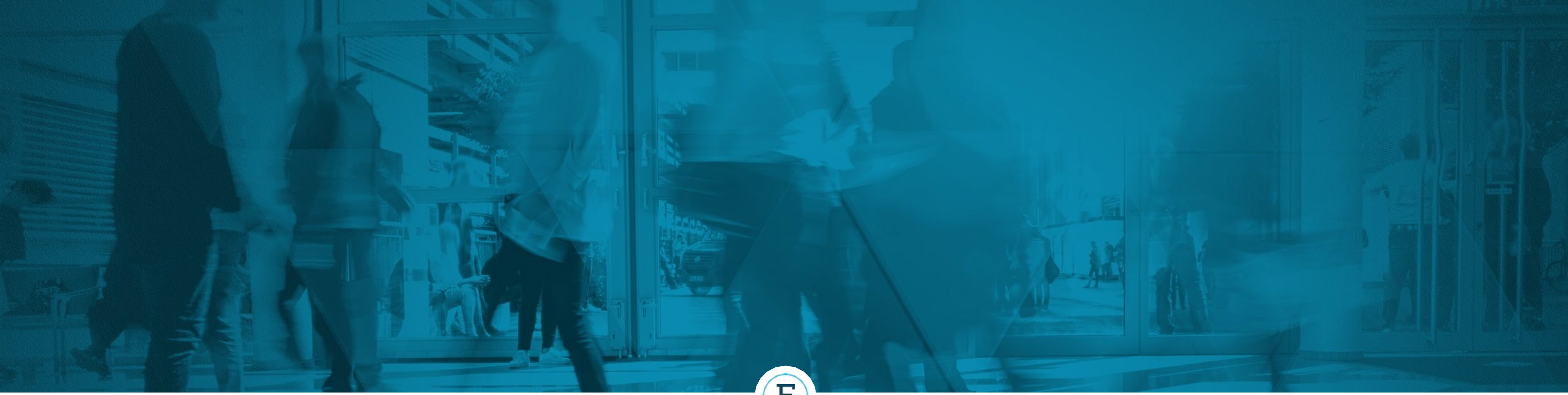
NZD

Following a period of relative quiet, lacking in major economic data releases, this week is shaping up to be a more eventful one in New Zealand. The second quarter GDP report will be released after a lag on Wednesday. Economists expect the data to provide confirmation that the New Zealand economy emerged from a technical recession in Q2, with modest expansion of 0.5% quarter-on-quarter pencilled in.

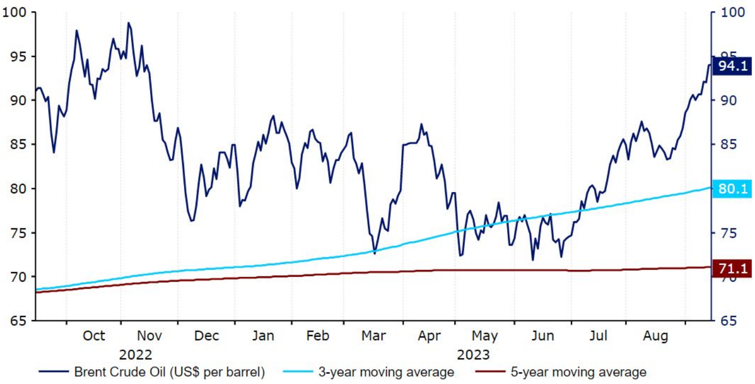


Given the time lag, we don't foresee a major reaction in NZD following this week's GDP report, particularly as markets are continuing to price in unchanged RBNZ interest rates for the foreseeable future. Thursday's trade balance data could be a market mover, although news out of China will probably once again remain the main driver for NZD in the coming days.

CAD

We have continued to witness an outperformance in the Canadian dollar in the past few weeks, which we think can be largely attributed to strong activity data in the US, and the sharp move higher in oil prices. Brent crude futures have continued to advance in the past couple of weeks, rising above the $94 a barrel mark for the first time since November, as signs of dovishness among central bankers raise hope over the global growth outlook. This should continue to provide decent support for the commodity-dependent currencies, including CAD, which look well placed to do well should the Fed disappoint expectations on Wednesday.

Figure 5: Brent Crude Oil Futures (2022 - 2023)



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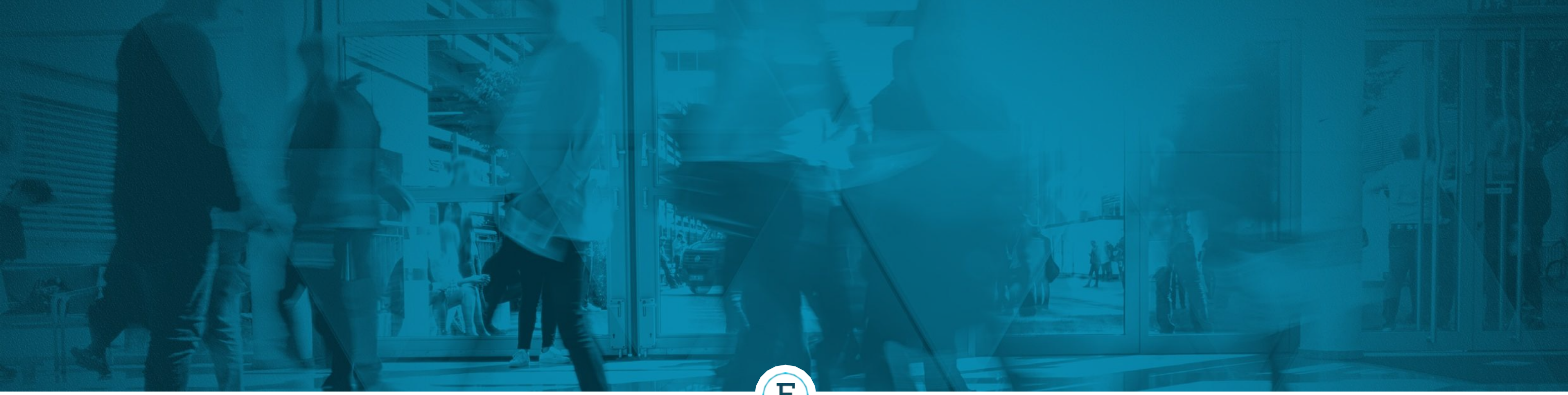
The August inflation report (Tuesday) will be the clear focal point for investors in Canada this week, with the steady increase in oil prices expected to be reflected in higher price pressures. Economists are eying up an increase in the headline rate to 3.8%, from 3.3%, which would be the highest level in three months. If confirmed, investors would likely push back their expected timing for BoC rate cuts, and the Canadian dollar could continue to be well supported during upcoming trading sessions.



SEK

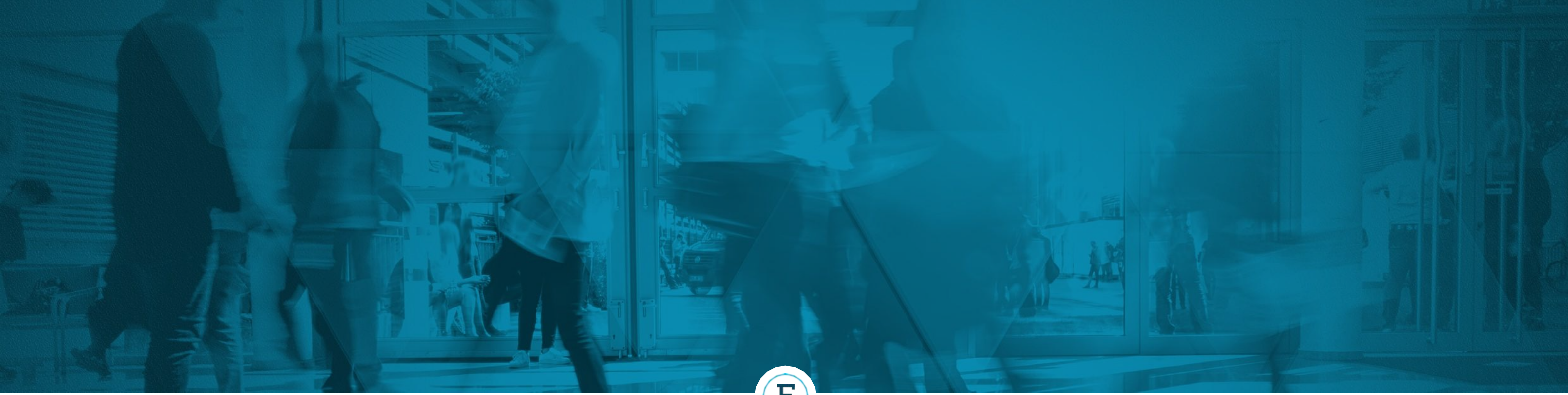
High-interest rate sensitivity and concerns over the state of Sweden's property market continue to weigh on the krona, which is trading near all-time lows. This week will be a key one for the currency as the Riksbank meets on Thursday. According to data released last week, the headline inflation rate fell in August to 7.5%, its lowest level since May 2022, after two months at 9.3%. The Riksbank's preferred measure of headline inflation, the CPIF index (the CPI index with a fixed interest rate) decreased to 4.7%, its lowest level since February 2022.

Despite easing of late, inflation remains at very high levels, and this is unlikely to change the Riksbank's plans to tighten monetary policy further. Markets are continuing to fully pricing in a 25bp hike this week, with another in November on the cards. Should the bank raise rates this week, while hinting that more may need to be done, then we could see a partial reversal in the recent krona sell-off.

NOK

Like other commodity-dependent currencies, the Norwegian krone appreciated against the euro last week as oil prices rose to their highest level in ten months. However, the currency did not start the week well, and has suffered a sharp depreciation, pushing the EUR/NOK pair down to the level of 11.54.

Norges Bank will also announce its latest monetary policy decision on Thursday. Both the market consensus and Norges Bank's June projection assume one more rate increase, most likely in September (as signalled at the last meeting). Further hikes beyond then, as emphasised by Norway's central bank governor, Ida Wolden Bache, are not out of the question, although these will depend on incoming data. Any hint of further tightening could boost the krone on Thursday. However, we believe that the continued moderation in inflation, coupled with signs that the Norwegian economy is starting to slow down, indicate that the end of the Norges Bank's hiking cycle is drawing ever closer. If the central bank makes reference to this, the krone could suffer.



CNY

The Chinese yuan had a stellar week, rising sharply against both the US dollar and its trade-weighted basket of currencies. The USD/CNY pair dropped below the 7.3 level, while the latter rose to its highest level since May, a move that can be attributed to both economic data and support from authorities. We began last week with the August financing data showing ramped-up borrowing. We ended it with a slew of hard data, which also came in largely better than expected. An uptick in industrial production and retail sales is particularly worth noting, as well as a slight drop in the unemployment rate.

Collectively, recent data gives hope that the peak weakness of the Chinese economy could be behind us. Authorities are working to ensure that's the case. On Thursday, the PBoC announced a 25bp cut in the banks' reserve ratio (RRR), the second one this year. As expected, the bank held the MLF rate steady the following day, although the PBoC injected 191 bn yuan on top of rolling over 401 bn yuan of medium-term loans maturing this month. The central bank remains committed to supporting the economic recovery, although it is not abandoning the yuan. Strong fixings continue, alongside verbal interventions, and some reports suggest guiding actions for financial institutions to stem the pressure on the currency. There's not much on tap this week aside from the 1- and 5-year LPR announcement on Wednesday. Given that there was no change to the MLF rate last week, any adjustment there would be a surprise.

Economic Calendar (18/09/2023 - 22/09/2023)

Economic Calendar	Country	Day	Date	Time (BST)
RBA Meeting Minutes	AUS	Tuesday	19/09	02:30
Inflation (Aug.)	EZ	Tuesday	19/09	10:00
Inflation (Aug.)	CAN	Tuesday	19/09	13:30
1Y and 5Y LPR Rate Announcement	CHN	Wednesday	20/09	02:15
Inflation (Aug.)	UK	Wednesday	20/09	07:00
Federal Reserve Monetary Policy Meeting	US	Wednesday	20/09	19:00
Riksbank Monetary Policy Meeting	SWE	Thursday	21/09	08:30
Swiss National Bank Monetary Policy Meeting	SWI	Thursday	21/09	08:30
Norges Bank Monetary Policy Meeting	NOR	Thursday	21/09	09:00
Bank of England Monetary Policy Meeting	UK	Thursday	21/09	12:00
Preliminary PMIs (Sep.)	AUS	Friday	22/09	00:00
Bank of Japan Monetary Policy Meeting	JPN	Friday	22/09	
Preliminary PMIs (Sep.)	EZ	Friday	22/09	09:00
Preliminary PMIs (Sep.)	UK	Friday	22/09	09:30
Preliminary PMIs (Sep.)	US	Friday	22/09	14:45

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