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Weekly Report

G10 Weekly FX Update

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4th December 2023

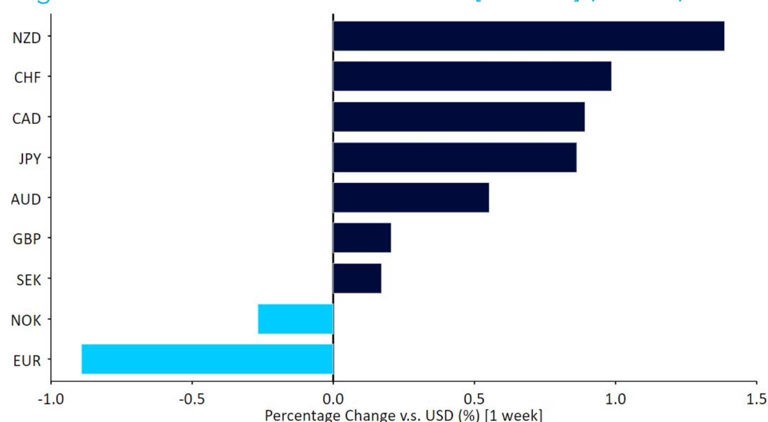
Financial markets celebrate as interest rates plummet

The apparent victory for central banks over inflation is pushing a gusher of cash into risk assets worldwide.

Stock and bond prices worldwide enjoyed a rally during November, and the key 10-year US Treasury rate has fallen from its recent highs of 5.00% to less than 4.20% as of Friday close. The dollar has fallen sharply, and last week was no exception. The main change was that the euro failed to follow through and fell against almost every major currency worldwide, as fears of recession in the Eurozone compound the effect of disinflation there. Special mention to the pound, which continues to outperform both the euro and the dollar, as markets increasingly expect UK rates to remain higher for longer than elsewhere

The question now is whether rates and the dollar have fallen too much, too fast. Crucial labour market information in the US will help both markets and the Federal Reserve answer that question this week. In addition to the JOLTS report on job openings on Wednesday, the payrolls report on Friday should print a strong number, as striking auto and entertainment workers return to work. The wage growth number in this latter report will also be key. In the Eurozone, we will look at the October retail sales number to get a read on the strength of consumer spending as the last quarter of 2023 got underway.

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

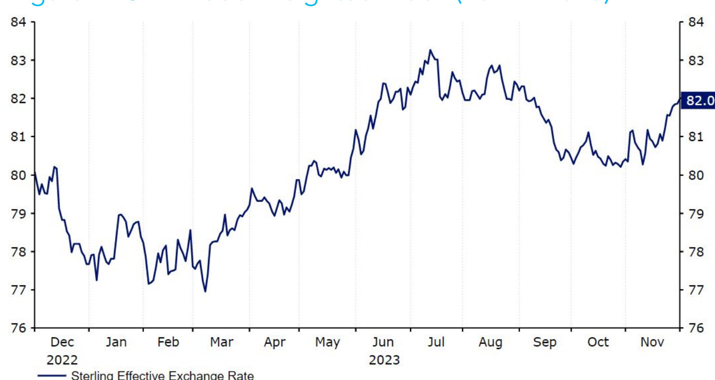


Source: LSEG Datastream Date: 04/12/2023

GBP

High UK rates, hawkish Bank of England communications and the prospect for fiscal stimulus as the next general election nears have turned the pound into the best performing European currency over the last couple of weeks. The trade-weighted GBP index is now trading at its strongest position since early-September, an appreciation of around 2% since the pound's late-October lows.

Figure 2: GBP Trade-Weighted Index (2022 - 2023)



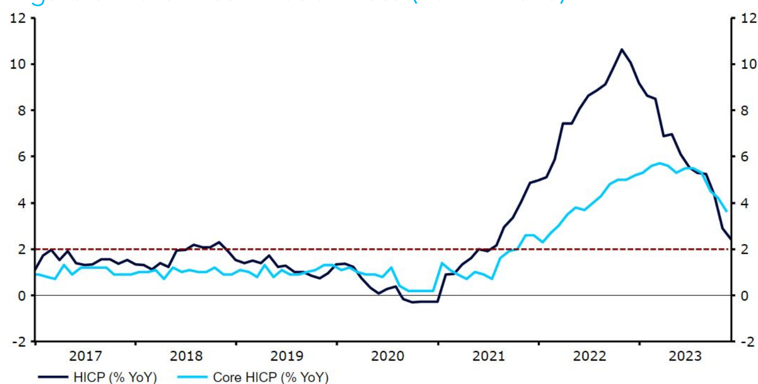
Source: LSEG Datastream Date: 04/12/2023

Bank of England governor Andrew Bailey warned again last week that interest rate cuts were not on the way any time soon, saying that lower rates were not in the offing for the 'foreseeable future'. On the one hand, UK growth is slowing, and a technical recession is entirely plausible in early-2024. MPC officials are, however, continuing to grapple with stubbornly high inflation and elevated wages, and are likely to be reluctant to signal that looser policy is on the way until they see clearer signs of a downtrend in both of these indicators. There is not much news on the docket this week, so sterling should track fairly closely the euro in the next few days.

EUR

The Eurozone is no exception to the global disinflationary trend. The November flash inflation report showed a sharper than expected fall in both the headline and core subindices, with both indicators falling 0.3 p.p. short of consensus. With the latter solidly below 4%, it is clear that the European Central Bank's hiking cycle is over, a notion that markets had come to grips with for some time. The European economy continues to underperform, and the worrisome numbers out of China mean that global demand is not going to come to the rescue any time soon.

Figure 3: Euro Area Inflation Rate (2017 - 2023)



Source: LSEG Datastream Date: 04/12/2023

Given the rather dour growth outlook, and the good chance we may see a Euro Area recession before year-end, we think it is likely that we will see cuts in the Eurozone before the US, with markets now eyeing up a first rate reduction in March 2024. This could, in our view, lead to a partial retracement in the euro in the next few weeks, and we are growingly confident in our call for the EUR/USD pair to end the first quarter of next year around the 1.07 level.

USD

Macroeconomic data out last week reinforced the view that the US economy is headed towards a soft landing, with inflation falling towards the Fed's target even as a full-employment economy continues to boom on the strength of domestic demand. The drop in medium-term rates and the dollar is starting to strike us as too optimistic, however, as an economy growing well above potential and a strong labour market hardly warrant interest rate cuts any time soon.

FOMC chair Powell once again pushed back against market pricing on Friday, saying that talk of looser policy was 'premature'. Futures markets are taking little notice thus far, and now see more than a 50% chance of a first cut in March, which we think is far too aggressive. This week's nonfarm payrolls report should reinforce that view, with markets expecting a rebound in job creation and wage growth from last month's modestly negative surprise.

JPY

Communications from Bank of Japan board members were relatively dovish last week, with messrs Adachi and Nakamura suggesting that it was still too early to be discussing the possibility of exiting the bank's ultra-loose policy stance. Markets largely overlooked these comments, with swaps continuing to price in a first rate cut by the BoJ's April 2024 meeting. Expectations for a policy divergence between Japan and the rest of the world have helped the yen on its way upwards in recent weeks, with JPY now trading at its strongest position since the middle of September.

This week will be a very important one of macroeconomic data out of Japan. Today will see the Tokyo inflation numbers for November, with the revised third quarter GDP figures to follow on Thursday. Wage growth data, also on Thursday, will be closely watched by investors. Any signs of an acceleration here could further bring forward expectations for BoJ policy tightening, and support the yen.

CHF

The Swiss franc was once again one of the better performers in the G10 last week and is now back trading below the 0.95 level on the euro. Thus far, the Swiss National Bank appears comfortable in allowing CHF strength, and has not intervened in a meaningful way in order to trigger currency weakness. This appears to be helping bring down rates of domestic price growth, with the November inflation rate unexpectedly slipping to just 1.4%, its lowest level in over two years.

The counter-argument would be that a strong domestic currency presents a downside risk to the growth outlook. Last week's Q3 GDP report, however, come in above expectations (+0.3% QoQ vs. +0.1% consensus). This may limit pressure on the SNB to deliver a policy reversal early-next year, and could continue to provide some near-term support for the Swiss currency.

AUD

A miss in last week's October inflation data contributed to the underperformance in the Australian dollar versus its New Zealand counterpart last week, although AUD still ended the week higher against most of its major counterparts, buoyed by the sharp drop in US bond yields. Attention this week will be firmly on Tuesday's Reserve Bank of Australia announcement. No rate hike is expected, although investors will be looking to see whether the RBA keeps the door open to further policy tightening (8bps of hikes priced in through March).

This week is also an important one of macroeconomic data out of Australia. The November PMIs (Monday), third quarter GDP figures (Wednesday) and trade balance data (Thursday) could all elicit a degree of additional volatility in AUD.

NZD

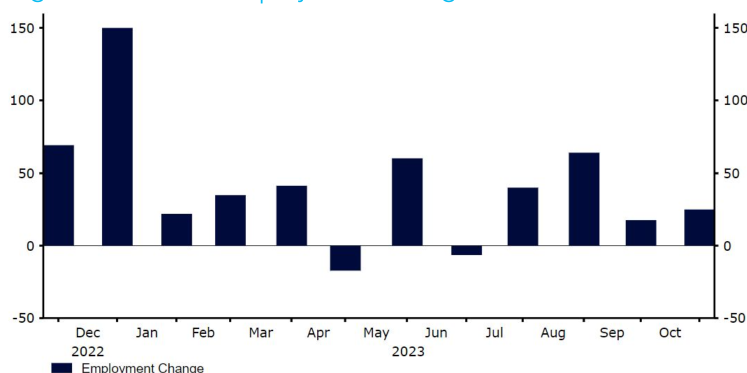
The Reserve Bank of New Zealand delivered a hawkish hold at its policy meeting last week, allowing NZD to once again outperform all of its G10 peers. Somewhat surprisingly, the RBNZ keep the door ajar to further rate hikes, saying that elevated core inflation could encourage the bank to raise the OCR again at upcoming meetings. While these hawkish communications have kept the New Zealand dollar well bid, investors still see little chance of another hike, with the next move in rates still expected to be downwards.

Last week's communications do, at least, perhaps suggest that the bank may be in no rush to begin reversing the hiking cycle at subsequent meetings. Swap markets are now pricing in the first cut in July 2024, although this may be slightly too early in light of the tone of last week's remarks. There will be no major economic data out of New Zealand this week, so the kiwi will likely be driven by events elsewhere.

CAD

Economic news out of Canada last week was largely encouraging. The September GDP data beat expectations, with the economy posting modest expansion of 0.1% QoQ (0% consensus). Jobs growth data on Friday was encouraging, as the Canadian economy added 25k net jobs last month, an acceleration relative to November. With the economy and labour market holding up relatively well, we see continued room for appreciation in CAD in the coming quarters, with the currency now trading just shy of its strongest position since August.

Figure 4: Canada Employment Change (2022 - 2023)



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This Wednesday's Bank of Canada rate announcement is unlikely to deliver any fireworks. There is no possibility of any change in rates, so attention will be squarely on the bank's communications. We expect the BoC to strike as non-committal a tone as possible, as it awaits further data before hinting at the timing of the first rate cut. This is currently largely priced in for Q1 next year, so any hawkish remarks that hint the bank will sit on its hands for a little while yet could suggest CAD this week.

SEK

The Swedish krona ended the month of November as the best performing currency in the G10, rallying by almost 8% against the US dollar, and around 5% on the euro, the best month for the currency since 2010. Clearly the improvement in market risk sentiment has supported the krona, although domestic factors have also helped the currency outperform its major counterparts. Chief among these factors has been the hawkish stance adopted by the Riksbank, which has remained open to the possibility of further interest rate hikes, at a time when almost every other central bank has effectively signalled an end to tightening. We also see valuation as playing an important role in the recent turnaround, with the near 10% depreciation in SEK in real effective exchange rate terms in the two years to mid-September leaving the currency rather undervalued.

The latest PMI data (Tuesday) and monthly GDP print for October (Friday) will be closely watched by market participants this week. Economists are expecting a modest rebound in the latter following the sharp contraction in September. Any surprise to the upside here could further support the krona, which appears to have a further room to rally against most currencies.

NOK

Aside from the euro, the Norwegian krone was the worst performing currency in the G10 last week, an underperformance that we largely attribute to another drop in global oil prices towards the end of the week. Brent crude oil futures sank below the $79 a barrel level this morning, a retracement of more than 5% from last Thursday's levels, amid concerns over global oil demand and scepticism surrounding the recent OPEC+ supply cuts.

News out of the Norwegian economy last week was actually largely enoucinging, although this was insufficient to prop up the krone. October retail sales and the November manufacturing PMI both beat expectations, albeit the data remains broadly in line with a slowing economy that is struggling under the weight of tighter monetary policy and elevated inflation, particularly in the core index. House price and current account data on Tuesday and Wednesday respectively are unlikely to garner too much attention this week, so the krone may well be driven largely by developments in commodity markets and broader risk sentiment this week.

CNY

The yuan edged modestly higher on the broadly weaker US dollar last week, despite some rather mixed economic news out of the Chinese economy. The November PMI figures from NBS were a disappointment, with the manufacturing index remaining pinned below the key level of 50, while the services index unexpectedly slumped to levels that barely indicate expansion. Friday's manufacturing PMI from Caixin was far more upbeat, as this leapt to a three-month low 50.7 (49.8 consensus).

Upcoming economic prints on the services activity (Tuesday) and trade (Thursday) will be closely watched this week. Further signs of fragility in this data could raise fresh concerns over whether recent stimulus measures are sufficient in order to prop up the economy. Until we get news of additional fiscal support, it may be difficult for the yuan to eke out anything more than rather modest advances against the US dollar.

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