Sucden Financial

FX Monthly Report

July 2023

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Research Desk
research@sucfin.com

Press Enquiries
press@sucfin.com

Authors:

Daria Efanova
Head of Research

Daniel Henson
Head of FX

Nimit Khamar
FX Desk Broker

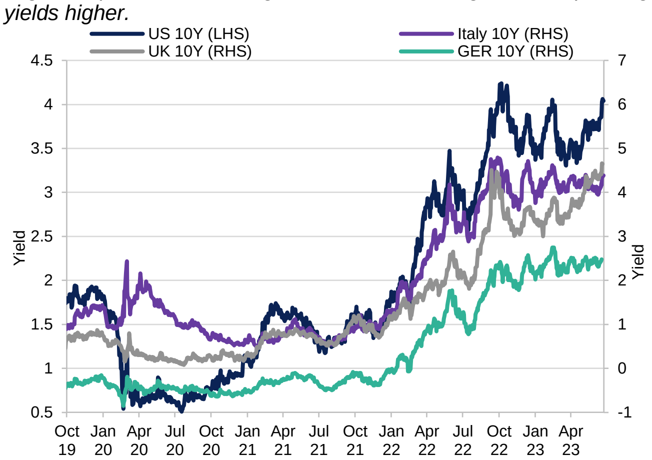
Chris Husillos
FX Desk Broker

UK Focus

Earlier this year, fading pricing pressures offered a brief relief for the UK economy, boosting consumer optimism that the cost of living crisis might be over. However, in Q2, risks started to mount as the economic and political environment began to sour once more. Sticky inflation is continuing to eat away at household incomes, which were slowly recovering from the impacts of the pandemic, growing from a low base. In Q1 2023, household savings represented 8.7% of total disposable income, vs 20.1% same time two years ago due to rising costs. Changes in consumer behaviour are taking away money that could have been spent in stores and the service sector, creating a drag on the economy that is forecast to contract by 0.3% in 2023, the lowest level of growth amongst advanced economies, according to the IMF. Labour strikes nationwide are also likely to weigh on performance, which slowed to 0.1% q/q in Q1 2023.

Developed Economies' 10yr Yields

After expectation of monetary policy pausing subsided, markets began to price in further tightness in the coming months, pushing yields higher.

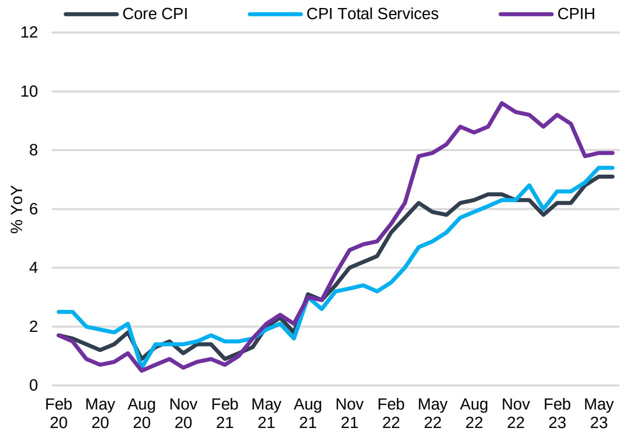


Source: Bloomberg

This, coupled with sticky inflation, is adding to stagflationary risks in the economy. After months of solid price decline driven by energy cost softness, UK CPI stalled in May, at 8.7% y/y, while core continued to advance to 7.1% y/y - the highest level in under three decades. The food and non-alcoholic beverages inflation was 18.4% y/y in May, while down slightly from 19.1% in April, still highlighting the squeeze of surging prices on households. Moreover, data continues to exceed expectations, bolstering the case for more aggressive action from the Bank of England (BOE). Production costs for food and drink manufacturers showed some signs of easing, falling for the first time since 2016. While this might provide some relief for households, it would take time for manufacturers to pass these changes down to consumers, and given the sharp price increases of last year, the easing in costs is more likely to be translated into margin recovery for manufacturers.

UK CPI vs Core vs Total Services

Consumer prices inflation remains sticky in the face of high interest rates, suggesting that the BOE has further room to tighten.

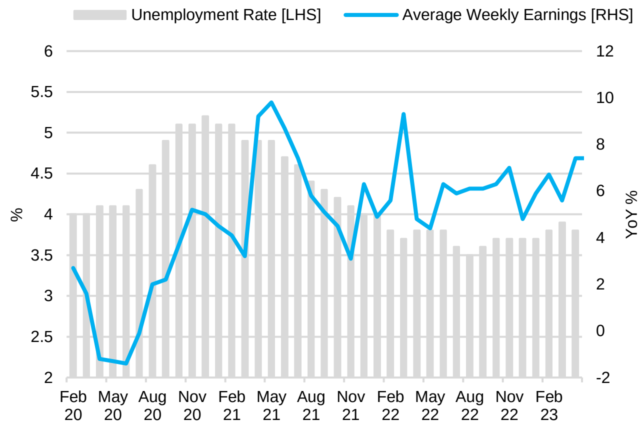


Source: UK Office for National Statistics

The UK economy is traditionally more sensitive to interest rate hikes, given the presence of the construction sector, meaning that rising house prices have been a driver of economic growth since the 2008 financial crisis. As of 2023, the rapid increases in interest rates and subsequent decline in housing prices have prompted worries among borrowers. Most UK mortgage holders have interest rates fixed for two to five years, rather than 10 to 30 years seen in other nations. About 2.4m homeowners are due to refinance by the end of next year, of which 800,000 will do so in the next six months, squeezing the finances of many borrowers and threatening to weigh on household spending and the broader economy. While current rates are lower than they were in the late 1980s, households now have much larger loans and bigger relative to their income. With national elections approaching in 2024, the mortgage crisis would represent another liability for a governing party. Still, the broader economic impact may be limited, given that many households remain on fixed deals that roll off slowly over time.

UK Unemployment Rate vs Average Weekly Earnings

Both the unemployment rate and employee wages point to a resilient labour market in the UK.

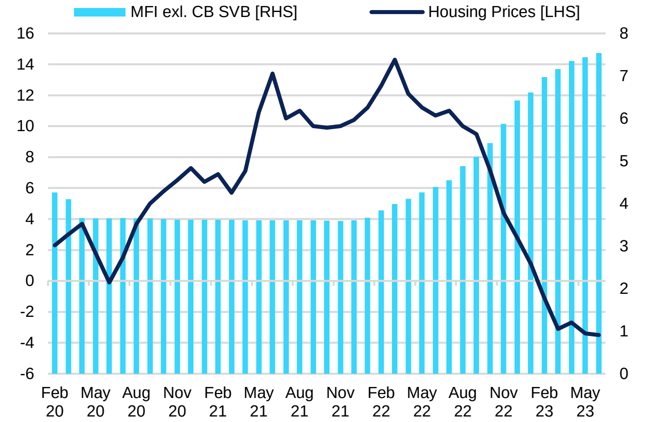


Source: UK Office for National Statistics

One silver lining for economic performance is the resilient labour market, which continued to show signs of improvement despite waning economic confidence. In April, the unemployment rate fell to 3.8%, while jobless claims fell by 13.6k in May. While this should prove as a tailwind to economic performance, we saw renewed pessimism trickle through as markets assessed the impacts of higher-for-longer rates on growth. Retention issues rose to a record high in May, indicating prevailing competition for staff and that overall wage pressures may remain elevated. The tightening of the wage-price spiral should force the BOE to stick to its aggressive tightening path for longer. While the officials have stated their intention to avoid the recession, the main goal of bringing inflation down to the target level remains intact. We believe that the UK is more likely than other major economies to dip into recession to ensure inflation returns to comfortable levels.

UK Housing Prices vs Mortgage Rates

Rising mortgage rates have deterred consumer buying of houses, leading to a subsequent decline in prices across the nation.

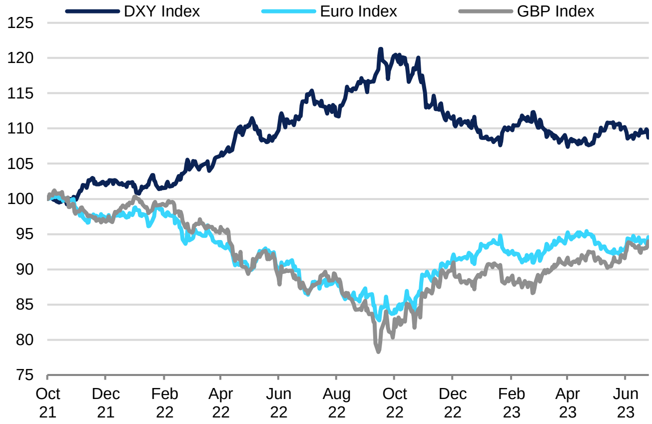


Source: Nationwide Building Society

Stickier inflationary pressures compared to other economies are pushing the BOE to continue its tightening cycle. The markets are pricing in 138bps until the end of the year, vs 29bps and 51bps from the Fed and the ECB, respectively. Investors are betting that policymakers will raise interest rates to 6.25% in December, the highest level in more than two decades. This is up from the expected peak of 5.0% a month ago. Faster-than-expected inflation alongside a path of further tightening seen from other central banks has led to a continued repricing of hike bets. Further increases are likely to inflict further damage on the UK housing market, squeezing consumers and borrowers. And while tighter monetary policy has traditionally supported the pound's performance, the recent increases in expectations have weighed on currency performance during the day, suggesting investors are beginning to assess the impact of higher-for-longer rates on the overall economic outlook.

Major Economies' Currency Performance

Relative to October 2021, the euro and the sterling continue to underperform in comparison to the dollar.



Source: Bloomberg

The UK bond market has been one of the worst-performing across major nations this year, despite a protracted increase in interest rates since late 2021. The picture is muddied because the government is flooding the market with gilts to fund its budget. Under its QT program, the BOE is unwinding its balance sheet of bonds built up since the financial crisis. We do not expect demand for bonds to return until investors are confident that inflation is on a sufficiently downward trajectory and policymakers are close to a peak rate. The visibility of the end of this tightening cycle remains low, and we expect the BOE to be one of the last major central banks to pause the tightening cycle.

In the meantime, the pound is likely to remain relatively elevated to the dollar, given greater expectations of further tightening than seen from the Fed. While this might act as a tailwind to the local currency for now, we expect that, as we enter the second half of the year, markets will start to pay more attention to the impact of higher interest rates on economic growth and, in turn, consumer performance, dampening the currencies' performance that benefitted from higher interest rate environment. The UK market remains tricky given the fast-changing environment and its impacts on economic performance. While we do not anticipate a housing market collapse, the economy remains more volatile relative to other developed economies. Given the amoebic outlook for the UK economy for 2023, we expect current strength to reverse in the latter half of the year.

Desk Comments

GBP

The UK continues to fight stubbornly high inflation. The UK growth outlook continues to lag behind other G7 nations. The economy is expected to contract by 0.3% this year and is yet to fully recover since the pandemic. The change in GDP is recorded at -0.5 since 2019 whereby comparison, the US is 5.4%. The BOE as recently as March, were looking to pause on the rate hike cycle but have now shifted towards a more aggressive stance, pricing a further 6 hikes by Q1 next year. Bringing the implied rate to 6.34. This is up from 4.5 priced in mid-May. Despite the higher rates, we are starting to see weakness in the GBP as fears of a recession and slower growth outweigh the benefits of the carry.

Wage growth and consumer prices will be watched closely this month with another overshoot may lead to BOE tightening even further and cause a recession. Household income is set to fall as the rates begin to effect homeowners. 2.4m are due to refinance by the end of next year.

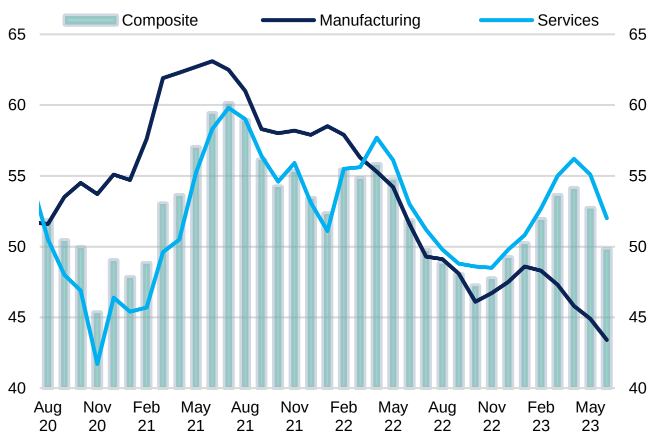
That being said, GBP remains steady at 1.2800 and GBPEUR has formed a double top at 1.1735 opening up a downside correction towards 1.1500. However, with vol levels at yearly lows 7.75%, we expect a steady weakness in GBP.

EUR

The growth in the eurozone continues to lose steam. GDP for Q1 was -0.1. Moreover, there has been a sharp drop in PMI's and economists have downgraded future growth forecasts. Despite the deteriorating conditions, the EUR has been resilient. Currently trading near the EURUSD highs from April. It is 2% higher on the month against the USD and performing better than any G10 nation outside of mainland Europe.

Eurozone PMIs Performance

Service performance is seen softening in recent month, catching up with the manufacturing.



Source: Markit

The ECB has been surprisingly hawkish at the recent Sintra meeting stating it Is unlikely for peak rates to be reached soon. As a result, forecasts are still pricing a further 2 hikes this year. In addition, inflation is starting to slow mainly driven by lower energy prices.

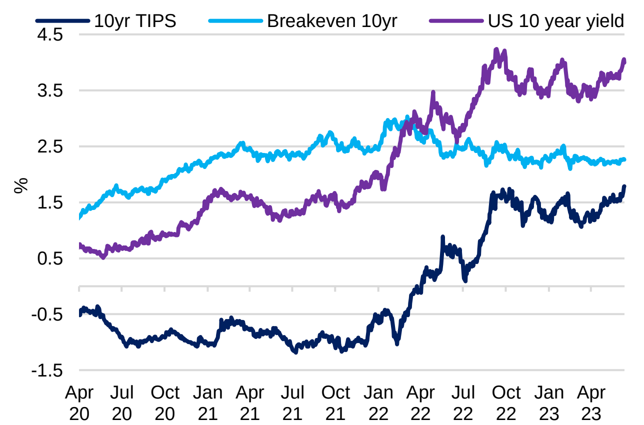
However, the road to recovery is long. It's very hard to gauge the impact of tightening among a range of nations and the real fall from double digit inflation is due to a fall in energy prices. There are a number of support programs needed to be withdrawn like the French energy tariff shield that may lead to a stickier print in the near term.

USD

USD index spent the first half of this year consolidating and we expect to see something similar during the second half 2023, with a slight upside bias. Data in the US has started showing US economy cooling, but these sporadic numbers are not significant enough for the FED to take foot of the gas and start cutting rates. Last week US Employment data showed similar narrative with Non farms missing consensus for the first time in 15 months, but disguised in the numbers was average earnings which rose more than expected demonstrating inflation is far from abating quickly, leaving OIS markets little changed.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Breakeven yield continues to drift lower as US real yield pushes higher.



Source: Federal Reserve

Over the last quarter expectations for terminal rates have increased from 4.95 to 5.4%, with remaining hike expected later this month. The other significant change is markets are expecting rates to remain higher for longer with first cut not expected to come until March/May 2024 in contrast to expectation end of Q1 where this was expected to happen in Sep 23. Our view on rates is very much in line with current market expectations.

Therefore, we expect movements in USD are likely to be heavily influenced by external factors rather than domestic developments. In the US where terminal rates seem to be on the horizon, same cannot be said with the European region where there is greater uncertainty amid sticker inflation increasing the chance of stagflation and a hard recession. Even as we move into the quieter trading periods of the summer season, expect these external dynamics to play significant role in determining the USD's trajectory over the next three months.

View - USD index Rangebound with slight upside biases/ USD Bullish vs European currencies / USD bearish vs LATAM and CAD.

Technical Analysis

GBPUSD

GBPUSD held the red uptrend and has now broken above the white trendline. A close now above the 200day MA should pave the way to gains up to 1.3163 and then 1.3328 (76.4% fib). On the Downside, a break below red trendline and 1.2686 could indicate a deeper pull back to the 1.23 and then psychological 1.20 area.

EURUSD

EURUSD after breaking uptrend in May, has been consolidating between the yellow channel lines. We expect EURUSD to continue trading in this range for the next few months between 1.05 – 1.12. On the downside, a break below bottom channel line will lead a deeper correction down to 1.05. A close below 1.05 would pave the way for further move lower down to 1.0316 (50% fib) and then parity level.

On the upside,200-week MA and upper channel line will need to be broken to indicate end of the consolidation phase. A close above 200 week MA / 1.1272 (61.8% fib) would indicate next leg higher to 1.15 and then 1.1682.

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United Kingdom
Sucden Financial Limited
Plantation Place South
60 Great Tower Street
London
EC3R 5AZ

Tel: +44 (0)20 3207 5000
Email: info@sucfin.com

USA
Sucden Futures Inc.
156 West 56th Street
12th Floor
New York, NY 10019
United States

Tel: +1 212 859 0296
Email: ny@sucfin.com

Hong Kong
Sucden Financial (HK) Limited
Unit 1001, 10/F
Li Po Chun Chambers
189 Des Voeux Road Central
Hong Kong

Tel: +852 3665 6000
Email: hk@sucfin.com

sucdenfinancial.com