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Q1 REVIEW

THE SECRET ECONOMIST

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Q1 REVIEW

Here are your Q1 headlines

US dollar battled with ongoing losses in Q1 before having a sudden reversal. Here's why.

- Geopolitical risks – The markets remain concerned by Russia's ongoing invasion of Ukraine
- Market risks – The failure of several US banks and one European bank has put renewed pressure on the financial system
- Interest rate peaks/spreads – Interest rate spreads between major economies have narrowed, widened and narrowed again in the latest quarter.
- Big moves in commodities – The CRB index has dropped from 277.75 to 257.78 over the course of this quarter (low of 254.03), driven by a slump in energy prices.
- Shipping costs/inventories – A sharp fall in the cost of moving freight, and an inventory run down has made global trade more challenging, which could be prompting a drop in currency volumes for trade.

Each quarter, the Secret Economist reviews the performance of major economies and explores the factors that have caused significant market moves.

It's been a dramatic few weeks for the US and European banking sector and in this edition, we'll look at the US dollar's rollercoaster Q1 performance, the Eurozone's continued efforts to close the interest rate gap, and how sterling has performed against economic headwinds. What does the outlook for currencies look like for the quarters to come, and how might changes to interest rate expectations influence their performance?

Figures quoted from Bloomberg

The first three months of 2023 have thrown in a few surprises for inflation and growth

Consumer price inflation

In the US, it fell from 6.5% in the December reading, to 6% in the February figures, whilst the core rate dropped far less significantly from 5.7% YoY in December, to 5.5% in February. UK headline and core inflation measures unexpectedly rose in the February readings from the previous month, to 10.4% and 6.2% YoY respectively. But these were still marginally lower than the December readings of 10.5% and 6.3%. In the Euro Area, headline inflation dropped from 9.2% to 8.5%, but core inflation was up from 5.2% to 5.6% between December and February, suggesting there was still some way to go for the ECB to get inflation back to target, if it was ever in its gift to do so.

Here is both the problem and potential solution for central banks. Ultimately this appears still to be a supply side problem, some of which is logistical, some of it is production based and some of it is geopolitical. Two of those three problems appear to be being rectified, but there is still some way to go on geopolitics. Even so, the momentum behind price rises is unlikely to be maintained, and despite central bank fears that inflation hasn't prompted widespread real wage growth, that would cause second round effects. Moreover, we could witness price falls given the ongoing downward momentum in energy and other raw materials.

Growth numbers

In its January World Economic outlook, the IMF revised its growth forecasts in 2023 up for the US and Euro Area, but down for the UK. Growth across the Western world was expected to be anaemic – meaning it's not expected to be strong - but the UK was the only major economy predicted to contract in 2023, by 0.6%.

The labour markets held up better than expected, with US employment figures reporting further strong growth in non-farm payrolls in January and February. Across Europe, unemployment is holding steady. In the UK employment growth posted additional gains, but the details showed a sharp increase in part-time and temporary workers and a reduction in the full-time headcount of around 95,000 in January. Are employers worried about future order books and cutting back on full-time staff, or is this more evidence of workers voluntarily withdrawing from the labour force?

This was all put to one side in March, as concerns over the banking sectors in the United States and Europe were forced back into the spotlight.

Silicon Valley Bank and Signature Bank in the US were placed under the control of regulators after concerns over solvency arose, whilst Credit Suisse was sold to UBS for a fraction of its market value only a few weeks earlier. That prompted significant revisions to interest rate expectations in all major economies just ahead of the final meetings of the first quarter.

Figures quoted from Bloomberg

Equity markets

It was a rollercoaster ride over Q1. The Dow Jones Industrial Average rose to a high of 34,302 in early January, but fell to a low of 31,819 in mid-March, as the markets grew concerned by the troubles in parts of the banking sector. The FTSE-100 had an even more meteoric rise, from a starting level below 7500 to a high of 8047 in mid-February, before falling to a low of 7206 towards the end of March. The Eurostoxx 50 rose from a low of 3802 at the beginning of the quarter to a high of 4324 at the beginning of March, before falling back towards the end of the quarter.

As for commodity prices, there has been progress in terms of bringing those back down, with oil prices dropping more than 10% over the quarter, and European natural gas prices dropping more than 30% thanks to a warmer than expected winter.

Interest rates at the end of Q1

3.5%

ECB (50bps increase)

5%

Federal Reserve (25bps increase)

4.25%

Bank of England (25bps increase)

In the end all the major central banks did what had been expected before the financial market turmoil began, but only because to do otherwise might have signalled to markets that the threat to financial stability was greater than feared.

For the central banks though, the issues around financial stability remain, and we could yet see action from central banks to shore up confidence, including rate reductions over the coming quarters.

THE UK

Bank of England hikes to 4.25%, but that's probably the end of the hiking cycle

Bank of England Monetary Policy Report - February 2023

GDP % YoY based on market interest rate expectations

	Q1 '23	Q1 '24	Q1 '25	Q1 '26
Mode	-0.25	-0.71	0.18	0.91
Median	-0.25	-0.71	0.18	0.91
Mean	-0.25	-0.71	0.18	0.91

GDP % YoY based on stable, 4%, interest rates

	Q1 '23	Q1 '24	Q1 '25	Q1 '26
Mode	-0.30	-0.75	0.00	0.76
Median	-0.30	-0.75	0.00	0.76
Mean	-0.30	-0.75	0.00	0.76

CPI inflation projections based on market interest rate expectations, %YoY

	Q1 '23	Q1 '24	Q1 '25	Q1 '26
Mode	9.73	3.01	0.95	0.37
Median	9.73	3.48	1.59	1.00
Mean	9.73	3.61	1.75	1.17

CPI inflation projections based on stable, 4%, interest rates

	Q1 '23	Q1 '24	Q1 '25	Q1 '26
Mode	9.72	2.91	0.83	0.19
Median	9.72	3.38	1.46	0.82
Mean	9.72	3.51	1.63	0.99

Table 1: BoE GDP & inflation projections

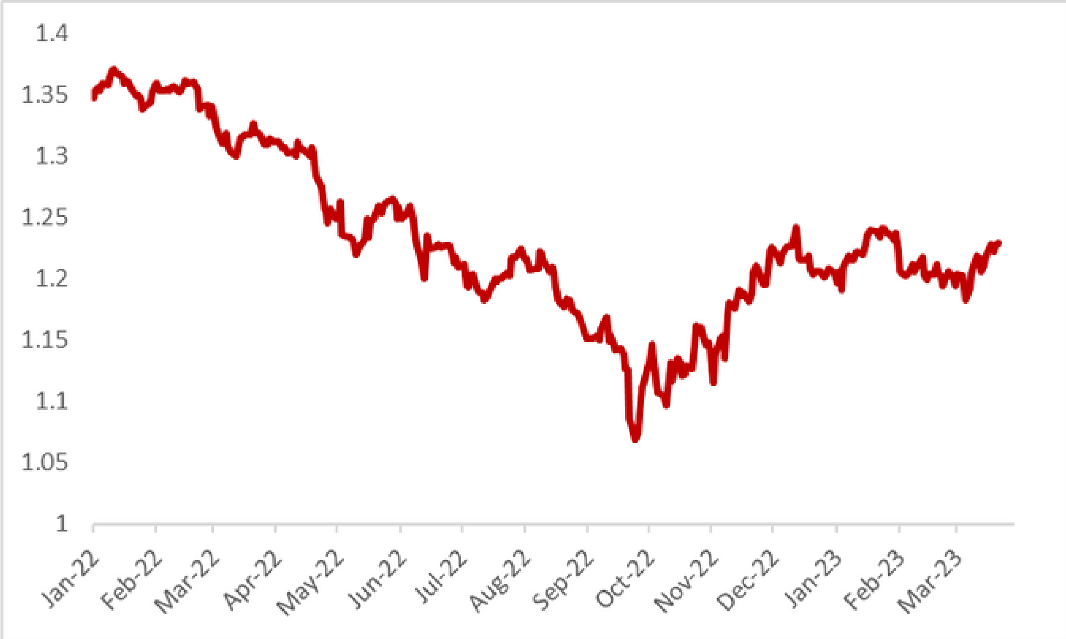
Q1 headlines:

- The Bank of England raised interest rates to 4.25% (from 3.5% at the end of Q4).
- Chancellor Jeremy Hunt introduces additional childcare assistance and abolishes the lifetime allowance for pensions.
- Energy price cap stays at £2,500 until end of June.
- Consumer price inflation rises unexpectedly in February to 10.4% YoY on higher food and services inflation.

Despite financial stability being called into question, the BoE continued to raise interest rates, albeit future rate increases now likely to require a much higher economic threshold before they are sanctioned. In the Q4 review I noted the BoE's forecasts looked increasingly at odds with the actions it was taking. Looking at the latest forecasts, conducted back in February, that is even more troubling now.

Q1 saw UK interest swap rates rising higher, but it was something of a rollercoaster. The 2-year swap rose to a high of 4.67% in early March, but closed the quarter below where it started (4.47%). 5-year rates managed to crawl above where they opened eventually, rising to 4.19% again at the beginning of March, but closing the quarter almost 0.5% below where they opened, and the 10-year swap rate opened at 3.75%, rose to just above 4% and then dropped sharply to close below 3.3%.

Chart 1: £/$ exchange rate (source: Bloomberg)



The pound's performance over in the quarter was unimpressive, but still constructive. On a trade weighted basis, it gained just a shade under 2.5%. Against the US dollar, the bounce in the pound was just 1.2%, whilst against euro it gained less than 0.7%.

The pound's recovery against the other major currencies appeared to be stalling in Q1. The questions on its performance will likely only grow in Q2, with the choices on monetary policy for the BoE expected to increase as well. Each way you look there are sub-optimal outcomes for the UK economy, monetary and fiscal policy, and increased risks to financial stability. These are hardly reasons to buy the pound against any of its rivals.

THE US

Uncertainty trumps data despite ongoing employment strength

Q1 headlines:

- The Federal Reserve raise the Fed Funds rate from 4.25% to 5% (upper bound).
- US CPI headline inflation drops further to 6% YoY in February from 6.5% in December. Core CPI inflation fell to 5.5% YoY, only slightly down from 5.7% in December.
- US GDP increased by 2.7% QoQ annualised in Q4 figures, lifting the economy out of the recession after H1 had recorded a technical recession. The US leading index continues to record drops in its reading, with February seeing the 11th consecutive monthly fall.
- Dollar index is broadly stable as markets consolidate after big swings in the previous two quarters.

The Federal Reserve's game plan to crush inflation anyway it can faced its first significant challenge from the recent bout of financial instability. The cumulative rise in interest rates, from 0.25% to 5% has taken only a year to complete, and in the face of the fastest rise in interest rates seen since the 1980s, the risk was always that something would be broken unintentionally. The Fed's decision making from here on will not only be determined by just macroeconomic data, but also on the risks to financial market stability and global dollar liquidity that any further tightening might incur.

The US dollar's bumpy ride continued in Q1. Versus the Chinese renminbi, the dollar initially fell from 6.92 to a low of 6.69, before rebounding back towards 6.98. In Q4 I said that Q1 could prove tricky for the FX markets to keep selling the dollar and that's how things have played out, with the markets struggling to continue to sell the US dollar on a persistent basis.

Q2 could see some more consolidation initially, but the US dollar looks set for a recovery over the course of the quarter.

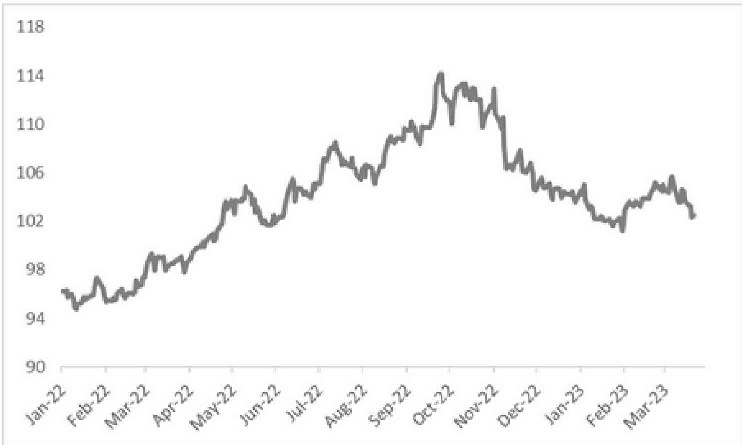


Chart 2: USD index – daily chart (source: Bloomberg)

EURO AREA

The situation is anything but normal but the ECB keeps hiking anyway

The Euro Area Q1 headlines were as follows:

- European Central Bank hikes refinancing rate to 3.50% from 2.50%.
- Q4 GDP flatlines on a quarter-on-quarter basis. This is better than was expected.
- Euro CPI headline inflation falls back to 8.5% YoY in February. Core inflation rises to 5.6% from 5.2% in December.
- Euro recovers against the US dollar to test repeatedly above $1.08 and briefly break through $1.10.

The European Central Bank's mission to bring down inflation is making headway in terms of the headline rates of consumer price inflation, but so far the core inflation rate is unresponsive. However concerns around Europe's banking sector could undermine the ECB's attempts to raise interest rates further.

Despite the ECB taking a more aggressive approach on monetary tightening than most other major central banks, the euro was unable to make consistent gains against the major currencies. It initially rose against the US dollar, but those gains were conceded back in late Q1. Against the pound it made limited gains and it fell against the yen, Canadian dollar, New Zealand dollar, Australian dollar and Norwegian krone.

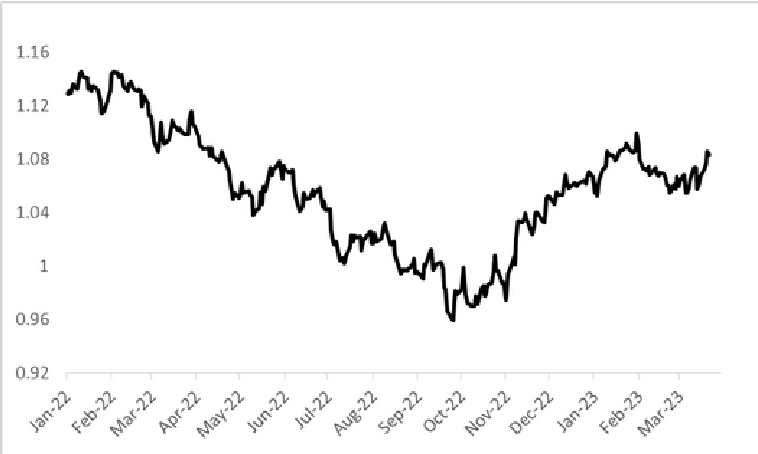


Chart 3: €/$ exchange rate (source: Bloomberg)

Figures quoted from Bloomberg

Q2 KEY TAKEAWAYS

- The UK is viewed as an outlier in terms of economic performance (weaker versus the other major economies). However, currency movements may be governed by financial risks, rather than macroeconomic differences.

- If interest rates start to be reduced by major central banks (Fed, ECB & BOE), the US dollar is likely to benefit.

- Lower energy prices (thanks to increased supply and a warmer winter) could prompt a collapse in inflation in H2, but residual/latent cost price pressures could keep inflation very high in Q2.

- Can the pound and euro continue to rally against the US dollar? Perhaps, but the challenge intensifies in the $1.24 and $1.10 region, whilst trap doors lie in wait beneath $1.18 and $1.05 respectively.

Figures quoted from Bloomberg

Thank you for reading!

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