Ebury What borders?®

Weekly Report

G10 Weekly FX Update

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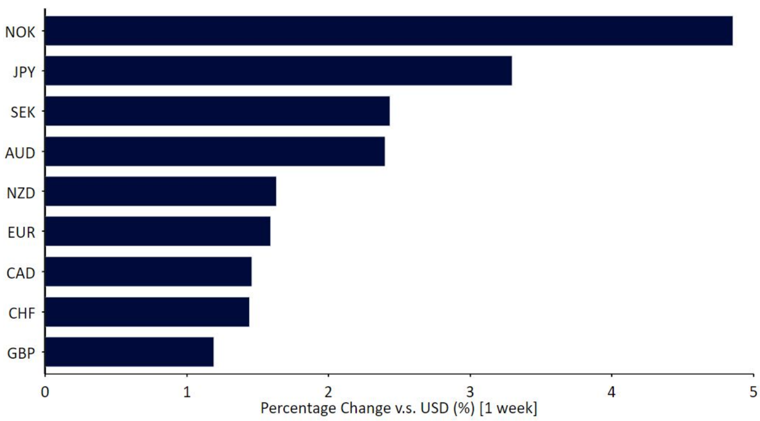
Federal Reserve pivot smashes the dollar

We said that last week would be a volatile one, with three key central bank meetings in quick succession, and currency markets did not disappoint.

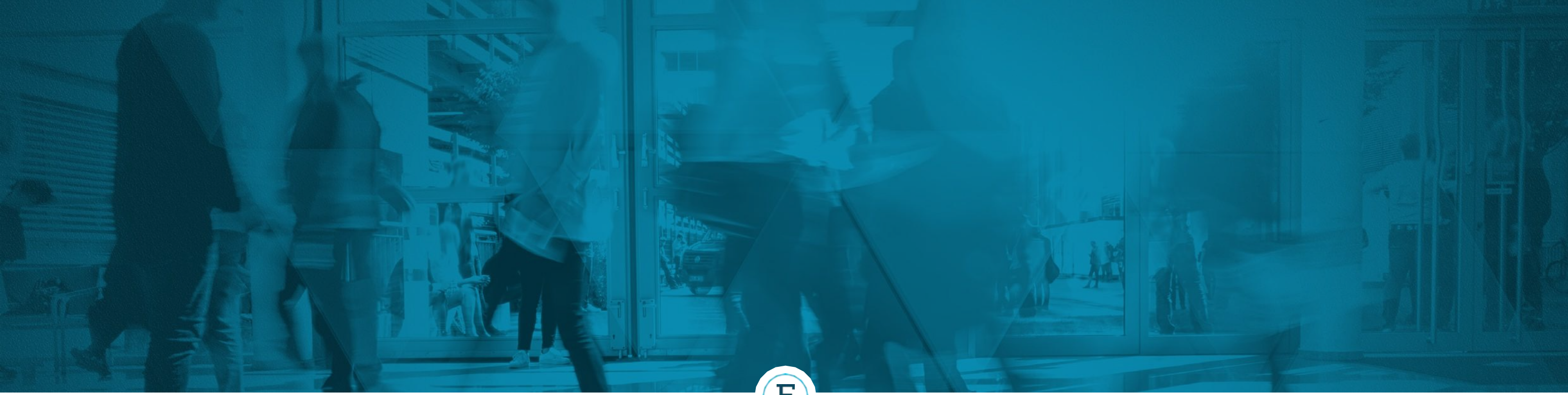
The Federal Reserve executed a clear pivot towards rate cuts, both in terms of rhetoric and its actual forecasts for rates in the "dot plot". By contrast, the ECB and the Bank of England were both hawkish, and pushed back against market expectations for rate cuts, in spite of the rather negative newsflow we have seen out of Europe recently. Financial markets celebrated the news out of the Fed jubilantly, sending stocks, bonds and just about every currency other than the dollar sharply higher.

The low-activity holiday period looms in markets. With the major central bank meetings out of the way, there will not be much data to move markets. Central bank communications will be key. For the first time in a long while, there appears to be a surprising gap in outlook between the Fed on the one hand and European policymakers on the other. This gap runs in the opposite direction to that between economic performances across the Atlantic, as the US economy continues to grow, while the Eurozone appears to be contracting again. In addition to getting further clarity on this puzzling contrast, this week will see inflation data out of the UK (Wednesday) and the US (Thursday).

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



Source: LSEG Datastream Date: 18/12/2023



GBP

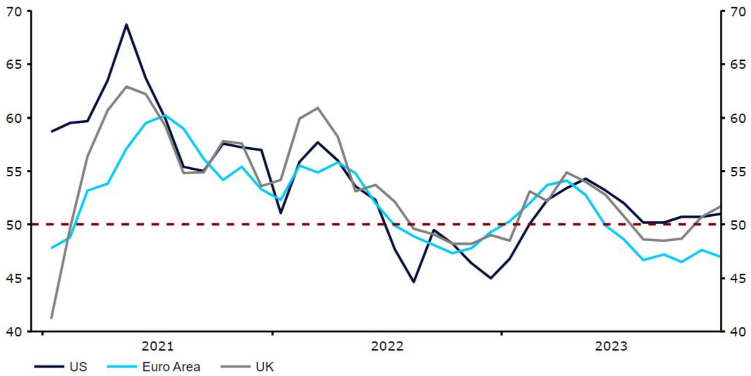
We had quite a hawkish surprise from the Bank of England last week. Three of the nine MPC members again voted to hike rates, as they did in November, and the bank did not change its forward guidance, saying that it was prepared to raise rates again should inflation prove 'persistent' This is significantly at odds with the cuts priced in by markets.

Sterling rallied sharply afterwards, and it got a second wind against the euro the next day, following the release of some surprisingly good PMI readings, which suggests that Britain's economy was accelerating as year-end approaches. A sharp improvement in the services subindex suggests that the UK economy is growing again and will avoid a recession, the opposite from the Eurozone trend. A hawkish central bank and improving economic sentiment should provide solid support for the pound in the coming weeks.

EUR

The European Central Bank stuck to its guns last week, with Lagarde saying that now was not the time to lower its guard, and that policymakers had not even discussed the possibility of lower rates. These hawkish communications were not particularly well timed. The very next day, the key PMIs of business activity for December surprised to the downside, following broad based slowdown in activity in Germany and France. A dismal reading well into contractionary territory seems to confirm that the Eurozone has entered into a technical recession in the second half of 2023.

Figure 2: G3 PMIs (2021 - 2023)



Source: LSEG Datastream Date: 18/12/2023

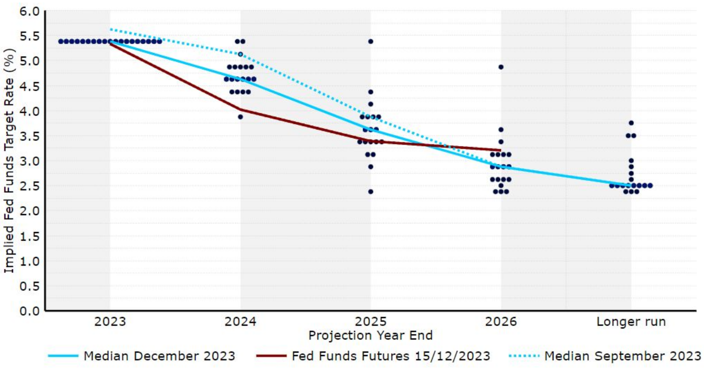
The euro gave up around half of its post-Fed gains on the news. Regardless of ECB rhetoric, we think it will be difficult for the common currency to break convincingly higher until we see a sustained turn for the better in Eurozone economic pessimism.

USD

The dollar is whipsawing, driven by two opposite forces: the apparent dovish pivot executed by the Federal Reserve, and the relative and absolute strength of the US economy. The former was underlined last week by a "dot plot" where the median Fed policymaker increased their expectation of cuts for 2024 from one to three. The latter was confirmed by a slate of second tier reports, such as retail sales and weekly jobless claims.

For now, the shock of the Federal Reserve's turn to the dovish side carries the day, though the dollar remains sensitive to bad economic news elsewhere, as well as any sign of pushback against expectations for cuts on the part of Fed officials. We have already seen such a repel from Fed member Williams and Bostic, who have both attempted to calm expectations for imminent cuts in their remarks since last Wednesday's FOMC announcement.

Figure 3: FOMC Dot Plot [December 2023]



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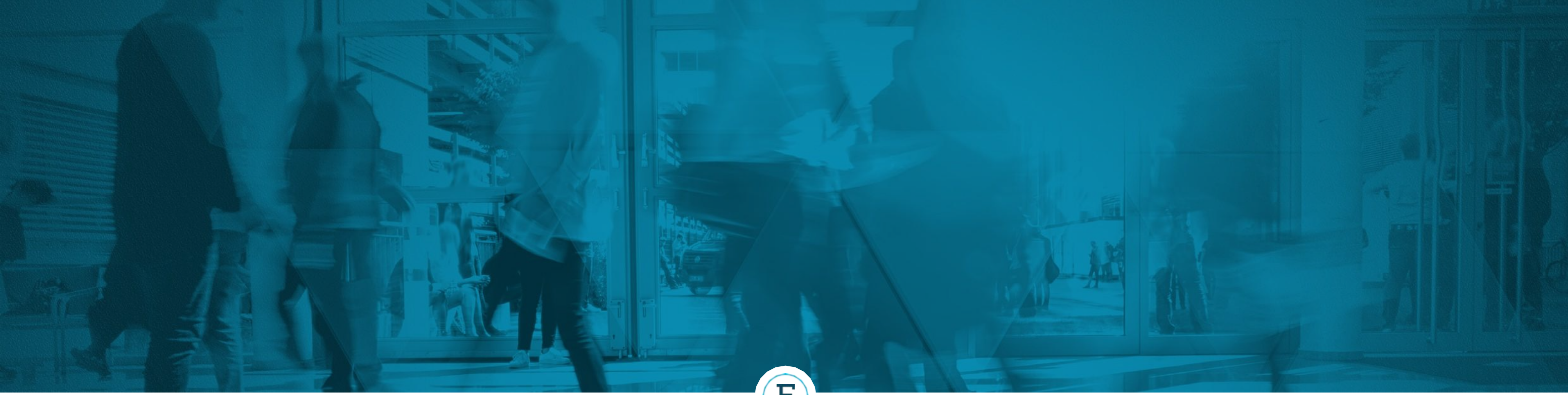


JPY

Aside from the Norwegian krone, the yen was the big winner in the G10 last week, as investors cheered the dovish turn from the Fed and the expected narrowing in US-Japan rate differentials. The yen has now advanced by around 6% since its lows, as Bank of Japan officials finally hint that a change in policy stance could be on the way in the not too distant future. No change in rates is seen as this Tuesday's BoJ meeting, although we are expecting a shift in rhetoric on inflation and/or its guidance on interest rates that tees up a first rate hike in early-2024. This may involve an official scrapping of the bank's yield curve control policy, which was effectively ditched when the parameters of the programme were relaxed in October.

A hawkish set of communications this week, which opens up the possibility of an end to negative rates in the first quarter of next year, would likely pave the way for additional JPY appreciation this week. However, should officials deflect higher rate expectations with a flat bat, then the only path for the yen will be lower.

CHF

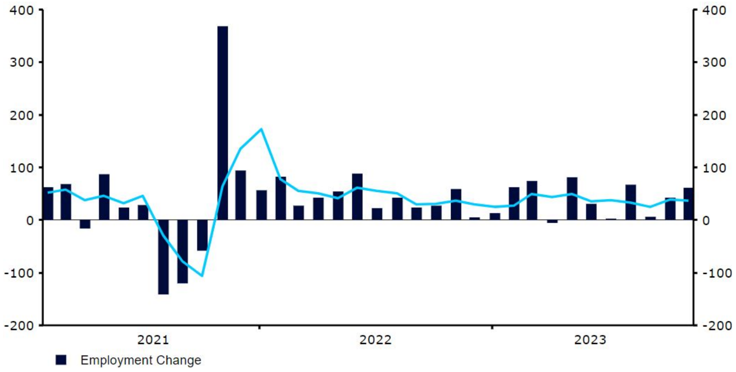
The Swiss franc ended the week little changed against the euro, and was one of the worst performing G10 currencies. This can be explained, at least in part, by the dovish turn of the Swiss National Bank. As expected, interest rates were left unchanged, although the bank remove from its statement a reference to possible further hikes. It also repeated its intervention pledge, but dropped wording about its focus on selling FX, signalling that its approach towards the currency has shifted.

The SNB's inflation projections were lowered across the forecast horizon, further strengthening the notion that policy easing is in store next year. Markets have ramped up their rate cut bets, and now see more than an 80% chance of a 25bp cut in March, and around 80bps of cuts through 2024. These expectations seem somewhat aggressive, although we have little doubt that lower rates will be justified in 2024 given the progress on inflation. The franc looks set to end the year as the best-performing major currency, although 2024 looks increasingly likely to be a rather difficult one for the currency. In the meantime, macroeconomic data will be in focus. The economic calendar for this week is rather light, but Tuesday's November trade data would be worth keeping an eye on.

AUD

A strong November employment report helped the Australian dollar on its way upwards last week, with AUD now trading around its highest level on the US dollar since late-July, just above our year-end forecast. Another 61.5k net jobs were added to the Australian economy last month, the most in three months and well above consensus (+11k). Financial markets are not pricing in any additional policy tightening, although comments from RBA governor Bullock last week, who said that the bank would take a 'cautious' approach to policy, suggests that the first rate cut may have to wait for a little while.

Figure 4: Australia Employment Change (2021 - 2023)



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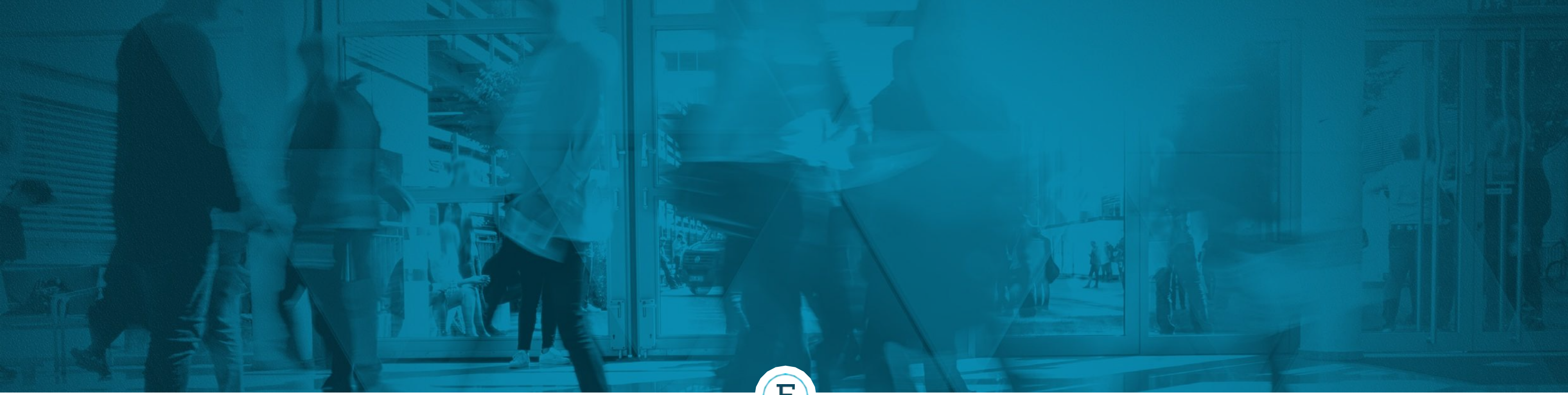
Tuesday's RBA meeting minutes should shed some more light on the bank's thinking on rates. The bank maintained its tightening bias at the last meeting, although the watered-down statement suggests that further hikes are now not in the bank's base case scenario.

NZD

A highly disappointing GDP report contributed to the underperformance in the New Zealand dollar relative to its Australian counterpart last week. The New Zealand economy unexpectedly contracted by 0.3% in the third quarter of the year, after investors were pencilling in a mild expansion, while there were also sizable downward revisions issued to previous data. This will be a big concern for policymakers at the RBNZ, and could elicit a more dovish response at upcoming meetings. Swap markets now see the first 25 basis point cut in May 2024. This seems reasonable in light of last week's data, although with inflation still running hot, the RBNZ will have a very difficult and unenviable job in setting monetary policy in the coming months.



CAD

CAD trading roughly in the middle of the pack among the G10 currencies last week, ending around its strongest position since early-August against the broadly weaker greenback. There was no major data out of Canada last week, although BoC governor Macklem did say on Friday that it was still 'too early' to discuss lower rates, a clear departure from the communications issued by the Federal Reserve.

Upcoming macroeconomic prints will test the Bank of Canada's policy stance. The November inflation report (Tuesday) is expected to show that consumer prices fell on a monthly basis last month to within 1.0 p.p. of the bank's target. Retail sales data on Thursday will also be closely watched, as will Friday's monthly GDP print for October. Economists are expecting a rebound in both data points, although the slight time lag in the data suggests that the market reaction could be relatively muted.

SEK

The policy stances adopted by the ECB and the Fed triggered the largest rally in the krona in a decade in November. While the Fed is signalling that US rate cuts are on the way, the Riksbank has left the door open for further hikes, which has helped the currency extend its appreciation and outperform most of its major counterparts. As a result, the Swedish currency has risen by around 5.5% on the dollar since its lows at the end of October.

However, Sweden is in technical recession and November inflation, which was released last week, brought good news for the central bank. After two months unchanged, the headline inflation rate declined to 5.8% in November, its lowest level since February 2022. Core inflation also declined to 3.6% in November, its lowest level in two years. This is an encouraging development and makes the Riksbank's task easier, as if consumer prices continue on this trend, it would allow the central bank to achieve its price stability objective without further weighing on an already struggling economy.

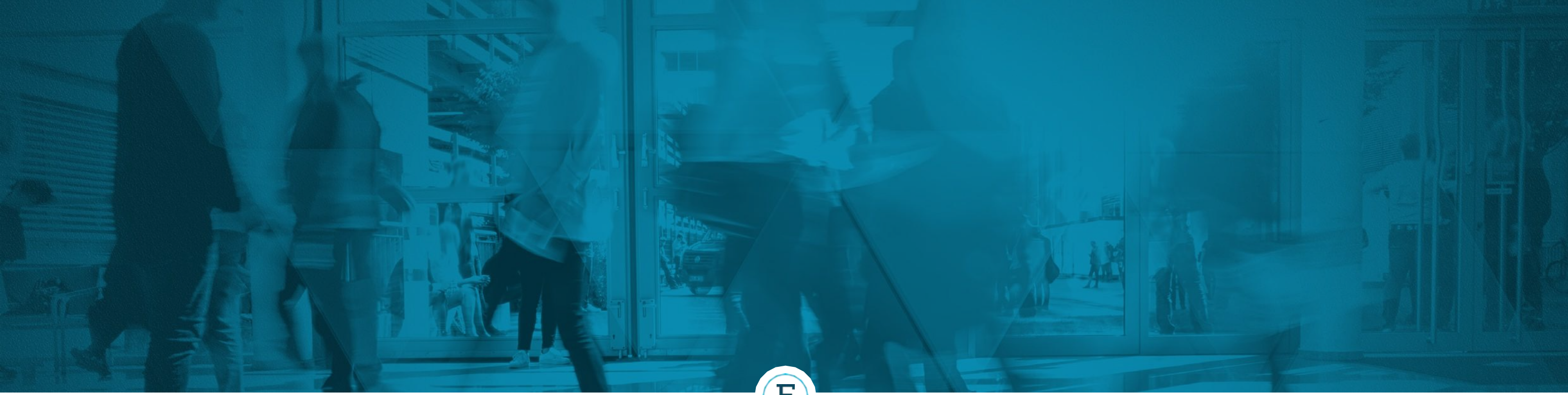
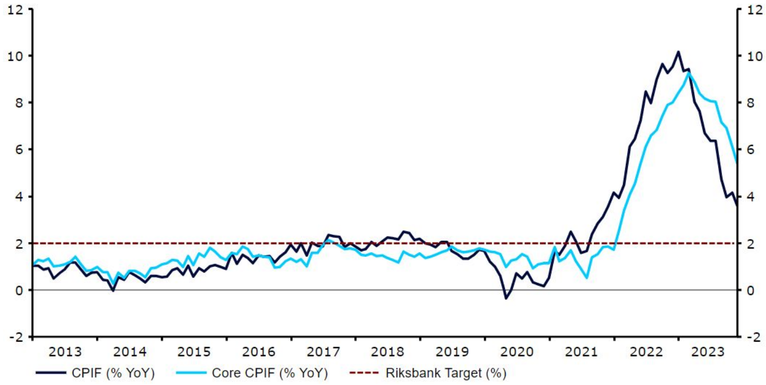


Figure 5: Sweden Inflation Rate (2013 - 2023)



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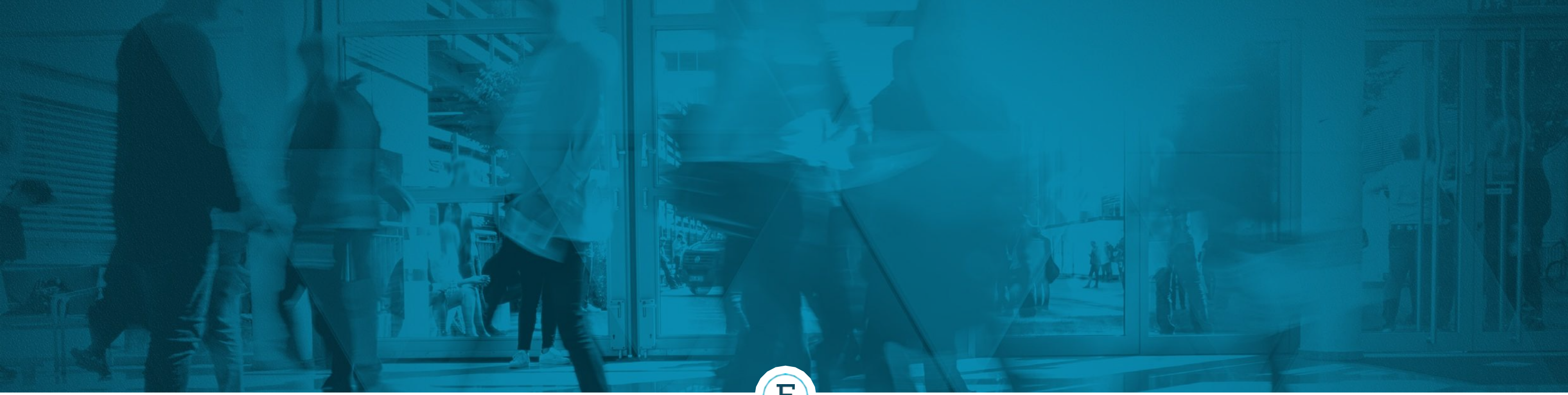
NOK

The Norwegian krone appreciated strongly last week after Norges Bank surprised markets with a 25 basis point rate hike at its last meeting of the year. NOK rose by more than 3% against the euro last week, and is now trading at its highest level since early-October.

Unlike the other central banks that met last week, Norges Bank raised rates by 25 basis points to 4.5%, resuming its hiking cycle after the at pause at the previous meeting. This caught markets wrong-footed, as swaps were only assigned around a 50% implied probability of an immediate hike. Norges Bank warned that interest rates will likely remain at this level for some time, citing elevated inflation (CPI of 4.8% year-on-year and core CPI of 5.8% in November). According to the bank forecasts, its key rate will remain around 4.5% until autumn 2024, at which point it could start to lower rates.

CNY

The dovish turn from the Federal Reserve helped the yuan rally to its strongest position against the greenback since June last week. On the other hand, its trade-weighted basket fell to its lowest level since September. The balance of domestic data released last week was negative. Financing data for November disappointed, followed by retail sales, which also fell short of expectations. The latter does not help to dispel concerns over chronic consumption problems in China. Industrial production fared better than expected, but the overall economic picture remains rather bleak.



Authorities are trying to help by offering their usual remedy – more liquidity. Last week saw the largest-ever liquidity injection via the medium-term lending facility (MLF): 800 billion yuan of fresh funds on top of the rollover. With the data not showing a way out of the torpor, calls for adjustments to key monetary policy instruments are growing louder. Further policy easing in the coming months would not be a surprise if we don't see significant improvement in the data. This week, the benchmark lending rates (LPR) are set to remain unchanged.

Economic Calendar (18/12/2023 - 22/12/2023)

Economic Calendar	Country	Day	Date	Time (GMT)
RBA Meeting Minutes	AUS	Tuesday	18/12	00:30
BoJ Monetary Policy Meeting	JPN	Tuesday	18/12	
Inflation (Nov.)	EZ	Tuesday	19/12	10:00
Inflation (Nov.)	CAN	Tuesday	19/12	13:30
1Y and 5Y LPR announcement	CHN	Wednesday	20/12	01:15
Inflation (Nov.)	UK	Wednesday	20/12	07:00
GDP Annualised (Q3)	US	Thursday	21/12	13:30
Retail Sales (Oct.)	CAN	Thursday	21/12	13:30
Inflation (Nov.)	JPN	Thursday	21/12	23:30
GDP (Q3)	UK	Friday	22/12	07:00
Retail Sales (Nov.)	UK	Friday	22/12	07:00
Retail Sales (Nov.)	SWE	Friday	22/12	07:00
PCE Inflation (Nov.)	US	Friday	22/12	13:30
GDP (Oct.)	CAN	Friday	22/12	13:30

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