FX Monthly Report

March 2023

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Published by:
Sucden Financial Limited
March 2023

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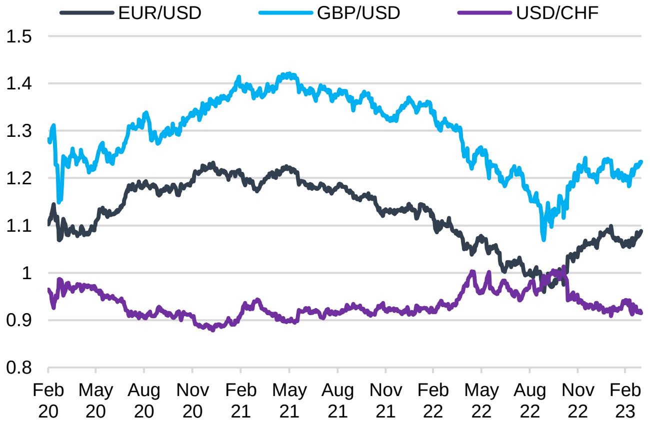
Key Currency Pair Focus

In March, the global banking sector was hit sharply by growing concerns over the impact of aggressive monetary policy tightening. Even with company-related news now subsiding, volatility has not diminished completely, and many central banks have now seen their tightening moves completely priced out for the year. Still, most banks across developed nations are better hedged to take the hit, and we do not expect the risk of a contagion exacerbating in the near term. European regional banks are better regulated, and we expect bank credit spreads to tighten in the near term as risks normalise. In the longer term, confidence in the banking sector is not expected to completely recover, especially given central banks' latest rounds of increasing interest rates on companies' portfolio valuations. The risk is that lending conditions will tighten even further as small regional banks see their deposits shrink, and regulators will use other means of propping up the banking sector, such as liquidity buffers.

Key Currency Pair Performances

Both EUR and GBP have held up better against the dollar given the pickup of confidence in the regions.

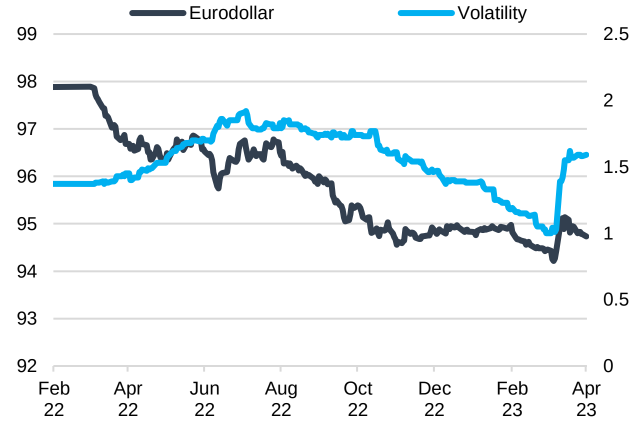


Source: Bloomberg

Sentiment has improved in recent months, with some economists claiming that US and EU might be able to avoid contraction this year, given the robust consumer indicators. Still, we believe markets are calling victory on a recession too early. The real impacts of previous hikes are still to filter through to the real economy. For the monetary policy's pivot to materialise, more weakness from the consumer and labour market sectors is necessary for the near term.

Eurodollar Prices vs Volatility

Both price and volatility move indicate a sharp correction in recent weeks following the banking sector risks.



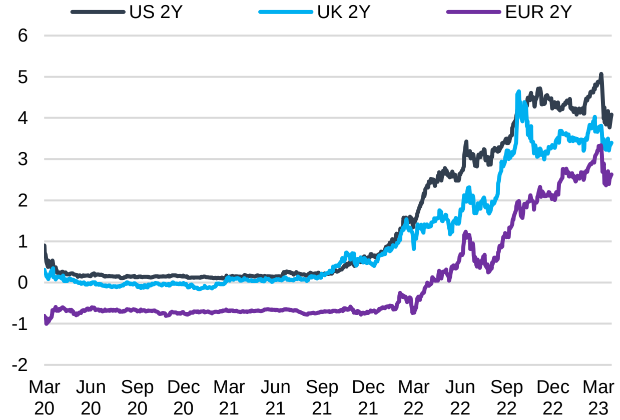
Source: Bloomberg

USD

The dollar has been subject to downward pressures since the end of last year, urging the index to test the lows of 100.82 before gaining traction again as recession fears subsided, and markets saw inflation figures proved upwardly sticky. The bets of interest rate hikes built back up in February, and forward swaps priced in a March Fed move as high as 42bps. A key sign of market strength came from the CPI, which continued to ease to 6.4% y/y in January, but the decline has been marginal, highlighting the upward price stickiness. While sectors such as energy, commodities, and food are now softening, core indicators, such as shelter costs, provide solid support for prices. We do not foresee inflation reading dropping below 5.0% in the coming months, and with that in mind, wages should continue to grow year-on-year. The wage growth that we have seen in the US has been relatively muted compared to inflation, at 4.6% in February, but there is little data to suggest that this growth will subside any time soon. The labour market remains tight, with the unemployment rate and initial jobless claims at 3.60% and 198,000, respectively, both at multi-year lows. The labour market supply and demand balance highlight the call for pay increases to incentivise employment at current levels. While unemployment is likely to increase in the coming quarters, easing in the labour market would be modest. Labour market tightness is poised to moderate over the coming quarters but remains strong relative to previous economic downturns.

2yr Yields for Developed Nations

Short-term yields corrected on the downside in recent weeks, but remain historically elevated

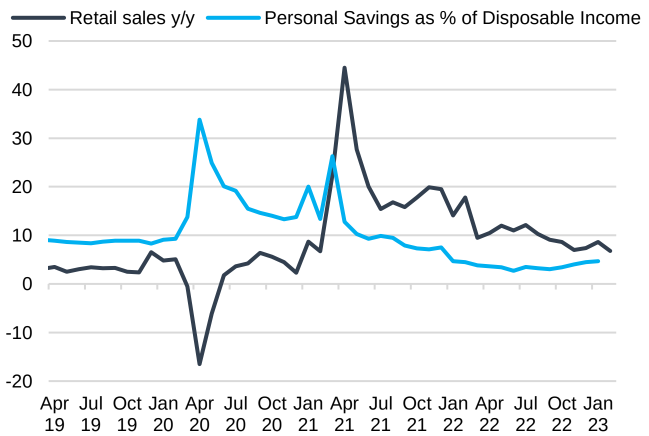


Source: Bloomberg

More recently, banking sector woes have rippled through major economic segments, with bonds taking the biggest hit. Small banks are now putting significant pressure on the economy, as they account for 43% of all commercial banking lending, and their pullback would create gaps that large banks could not fill. Despite the Fed hiking by 25bps in late March, the market response to the move has been similar to that if the interest rates were cut. We have seen a continued gain in traditional safe havens such as gold, and US stocks strengthened on the open. While this is partly driven by market confidence that the banking sector risks are not broad enough to cause a shift in monetary policy, we believe investors are also cautious about the upcoming outlook for the Fed and whether we might see a pause in interest rates take place. Forward swaps are pricing in a 12bps hike in May and the case for a pivot building in the latter part of the year. We expect financial conditions to tighten following the SVB and other banking sector risks; markets are to remain anxious, testing other banks weaknesses. With that in mind, it is still too early to price in the Fed meeting moves in May, given the bulk of data releases ahead of the meeting. At the same time, we expect policymakers to reassure markets of financial stability, helping to raise confidence. Resilient inflation and labour market readings would help reaffirm this outlook.

US Retail Sales and Personal Savings

We have noticed a trend of savings ratio picking up slightly as retail sales soften.



Source: US Census Bureau, Bureau of Economic Analysis

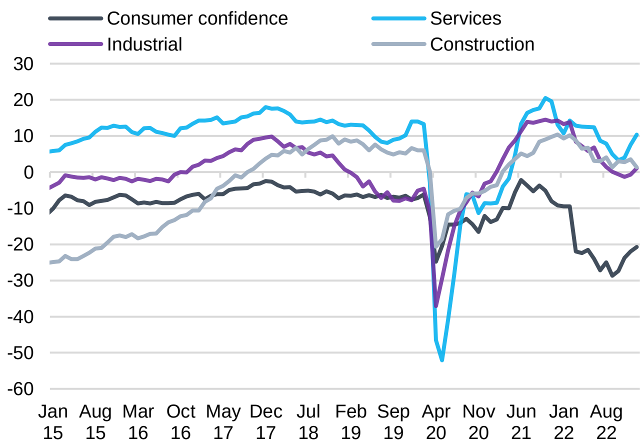
US consumers remain resilient to the market shocks, with personal spending robust at 1.8% m/m in January. Retail sales, albeit softening, remained strong at 5.4% y/y in February, and inflation pointed to elevated demand for services, more so than goods. This is seen more clearly in the non-discretionary spending, which saw declines in prices of used vehicles, at -13.6% y/y, as well as appliances, such as TVs and smartphones. With wages not keeping up with inflation, savings as a percentage of total disposable income remain low and now stand at 4.7% in January. We do not expect this to translate into a sharp correction in retail sales just yet; credit card use has expanded in recent months, and as of 2022, the credit card debt has nearly reached $1tr, the largest annual growth on record. Once consumers realise that inflation is here to stay, the impact on retail sales will become more widespread. By then, consumers would have already spent much of their savings. With the Fed's tightening underway and prospects of economic slowdown, the impact on the real economy will become more prevalent in the latter part of the year.

EUR

European economy started the year on the front foot, with energy prices and, in turn, recessionary fears abating, lifting the end-of-year GDP forecasts. Indeed, the European Commission raised its growth forecast to 0.8%, stating that the bloc might be able to avoid a recession after all. We are cautious of calling victory on recession too early and believe that the downside momentum is set to grow in the coming months. Still, with exceptionally mild winter and warmer months now on the horizon, Europe is likely to leave behind the fears of an energy-driven crisis. Natural gas prices are now back at EUR42/MWh, almost five times lower than last August's record-setting peak. Confidence levels continue to increase, reaching the highest since February 2022, driven by energy price development. In Germany, the most prominent leading indicator, the Ifo index, increased for the sixth month straight, falling to 93.3, given lower wholesale gas prices and the reopening of the Chinese economy boosting confidence. Still, the eurozone economic prospects remain bleak for 2023 as governments gradually withdraw fiscal support and ECB continues its most aggressive tightening campaign in history.

Eurozone Confidence Indicators

Confidence in the area improved, leading to better local currency performance.

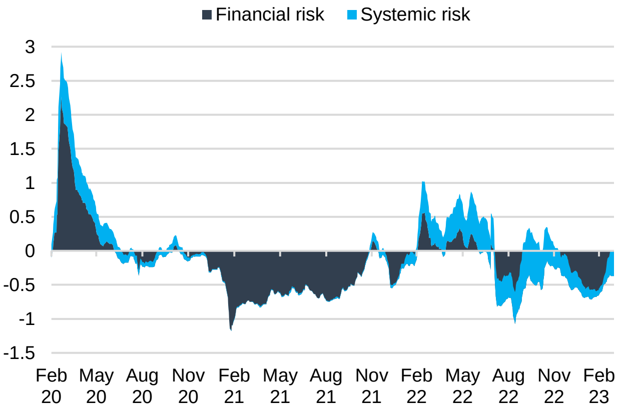


Source: European Commission

As of now, the indicators point to some resilience in the consumer sector. The PMIs pointed to a further divergence between the service and manufacturing sectors. The service PMI continued to rebound, growing to 55.6 in March, while manufacturing remained contractionary at 47.1. Still, the recovery is not uniform across the bloc, and countries such as Germany and Spain dipped into negative GDP growth in Q4'22, creating risks for a technical recession. We expect this divergence to intensify in the coming months, creating pockets of pessimism for those that have not yet priced in a recession. In line with the US, European inflation remains upwardly sticky, at 6.9% in March, but core inflation increased to 7.5% y/y, calling for a more aggressive tightening path from the ECB. The labour market remains robust, with a very low unemployment rate of 6.7% in January, which was hardly changed by the end of 2022. As a result of such tight labour markets and inflation compensation effects, wages are expected to grow at rates well above historical averages, hampering ECB's efforts to get inflation back to its 2% target.

Financial stress risk index in Europe vs ECB systemic stress risk

Whilst financial risk in Europe remains subdued, recent banking turmoil led to a growing systemic risk for the ECB.

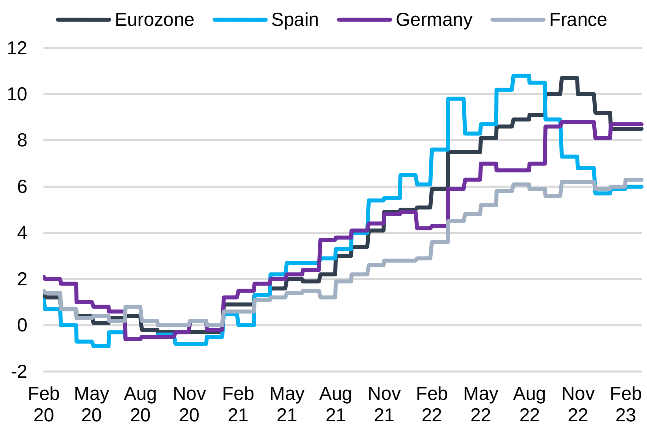


Source: European Central Bank, Westpac

Given the ECB's commitment to a 50bps hike amid the growing banking crisis, the central bank is still behind the curve and is set in stone to tackle the inflationary pressures and tighten monetary policy ahead of the potential slowdown. Since the financial crisis in Europe, regional banks have been subject to much stricter regulation than before, providing support for current system with strong capital and liquidity buffers. Moreover, European banks raised a record amount of debt across covered bonds, making them better positioned to endure the closure of primary markets. According to the ECB President, the European banks are much more resilient than in 2008, with no risk of contagion spreading from the Credit Suisse collapse. The forward swaps are pricing in a terminal rate peak at 3.25% before subsequent cuts into the year-end. With this in mind, we expect the euro to benefit over the next couple of months, especially against the dollar.

CPI All Items YoY Europe

We see a divergence in pricing pressures between the bloc's economies, given the reliance on energy imports.



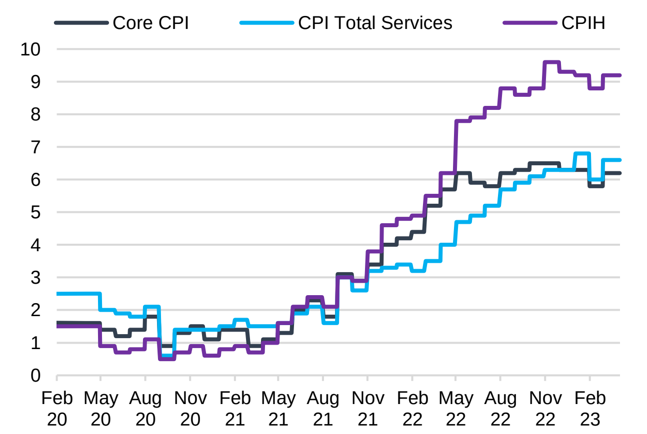
Source: Eurostat. INSEE, German Federal Statistical Office, INE

GBP

The UK economy faces similar challenges to the rest of Europe; however, when coupled with past events of political instability, the economy remains vulnerable to external shocks. UK economy managed to avoid a technical recession in Q4'22, and January performance surprised on the upside, growing by 0.3%. The economic outlook improved slightly in recent weeks on the back of recent reductions in mortgage rates, improving consumer confidence, and continuing resilience in the labour market. Still, IMF predicts that the UK will go into recession in 2023, while every other major economy will avoid that, given the country's high exposure to natural gas and higher prices being passed down to consumers. We expect the underlying activity to continue a general downward trend throughout the year, driven by deteriorating consumer demand in the face of elevated inflation.

UK Core vs Services vs Inflation

Breakeven yields continue to edge lower given the easing inflationary pressures.



Source: Office for National Statistics

Despite banking woes weighing on key central banks in recent days, inflation jumped higher in February, growing by 10.4% y/y, up from 10.1%. Core services inflation, a gauge that the BOE pays close attention to, increased to 6.6% after a dip seen at the start of the year. The labour market remains tight, and companies have struggled with recruitment in recent months. The unemployment rate is at 3.7%, a historic low, and this could provide another boost to wage increases as companies try to attract employees. With that in mind, the BOE increased interest rates by 25bps, and the markets expect a 56bps interest rate increase by the end of the year. The key focus has been on the BOE and its divergence from other central banks when it comes to monetary policy outlook. At the same time, interest rate cuts have now been mostly priced out this year, and instead, traders have bolstered their bets for a higher peak at above 4.75% by the end of the year. We anticipate a pause in rates, keeping a higher terminal rate for longer into the year. Lingering political uncertainty is also adding pressure on GBP, and while the new deal with the EU is set to remove some frictions in relation to Northern Ireland, it is unlikely that it will make any material difference to the wider economic outlook. In the longer term, we do not expect the central bank to pivot in H1 2023.

Desk Comments

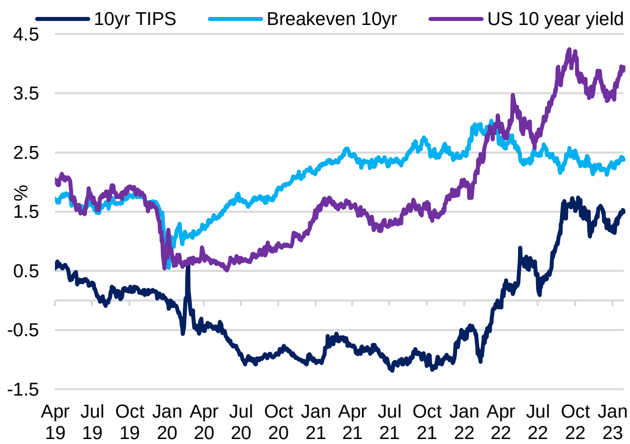
Our base case for the dollar remains that of resilience: the dollar remains the safest currency, and the Fed's higher-for-longer terminal rate outlook and a possibility of further tightening in May should provide support for the index. We expect the support at 100 to remain intact. As central banks face tensions between inflation and financial stability, we have seen the markets downgrade on their monetary policy's tightening expectations sharply. Still, the near-term outlook for key economies will be that of higher terminal rates for longer, and we expect markets to pay attention to signs of a pivot closer to the year-end. In the meantime, the driving force behind EUR and GBP currency pair moves will be primarily driven by the monetary policy outlook from the two nations against the US: with the ECB and BOE expected to raise rates by 21bps and 22bps during the next meeting, respectively, vs 13bps from the Fed. We expect these estimates to remain volatile, given the upcoming macro data driving the sentiment. This should give the GBP and EUR a further boost against the USD in the coming months, keeping the pairs elevated above 1.24 and 1.10, respectively.

USD

The USD remained on the defensive last month. DXY traded from a high of 106 down to 102 mainly on the back of the banking crisis and a risk off environment. Gold traded and tested resistance at 2000 but a close back below and banking sector risks now easing has seen risk resume. Last month started with a strong USD and a hawkish testimony from Powell. Indicating an extremely tight labour market and stating the FED was prepared to speed up rate rises if warranted by data, thus opening the door for a further 100 bp and a terminal rate of 5.75%. What ensued has been extremely volatile. Rate forecasts cut to 3.8% by end of Q2 indicating no hike and a pivot as early as April. EURUSD trading above 1.09 and the forward spreads widening to 2008 levels as uncertainty enveloped the market due to the initial collapse of SVB and the risk of contagion. The rate path has recovered. At time of writing 4.9% terminal rate priced in, which could rise further as we continue to see upbeat US macro data. March PMI pointed towards a pickup in economic growth and headline inflation eased. Last week's NFP will give us a good indication on the labour market.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Yields have further to climb following upwardly sticky inflation.



Source: Federal Reserve

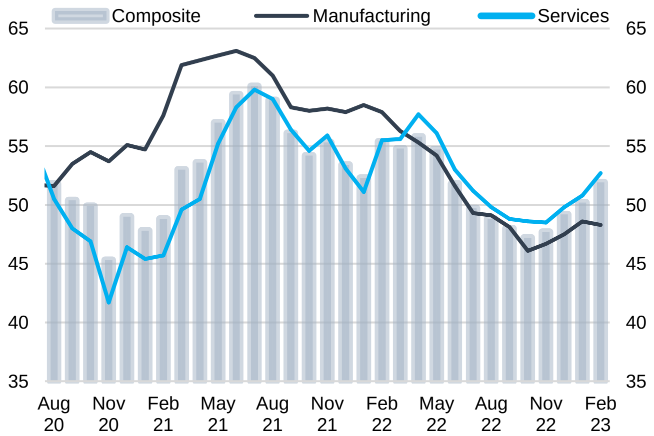
Although, we see positive signs in the US, the divergence in rate paths still exists so we hold on to our view of further weakness in the USD. We see good support in DXY at 102, which if broken will open up the way for GBPUSD to rally through 1.24.

EUR

The risk of recession has subsided in recent months, namely due to the risk of an energy crisis receding. In addition, the European commission raised its growth forecast by 0.8% after further positive contributions to euro area growth. German industrial production expanded by 1.8%. The service PMI continued to strengthen. Growing 55.6 in March. This suggests overall GDP growth in Q1 up from previous forecast of a small contraction.

Eurozone PMIs Performance

Service and manufacturing performance is set to diverge further in the coming months, with the former more resilient.



Source: Markit

The ECB hiked 50 bp last month and a further series of hikes is expected in the near term as they remain behind the curve in tackling inflation pressures. With this in mind, we expect to see further gains in the EUR against the USD. Vol is still at low levels 7.7 % and although there remains a risk of contagion from the collapse of Credit Suisse, these risks are low due to the higher capitalisation and risk controls of European banks since 2008. However, we remain vulnerable to economic shocks and at risk to a big miss in economic data so long vol with a bias to be long EUR vs USD remains our view.

GBP

The BOE remained in tightening mode last month albeit at a slower pace. Members voted 7-2 to hike 25bp, with two members voting for no change. Inflation printed 10.4%, higher than all estimates leading to a further 25bp hike being priced in at the next meet and a likely pause in the cycle thereafter as we process the effects of the tightening cycle.

UK house prices have already fallen at the sharpest pace since 2009 as borrowing costs remain elevated and household income under pressure from high inflation. However, demand will not recover in the near term as the cost-of-living crisis is far from over. The British Retail Consortium said inflation accelerated to 8.9% last month, a fresh peak for the index.

As a result, with more upside potential on rates and the possibility of cuts being priced out completely this year, which is a divergence on the policy in the USD, we see a buy on dips in GBP. The current economic uncertainty and sensitivity to macro data means we also remain long of vol. Implied currently at the lowest we've seen in 6 months. 8.55%. We look for an upside break in GBPUSD.

Technical Analysis

GBPUSD

Continued USD weakness and a break below 102 level on the DXY has seen GBPUSD test 1.2450 resistance. A close above would validate the double bottom. This will open the way to 1.2660 and 1.2990. A failure to hold above 1.2450 will see GBP test the short-term trend line at 1.2335. A larger correction should hold above 1.1875 (38.2 % fibo and double bottom).

EURUSD

The divergence in the rate cycle has seen EUR bounce above 38.2% fibo at 1.0461 and is now testing 50% fibo from 2021 highs to 2022 lows. If broken, we could see a test of 03/02 highs at 1.1030. Longer term target of 1.1500 will then come into play. Any pull back will meet support at 1.0750 and a deeper correction will be supported by 1.0461.

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