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Q3 REVIEW



THE SECRET ECONOMIST

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Q3

REVIEW

If you thought Q2 was an interesting quarter for FX market moves, geopolitical risks, inflation and tightening monetary policy, then Q3 was even more fascinating, if not frightening. Before looking at Q3, let's remind ourselves of some of the key points of Q2.

- **Growth forecasts downgraded sharply by the IMF in their April update, and in the OECD's and World Bank's June forecast revisions.**
- **US dollar index rises more than 5% (rising 9.5% versus Japanese yen, 6% versus the pound and the dollar tested \$1.0350 against the euro).**
- **Inflation rises further above target. UK consumer price inflation hits 9.1%, US inflation rises to 8.6%, and Euro Area inflation rises to 8.1%.**
- **Fed hikes rates to 1.75% with the pace of tightening increasing (75bps hike in June); BoE hike interest rates to 1.25%; whilst ECB lay the foundations for hikes but the refinancing rate remains at 0%.**
- **Equity markets drop sharply (Dow Jones Industrial average down over 9.5%, FTSE 100 down more than 4.5%, and Eurostoxx 50 down almost 11.5)**
- **Commodity prices (CRB index) drops 1.5% over the quarter, but fall more than 11.5% in the final 3 weeks of the quarter from highs of over 329.5 (its highest reading since September 2011).**

So how could one describe what has happened in the third quarter?

"Panic" is one that springs to mind

Concerns over inflation becoming embedded in the general economies of the UK, Euro Area and UK prompted significant additional monetary tightening from central banks, which in turn worsened economic outlooks and prompted a further sharp increase in the value of the US dollar. There was also a sharp additional fall in equity values, rise in credit spreads and fall in commodity prices associated with the worsening global outlook.

The panic in markets reached a crescendo towards the end of the quarter, with the pound plunging beneath \$1.09, the euro dropping below \$0.97, and dollar-yen rising to a high of ¥145.90. Meanwhile, US equities (Dow) dropped more than 13% in less than 6 weeks, the FTSE-100 dropped by more 7% and European equity markets (Eurostoxx 50) down almost 12%.

If the central banks wanted to undermine risk appetite, they did an outstanding job. They also helped to reduce commodity prices by more the 7.5% according to the CRB commodity price index.

Meanwhile, the problems in terms of supply chains from the Far East only alleviated a little, with the Chinese government continuing to pursue a zero-COVID strategy. As for geopolitical risks, there appears no end in sight for the Russia-Ukraine war, which continues to cause issues in terms of gas supply and gas prices, as well as boosting the costs of other energy supplies.

UK- Q3 2022



BANK OF ENGLAND RAISES RATES TO THE HIGHEST LEVEL IN 14 YEARS DESPITE THE UK HEADING INTO RECESSION

Bank of England Monetary Policy Report – August 2022

GDP %y/y based on market interest rate forecasts

	Q3 '22	Q3 '23	Q3 '24	Q3 '25
Mode	2.26	-2.07	-0.04	0.38
Median	2.26	-2.07	-0.04	0.38
Mean	2.26	-2.07	-0.04	0.38

GDP %y/y based on stable, 1.75%, interest rates

	Q3 '22	Q3 '23	Q3 '24	Q3 '25
Mode	2.44	-1.32	0.09	0.27
Median	2.44	-1.32	0.09	0.27
Mean	2.44	-1.32	0.09	0.27

CPI inflation (%y/y) based on market interest rate forecasts

	Q3 '22	Q3 '23	Q3 '24	Q3 '25
Mode	9.93	9.53	2.00	0.76
Median	9.93	10.33	1.93	0.77
Mean	9.93	10.33	1.92	0.77

CPI inflation (%y/y) based on stable, 1.75%, interest rates

	Q3 '22	Q3 '23	Q3 '24	Q3 '25
Mode	9.96	9.92	2.53	1.27
Median	9.96	10.71	2.46	1.28
Mean	9.96	10.92	2.45	1.28

Table 1: BoE GDP & inflation projections

The headlines from Q3 were as follows:

- Bank of England raised interest rates to 2.25%.
- Liz Truss succeeds Boris Johnson as UK Prime Minister.
- New Chancellor, Kwasi Kwarteng, delivers £70bn+ tax cut stimulus to UK economy.
- Consumer price inflation hits 10.1% peak.
- UK GDP contracts in Q2.

Q2 was about inflation and whether it would throw the UK economy into recession. The Bank of England suggested it wouldn't then, but changed its tune in Q3, noting in its August Monetary Policy Report that whether interest rates remained at 1.75% (where they were at the time) or rose in line with market expectations (which were for a peak of around 3.75%), a recession was inevitable. Moreover, inflation would undershoot sharply at the three-year forecast horizon. A summary of the August BoE Report can be found above.



However, the UK government intervened to help with soaring household energy bills, and put together a massive package of additional tax cuts in the hope that it would stimulate growth and reduce headline consumer price inflation rates. It is likely to do the latter in the short term, but as for growth, given what's happened with UK yields over the course of Q3 (2y swap rates surging from under 2.7% to above 5.15% and 5y swaps rising from under 2.5% to over 4.6%) growth might be harder to stimulate. Notably, UK interest rate expectations recorded a peak in official rates of over 5.5%.

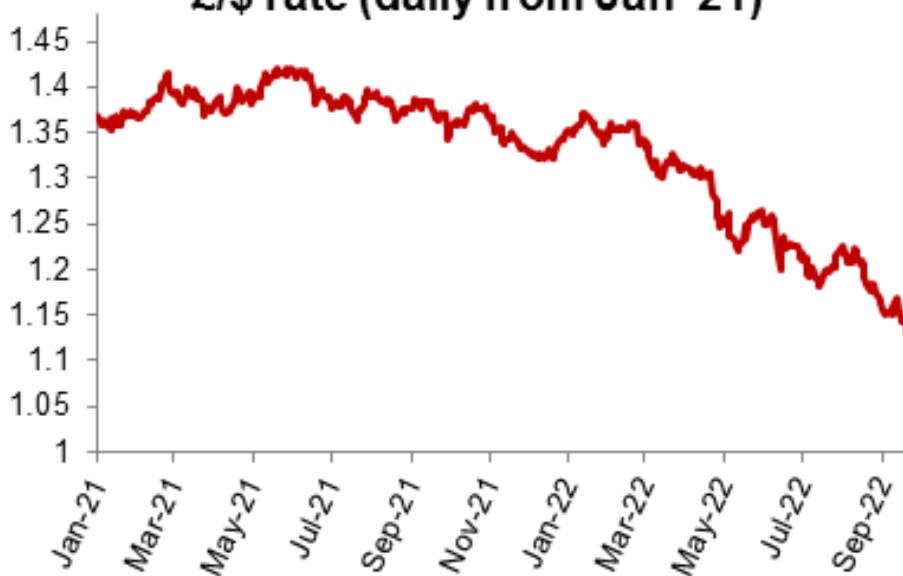
There was also a further fall in consumer confidence readings, with September coming in at a new record low of -49, and that in spite of the much-trailed help for households from the UK government. Moreover, signals from business activity surveys pointed to a stagnation or modest recession already underway for manufacturing and services, whilst construction output was recorded down sharply in June and July outturns.

The pound's performance over Q3 was abysmal. Against the US dollar, it started the quarter at \$1.2178, and as the end of the quarter approached had dropped below \$1.0850. A 6% loss in Q2 was followed with a loss of almost 11%. Against the euro, the losses were less noteworthy, but still significant, dropping from €1.1618 to below €1.12, and even against the yen, the pound fell almost 6%, something that was a surprise given that dollar-yen hit 24-year highs in the quarter.

In short, the pound was the worst performing currency of all G10 currencies in Q3. In Q2 I speculated whether the pound had reached its lows, and suggested probably not. That was emphatically proven in Q3. For the final quarter of the year, we may see some sizeable swings in the pound's valuation, and the lows could be found, but they are probably a lot lower than closing rates for sterling against most, if not all major currencies. With the break to all-time lows in late Q3 reaching \$1.0350, and the test below €1.08, that opens the door to 1985 lows in £/\$ at \$1.0520 and a test of the 2020 lows in £/€ at €1.0525. There is also a risk that £/¥ drops below ¥150 in Q4, given that the Japanese authorities intervened to try and stem the tide of yen losses in September.

The worsening in the UK's economic outlook in Q2, was further highlighted in Q3. Forecasts from the International Monetary Fund suggested that the UK would be the worst performing major economy in 2023, doing worse than Japan and Germany in spite of the problems these economies are currently suffering from.

£/\$ rate (daily from Jan '21)



Source: Bloomberg

The US - Federal Reserve show no signs of stopping

THE US Q3 HEADLINES WERE AS FOLLOWS:

- **US CPI inflation drops from its headline peak of 9.1% y/y in June to 8.3% in August. Core CPI inflation rises to 6.3% from 5.9% over the same period.**
- **US GDP drops again in Q2 figures, plunging US into a technical recession. US leading index records sixth straight drop in August. The last time that happened was during the financial crisis!**
- **US Federal Reserve hikes interest rates a further 1.5 percentage points in Q3 to leave the Fed funds rate at the highest level since December 2007.**
- **Dollar index rallies a further 8% in Q3.**
- **US equities drop sharply in September.**

The Federal Reserve stepped up not only the language regarding its proposed actions, but also the scale of its tightening. Concerned about the inflation outlook with core inflation rates picking up again, the upper bound of the targeted Fed Funds rate rose to 3.25%, its highest level since December 2007. Interest rate hike expectations predict that US interest rates will rise to a peak of 4.7%, in line with the September dot plots released by the Fed post its latest meeting and decision. The Fed continue to suggest they are trying to engineer a soft landing for the US economy, but they appear unconcerned by the drop in risk appetite, a housing market already in recession and signs of a building problem in retail.

Mortgage rates continued to climb, and the savings ratio fell to 5% in June data and remained there in the July reading, an almost 14-year low. Consumer credit also continued to expand rapidly, suggesting that financial conditions in the US economy were worsening in the face of sharp rises in necessity goods prices. Mortgage applications dropped to 20-year lows, and home sales were down across the board in Q3.

The one bright spot remained the US labour markets, which reported ongoing strength in hiring across the overall US economy, and that despite signals from retail and hospitality of more challenging conditions in those sectors. Average earnings growth continues to track around 3 percentage points below consumer price inflation, meaning a big bite will be taken from consumers' disposable incomes unless earnings adjust.

The US dollar remains the strongest performer of the major currencies. Over the course of Q3 it rallied a further 8% on a trade weighted basis, after a 5% gain in Q2. Notably, versus the Chinese renminbi, markets saw dollar-renminbi rise back above 7.1. That was an additional 6%+ gain in dollar-renminbi to add to the 4.5% gain in Q2.

In Q2 I thought that the the US dollar potentially had another 2-3 percentage points of upside possible in Q3, but it has done multiple times that. Q4 provides a number of challenges for the US dollar, including the US mid-term elections for the House of Representatives and Senate, a possible further set of problems including government debt limits and possible government shutdowns. Moreover, there has been intervention against the US dollar in the major currencies (Bank of Japan), for the first time in many years. Further dollar strength will prove harder to maintain given the moves below €0.96, and \$1.04 against the euro and pound, and above ¥145 in \$/¥ respectively.

Dollar index - from Jan '21





EURO AREA

EUROPEAN CENTRAL BANK HIKES AGGRESSIVELY IN Q3 AND SIGNALS FURTHER LARGE STEPS TO COME

The Euro Area Q3 headlines were as follows:

- European Central Bank hikes refinancing rate to 1.25% from 0.00% in Q3.
- Q2 GDP massively outperforms expectations. Euro Area grows 0.8% versus the first quarter, having grown 0.7% then. Signals from surveys suggests consumers and businesses are pessimistic about growth in the future.
- Euro CPI inflation rises to 9.1% in August, core inflation rises to 4.3%.
- Concerns over Russia-Ukraine war increase as Russian President Putin conscripts 300,000 reservists, seeks to formally annex disputed territory and threatens the West with deployment of nuclear weapons
- Euro hits 20-year low versus the US dollar below \$0.96.

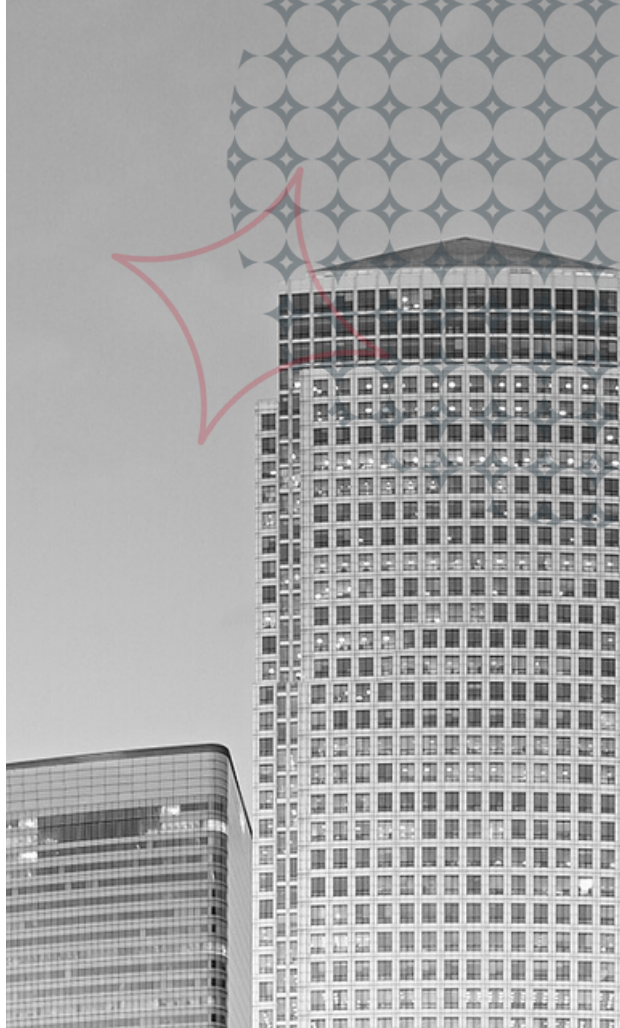
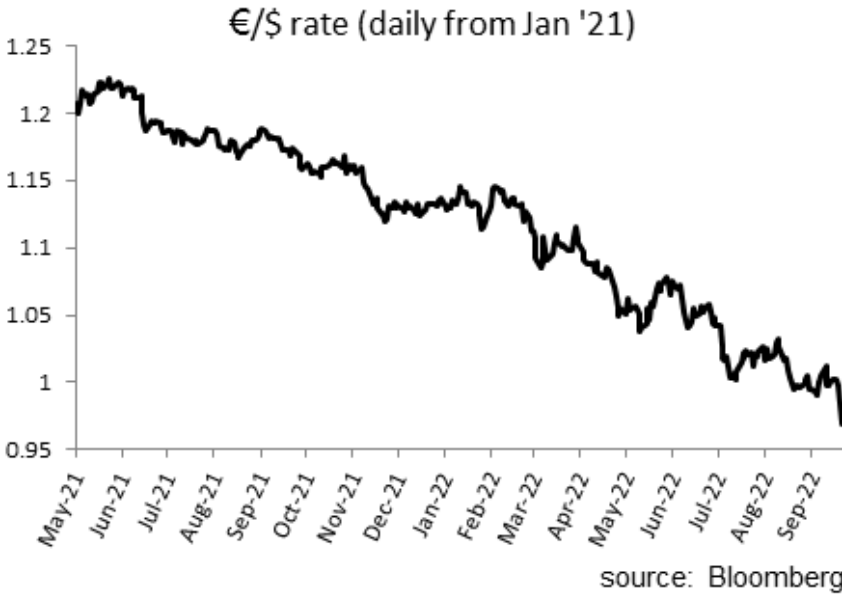
Whilst Q2 was all about the set up, as far as the European Central Bank raising interest rates was concerned, the third quarter was about what the European Central Bank would do with policy rates in the face of surging inflation.

The signs from the economy continued to worsen, with most surveys pointing to a fairly sharp contraction in the second half of 2022. However, the first half of 2022 has been a far better period for growth than the authorities were expecting, with a 0.8% expansion in Q2 following on from a robust 0.7% expansion in Q1.

The ECB hiked interest rates by 0.5% in July and then by 0.75% in September as the rate of inflation climbed to above 9% in the August reading. The European Central Bank have promised that the rate of borrowing will continue to climb as they attempt to get control of inflation. That inflation though is driven by intensifying geopolitical problems and a supply chain that remains disrupted. More hikes from the ECB will only worsen the economic outlook, which by the end of the quarter had deteriorated to the worst picture since the height of the COVID crisis less than 2½ years ago.

The euro's poor performance in Q2 was repeated against the US dollar in Q3. It dropped below the mid-May lows of \$1.0350 to fresh lows below \$0.96 by the end of September. The euro fared better against the pound, rising above £0.92 just before the end of the quarter. As for euro-yen, that rallied a little further in early September, but the market chaos in late September saw it fall below the Q3 open of ¥142.27 to ¥137.4 towards the end of the month, although notably the rate had hit a low of ¥133.4 earlier in the quarter.

As I suspect, the euro fared better against the GBP in Q3, but surprisingly lost ground to the JPY after the Bank of Japan embarked upon direct FX intervention to stem the JPY's losses. During the course of Q4 the challenges from an all-mighty dollar may see new lows tested versus in $\text{€}/\text{\$}$, but I suspect it will hold up well versus the pound. I am less certain about where the currency goes against the yen, because of the Bank of Japan's activism in FX markets in late Q3.

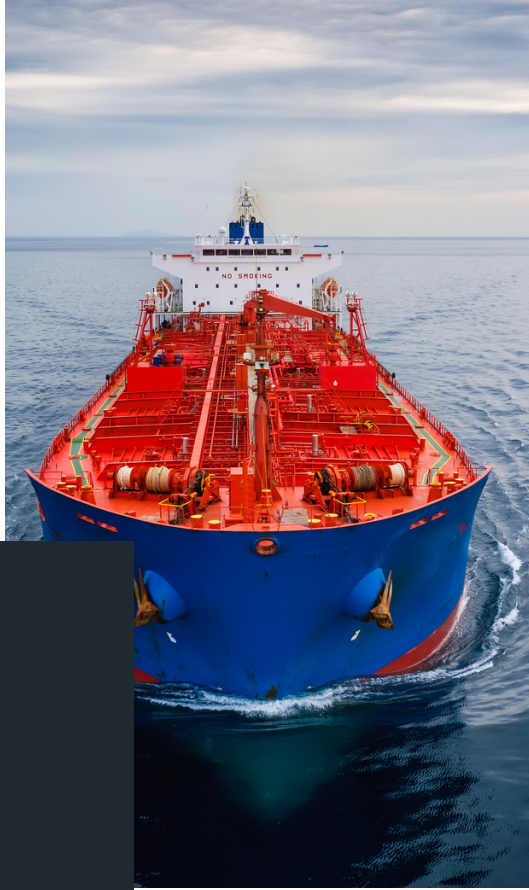


Post the UK's mini-Budget delivered on the 23rd September, the pound slid to record lows against the US dollar, reaching \$1.0350, admittedly during Asian trading hours when volumes and liquidity are traditionally lighter than during European and US sessions.

The pound has recovered some of its losses, but the moves were not confined to just $\text{£}/\text{\$}$, but also the euro, Canadian dollar, Australian dollar, NZ dollar and renminbi also, with the dollar-renminbi rate briefly breaching 7.20.

The final quarter of the year may be even more volatile than I had previously imagined, with risks of parity and below for the pound against the US dollar, and fresh multi-decade lows for the euro versus the dollar, having grown far larger after the events in the run in to the very end of the quarter.





HOW DID I DO?

What I said in Q2 review

“Dollar strength may continue in early Q3, but dominance will wane.” Well the US dollar remains dominant.

“GBP still at risk” – wasn’t that the truth, with the GBP the worst performing major in Q3.

“Safe haven currencies to continue to benefit from output destruction” – US dollar and Swiss Franc have both benefited significantly over Q3.

KEY MESSAGES FOR Q4

GBP downside risks remain with fiscal and monetary authorities at polar opposite ends of the spectrum.

US dollar to stay strong whilst Federal Reserve continues to hike, despite technical recession.

Watch for a slump in commodity prices (irrespective of the next moves from Russia on energy).

Scandies could be in for a rough ride over Q4.

THANK YOU FOR READING!



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