FX MARKETS UPDATE | AUGUST 2023

SUMMARY

- Higher rates for longer appears to be the common theme with the Fed, BoE and ECB.
- Currency markets have been influenced by rising US treasury yields and poor data from China.
- Forward looking ISM Surveys have been weak in Europe, UK and US.
- Post Jackson Hole symposium, analysts ponder a final hike from the Fed.
- BoE is expected to hike interest rates further, but the jury is out with the ECB.

ANALYSIS

United Kingdom

The Bank of England followed its June interest rate increase with a further 0.25% hike in August, taking the benchmark rate to 5.25%. Persistent inflation remains an ongoing concern for policymakers on the MPC, with July's CPI release coming in above market expectations. Core inflation jumped to 6.9% against expectations of 6.8%, with the headline rate rising to 6.8% against the 6.7% predicted. Whilst Governor Bailey and rate setters will doubtless be happy that inflation finally sits on a 6% handle, prices remain considerably above the central bank target. A fall in wholesale energy prices and reduction in household energy bills next month is likely to help inflation glide lower, but markets remain convinced that the central bank will be forced to announce at least one more hike of 0.25%. Whilst the BoE remains committed to fighting inflation by increasing interest rates, the impact on consumers and businesses remains clear to see. The housing market remains troubled, retail Sales remain soft as families cut back and recent PMI surveys point to a slowdown in activity. Composite PMI dropped from 50.8 in July to 47.9 in August – the lowest level in 31 months with high borrowing costs mainly to blame for the fall. In recent times the dominant services sector has been the most resilient part of the economy, helping to offset a shrinking manufacturing sector. However, both are now in negative territory with the drop in services down to a level last seen when the country was in lock down.

Europe

In Europe, the ECB delivered a further 0.25% rate increase at the 27 July meeting, however sticky inflation and recent soft data have given the ECB a predicament. Officials will now need to consider whether price pressures are too persistent to risk keeping rates unchanged at the 14 September policy meeting. Consumer prices rose 5.3% from a year earlier, more than twice the target rate set by the ECB and higher than analysts had predicted. Rate setters at the central bank have been watching recent data closely, facing the predicament of raising interest rates for the 10th consecutive time or leaving the current benchmark rate as is.

Moreover, policymakers will need to consider the sharp decline in services PMI led by a drop in Germany where the headline reading fell to 48.3 in August from 50.9 in July and considerably softer than predicted. The manufacturing sector continues to suffer despite a small uptick in the August report. A print of 43.7 was an improvement on the previous reading of 42.7 but the forward-looking survey remains considerably below the 50 mark that separates contraction from expansion. The recent slowdown in China is also having a negative impact in Europe, especially from Germany with their reliance on the auto sector.

United States

The US Federal Reserve appears close to reaching the end of their aggressive rate hiking cycle, with many believing that the terminal rate has been reached or is close to being reached. The recent Jackson Hole symposium attended by global central bankers, provided few fresh clues – however, the mantra of 'higher for longer' continues to stand. Chairman Jerome Powell used his address at Jackson Hole to confirm that the central bank "will proceed carefully" with regards to hiking interest rates, adding that "persistent above trend growth could warrant tightening." After pausing in June, the Fed delivered a 0.25% hike in July, and it remains to be seen whether officials will deliver a potentially final increase when they next gather and announce their policy decision later this month. The latest US inflation report came in broadly in line with expectations and Fed officials remain divided, so markets continue to focus on the data for further clues on when the central bank will be 'done'. Recent softer than expected labor market reports have had little impact on the outlook for the US with Job openings and ADP Private payrolls disappointing slightly to the downside. Key August Non-farm Payrolls came in broadly in line with expectations, however the unemployment rate crept up to 3.8% from the consensus 3.5%. The next CPI inflation report is out on 13 September giving officials and investors a week to ponder the outcome of the 20 September policy meeting. Markets have been paying close attention to US treasury yields which have set much of the tone for currency markets with yields steadily rising in recent months. The greenback has remained well supported against many of its G10 peers further boosted by soft data coming out of China. A dramatic slowdown in China has sounded alarm bells around the world with the yuan losing ground prompting China's central bank, the PBoC to deliver small cuts to lending rates.

CURRENCY PAIRS: What happened and what is next?

GBP/USD

GBPUSD continues to be one of the best performing pairs of the year but comes from a low base following the disastrous mini budget last year when the pair dropped below 1.07. Expectations of higher interest rates have kept the pound supported, aided by the "cost of carry", however investors remain wary that the UK outlook remains fragile with households and businesses restricted by higher borrowing costs. The chart below shows that GBPUSD has traded within a range between approximately 1.25 and 1.30 for the past few months. Cable did finally manage to breach the key 1.30 level in July following a softer than expected US inflation report which prompted investors to pare back their interest rate expectations for the Fed. However, despite an above consensus UK inflation report suggesting that the BoE would be on course to deliver additional interest rates hikes – GBPUSD failed to rally further, running in to sell orders as investors became increasingly concerned over the impact of 'higher for longer' rates on the UK outlook.

Sterling's appeal was further dampened by recent PMI data which showed that the typically dominant services sector is losing ground as well as the under-pressure manufacturing sector which again is weighing on sentiment. With one or maybe two interest rate increases in the pipeline from the BoE, some would argue that the pound should benefit from the interest rate differential prompting investors to hold GBP and elevate the pair closer to the psychological 1.30 area.

However, recent price action suggests that investors favour a softer pound with falling housing markets, rising unemployment, and declining data surprises trumping potential cost of carry benefits. After failing to significantly hold on to gains above 1.30, GBPUSD needs to breach and hold above the initial resistance at 1.2850 to target a potential move higher. Towards the end of August as the US dollar gained traction, GBP slipped within striking distance of 1.2550, a level which remains key support. A break of this area on the downside opens a potential move to 1.22, a level last reached in March of this year.

Source: Bloomberg

Despite GBPUSD trading within a reasonably narrow range within the past few months, analysts remain divided on the outlook for the pair. UK interest rates remain higher than the US, and it appears more likely that the Fed will start to cut rates some time before the BoE is able to. Concerns over China continue to weigh on risk appetite, further favoring the greenback which traditionally benefits from its safe haven status. This uncertainty can be seen in the latest FX Forecasts published below.

Region G10 | Currency British Pound | As of 09/01/23

GBPUSD			Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Spot	1.27	Median	1.27	1.27	1.28	1.29	1.30	1.32	1.28	1.27
Q2 23	Actual	Mean	1.27	1.27	1.28	1.30	1.31	1.31	1.27	1.27
	1.27	High	1.37	1.40	1.43	1.34	1.43	1.45	1.32	1.34
Q2 23	Forecast	Low	1.13	1.16	1.18	1.26	1.20	1.20	1.20	1.20
	1.24	Forward	1.27	1.27	1.27	1.26	1.26	1.25	1.25	1.24

Source: Bloomberg

With the focus remaining on the outlook for inflation and interest rates, markets will be paying close attention to upcoming economic data for further clues on the path for GBPUSD.

Date	Country	Economic Release
5-Sep-23	UK	Services PMI for Aug
5-Sep-23	UK	Composite PMI for Aug
5-Sep-23	UK	Construction PMI for Aug
12-Sep-23	UK	Employment report for Aug
12-Sep-23	UK	Monthly GDP for Jul
21-Sep-23	UK	Bank of England policy meeting
20-Sep-23	UK	CPI Inflation MoM for Aug
20-Sep-23	UK	CPI Inflation YoY for Aug
22-Sep-23	UK	Retail Sales for Aug
29-Sep-23	UK	GDP for Q2

EUR/USD

After posting gains in July to test 1.12, the single currency has lost ground against the US dollar, registering seven weekly losses. Markets continue to focus on several key factors, all of which are impacting this pair. Rising US treasury yields, and soft Chinese data have boosted the greenback, allowing the currency to gain due to its safe haven status. The euro has suffered further thanks to weak data coming out of the EU, particularly from Germany. The weaker PMI readings have weighed heavily on the outlook for the economy and inflation remains sticky, giving the ECB a difficult dilemma.

Recent ECB commentary has been non-committal about the prospects of a September rate increase, stressing ongoing data dependence. President Christine Lagarde did not focus on the near-term outlook for the bloc in her recent speech at Jackson Hole, however as with her US counterpart, she hinted at the need for a sustained period of higher interest rates. This uncertainty has kept EURUSD capped around 1.0930 in recent weeks, with the pair struggling several times to breach this level. A post August Non-farm Payroll sell-off pushed the pair lower and currently a fresh attack of the 1.0950 area would require hawkish ECB comments and better than expected data coming from Germany. The risk remains to the downside with 1.08 offering some support ahead of the 1.0763 support band which may give bears a fresh attempt at 1.07 or below.

Source: Bloomberg

The outlook for EURUSD remains uncertain but with the ECB likely to announce a final increase rate interest in September, markets will be forced to continue to monitor data and central bank commentary for clues on the direction for the currency. If a hike is not forthcoming on 14 September, markets will likely just push their expectations out to the following meeting. The added complication of the Federal Reserve coming ever closer to their terminal rates increases the uncertainty, however the chances of a move lower currently outweigh the odds of a significant move to test the year high around 1.12.

Region G10 | Currency Euro | As of 09/04/23

EURUSD			Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Spot	1.08	Median	1.10	1.10	1.12	1.13	1.14	1.15	1.16	1.18
Q2 23	Actual	Mean	1.09	1.10	1.11	1.12	1.14	1.16	1.17	1.17
	1.09	High	1.13	1.16	1.20	1.19	1.22	1.23	1.23	1.20
Q2 23	Forecast	Low	1.00	1.03	1.04	1.05	1.05	1.11	1.14	1.14
	1.08	Forward	1.09	1.09	1.10	1.10	1.11	1.12	1.13	1.15

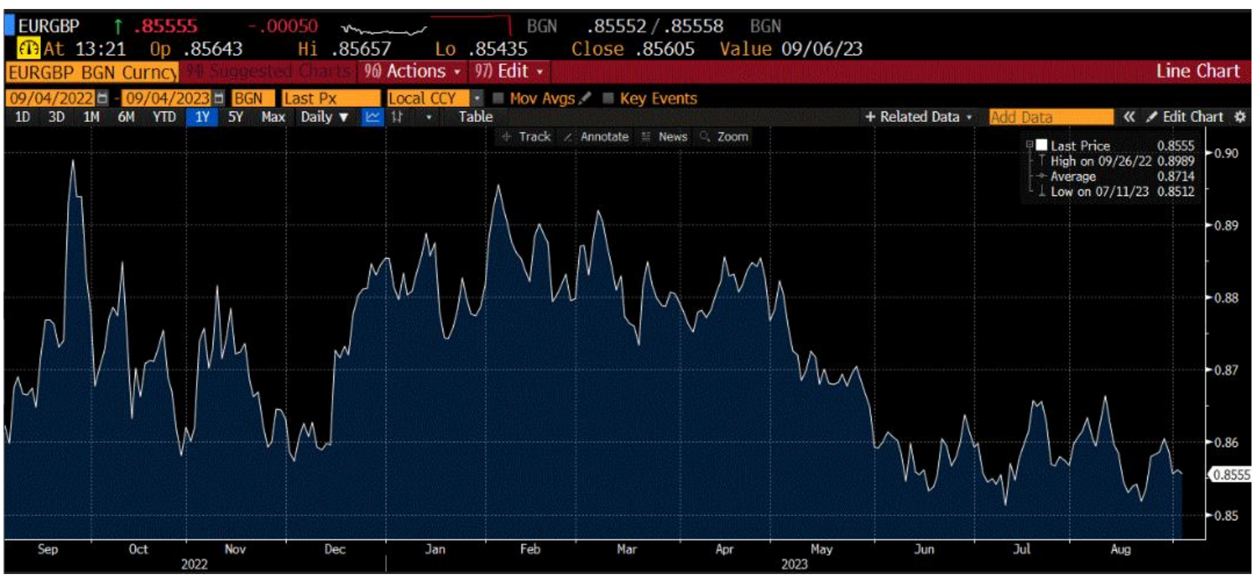
Source: Bloomberg

Date	Country	Economic Release
5-Sep-23	EU Aggregate	PPI MoM for Jul
5-Sep-23	EU Aggregate	PPI YoY for Jul
7-Sep-23	EU Aggregate	GDP for Q2
12-Sep-23	EU Aggregate	ZEW Survey Expectations for Sep
14-Sep-23	EU Aggregate	ECB policy meeting
19-Sep-23	EU Aggregate	CPI MoM for Aug
19-Sep-23	EU Aggregate	CPI YoY for Aug
22-Sep-23	EU Aggregate	Manufacturing PMI for Sep
22-Sep-23	EU Aggregate	Services PMI for Sep
22-Sep-23	EU Aggregate	Composite PMI for Sep

Date	Country	Economic Release
6-Sep-23	US	Services PMI for aug
6-Sep-23	US	Composite PMI for Aug
13-Sep-23	US	CPI MoM for Aug
13-Sep-23	US	CPI YoY for Aug
14-Sep-23	US	PPI MoM for Aug
14-Sep-23	US	PPI YoY for Aug
20-Sep-23	US	FOMC policy decision
28-Sep-23	US	GDP for Q2
29-Sep-23	US	PCE for Aug

EUR/GBP

EURGBP has traded within a 0.85 to 0.87 range for the past few months after falling from 0.88 at the end of April. As with the fall witnessed in EURUSD, weaker European data can be partly attributed to the drop in this pair. The prospect of the ECB reaching the terminal interest rate ahead of the BoE is also keeping the single currency towards the bottom of its recent range. 0.8550 was seen as a pivotal level with the cross facing further selling pressure as investors remain cautious that any additional monetary tightening from the ECB could potentially push the Eurozone's economy into a recession.



Source: Bloomberg

Region G10 Currency Euro / British Pound Cross As of 09/04/23

EURGBP			Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Spot	.86	Median	.87	.87	.88	.85	.87	.89	.90	.92
Q2 23	Actual	Mean	.87	.87	.87	.87	.87	.89	.92	.92
	.86	High	.92	.93	.93	.94	.95	.95	.95	.97
Q2 23	Forecast	Low	.84	.83	.82	.82	.82	.84	.88	.87
	.88	Forward	.86	.87	.87	.88	.88	.90	.91	.93

Source: Bloomberg

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