JANUARY 2023

Q4 REVIEW

THE SECRET ECONOMIST

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TABLE OF CONTENTS

Q4 REVIEW

Q3 finished with the US dollar rocketing to multi-decade highs as the markets took fright from some concerning geopolitical and domestic political issues. What are some of the key events that prompted the big FX market moves in Q3?

- **UK mini-Budget (Truss-Kwarteng) prompts slump in pound and a sharp rise in borrowing costs as markets fear it is destabilising the public finances.**
- **Ukraine counteroffensive sees Russian missile strike near Ukrainian nuclear facilities and a shutdown of gas supplies.**
- **Monetary tightening from major central banks speeds up as inflation overshoot increases.**
- **Equity markets fell in Q3 as risk appetite was negatively affected by a combination of higher supply-side inflation and higher interest rates.**
- **Growth forecasts were revised down again by the International Monetary Fund.**

After the mayhem of Q3, how did Q4 pan out?

The concerns over consumer price inflation intensified in the UK and Euro Area, with the rates hitting peaks of 11.1% and 10.6%, respectively, in October, although both inflation rates dropped back in the November readings and by more than expected. For the US, though, the headline and core CPI inflation rates continued to fall after starting to trend lower towards the end of Q3.

Growth numbers continued to slip, although the Euro Area GDP outturn was more positive than expected at +0.3% quarter on quarter, and the US Q3 GDP outturn reported a significant upturn in the US economy's fortunes, a 2.9% annualised increase led by a marked improvement in net trade. For the UK, the Q3 GDP figures reported a slip in UK output, but this was likely driven by the passing of Queen Elizabeth II and the period of mourning at the end of the quarter.

However, the underperformance of the UK economy versus its counterparts looks like it will be a theme in 2023. In its October World Economic Outlook, the IMF revised down its forecasts for growth in 2023 again. The US was seen as the best performing of the three economies (US, EA & UK), with growth of 1%, while the Euro Area was expected to grow by just 0.5% and the UK by a meagre 0.3%.

Figures quoted from Bloomberg

There was also a further substantial weakening in the US and UK housing markets, with the UK seeing some of the largest persistent price declines since the financial crisis and the US house prices also starting to drop after months of weakening demand.

As far as the equity markets were concerned, the FTSE-100 rallied from just below 6900 to a high of close to 7600 over the fourth quarter. The Dow Jones Industrial Average rallied from under 29,000 to a high of over 34,700. Eurostoxx 50 saw the most impressive rally, rising from just over 3300 to a high of 4035.

The FX markets recovered as the initial panic from the UK political chaos and Russian threats died down. The pound rallied against the US dollar from $1.1173 to a high of $1.2446 in mid-December, and the euro bounced from $0.9803 to a high of $1.0735. Even the Japanese yen caught a break against the dollar, falling from ¥148.71 to a low of ¥133.63 in early December.

Central banks continued to put focus on the inflation fight and raised interest rates aggressively over the fourth quarter. The Federal Reserve lifted its upper bound of the targeted Fed Funds rate to 4.5% from 3.25% in its two meetings, the Bank of England raised the Bank rate to 3.5% from 2.25% as it stepped up the pace of its tightening, and the European Central Bank increased the refinancing rate from 1.25% to 2.5%.

Supply chains remained challenging, with the Chinese government forced into relaxing some COVID restrictions after widespread protests in major cities across China. That, though, may bring about a different problem for China, with lower levels of immunity to COVID possibly prompting healthcare issues in 2023. There also appears to be no end in sight for the Russia-Ukraine war, which continues to cause problems in terms of gas supply and gas prices.

Figures quoted from Bloomberg

UK

BANK OF ENGLAND BECOMES EVER MORE DIVIDED AS THE UK ECONOMY HEADS INTO RECESSION

Bank of England Monetary Policy Report - November 2022

GDP %y/y based on market interest rate expectations

	Q4 '22	Q4 '23	Q4 '24	Q4 '25
Mode	0.17	-1.94	-0.13	0.66
Median	0.17	-1.94	-0.13	0.66
Mean	0.17	-1.94	-0.13	0.66

GDP %y/y based on stable, 3%, interest rates

	Q4 '22	Q4 '23	Q4 '24	Q4 '25
Mode	0.30	-1.07	0.39	0.79
Median	0.30	-1.07	0.39	0.79
Mean	0.30	-1.07	0.39	0.79

CPI inflation projections based on market interest rate expectations, %y/y

	Q4 '22	Q4 '23	Q4 '24	Q4 '25
Mode	10.86	5.20	1.43	0.02
Median	10.86	5.50	1.82	0.41
Mean	10.86	5.58	1.93	0.52

CPI inflation projections based on stable, 3%, interest rates

	Q4 '22	Q4 '23	Q4 '24	Q4 '25
Mode	10.89	5.61	2.16	0.84
Median	10.89	5.91	2.56	1.24
Mean	10.89	5.99	2.66	1.34

Table 1: BoE GDP & inflation projections

The headlines from Q3 were as follows:

- Bank of England raised interest rates to 3.5%.
- Liz Truss resigns as PM, and Rishi Sunak takes her place. Jeremy Hunt succeeds Kwasi Kwarteng as Chancellor.
- Mini-Budget reversed; energy price support scheme far less generous.
- Consumer price inflation hits an 11.1% peak.
- UK GDP contracts in Q3 after Queen's death.

Q3 saw the Bank of England abandon any attempt to balance growth objectives with the overshoot of inflation, and Q4 then turned into an exercise to try and increase interest rates as quickly as possible to limit the overall peak. With inflation overshooting by more than expected and the hokey-cokey from the UK fiscal authorities between stimulus and deterrent, the Bank of England saw few good choices available to it, and the Committee became more split.

By the end of the year, the Bank of England had dissenting voices on either side of the debate, and a set of forecasts that looked increasing at odds with the actions it was taking.

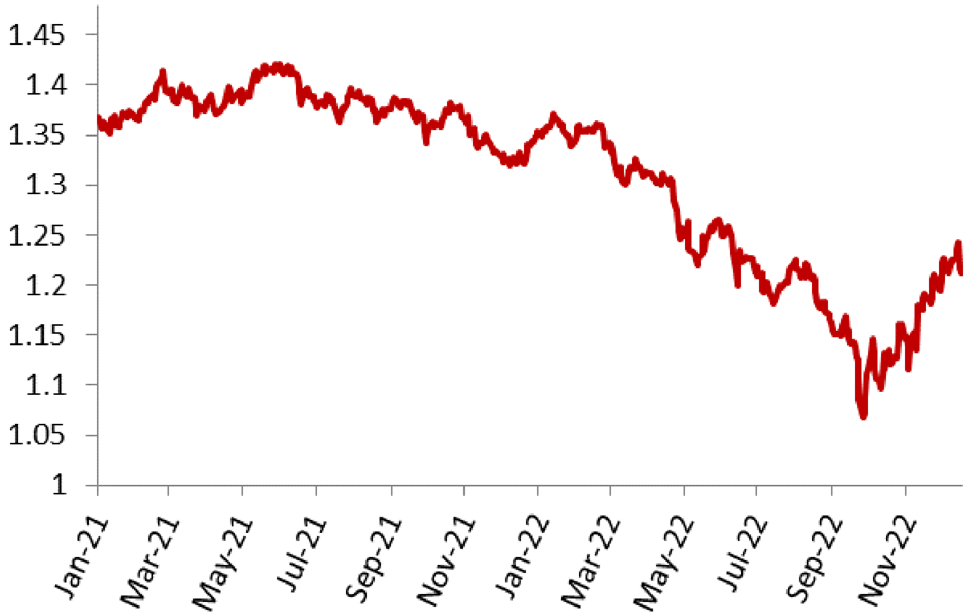
Q4 also began with UK interest rate swaps seeing yields dropping back after surging in late Q3. The 2-year swap started the quarter at just over 5.42% and dropped below 4.2% in mid-December. 5-year rates dropped from 5.05% to below 3.7% in mid-December, and 10-year swap rates dropped from 4.44% to a low of 3.14% in mid-November, before rallying into the end of the year. The key driver behind this was the Truss-Kwarteng un-costed tax cut programme, but there was also a Liability Driven Investment crisis that required the Bank of England to step in temporarily to restore liquidity.

After suffering a diabolical performance in Q3, it was no surprise that the pound performed somewhat better against most of the majors in Q4. Against the US dollar, the bounce from just beneath $1.12 to a test of $1.2450 at one point was encouraging and suggested some confidence had been restored. Against the euro, the pound's recovery was less impressive, barely clinging on to any gains from the end of September, having tested €1.17 at the start of December, and versus the yen, the pound gained more than 2%, but that was set against gains of more than 5% at one stage in late October.

In short, the pound wasn't the worst performing currency of all G10 currencies in Q4 because that plaudit fell to the US dollar. Still, its recovery against the dollar should be set against the far less impressive performances elsewhere.

In Q3, I wondered whether there were further lows to be found for the pound in Q4. As it turned out, there weren't, but I don't think the pound is out of the woods yet. Another poor performance in the UK economy relative to the performance of the US, Euro Area, and Japanese economies, and the pound could be under pressure again at the start of 2023.

Chart 1: £/$ exchange rate – daily chart



Source: Bloomberg

The US - Federal Reserve seeks a higher rate peak than the markets price for

THE US Q4 HEADLINES WERE AS FOLLOWS:

- **US CPI headline inflation drops further to 7.1% y/y in November. Core CPI inflation fell to 6%, having peaked at 6.6% only in September.**
- **US GDP recovered in Q3 figures, growing by an annualised 2.9% in Q3 after the economy had recorded a technical recession in the first half of 2022. The US leading index recorded nine straight drops in its reading in the November figures.**
- **US Federal Reserve hikes interest rates a further 1.25 percentage points in Q4 to leave the Fed funds rate at the highest level since November 2007.**
- **US Republicans fail to gain control of the Senate but narrowly with the House of Representatives in mid-terms.**
- **Dollar index dropped over 6% in Q4.**

The Federal Reserve's game plan is clear. That is to crush inflation in anyway it can. The rise in interest rates in Q4 meant that overall interest rates in the US had risen 425 basis points over the year, and the last time the Fed tightened that quickly was back in the early 1980s. Even a slump in the US housing market, emerging problems in the tech sector, and a collapse in US equity markets made little difference to the Fed's determination.

Alongside the December monetary policy decision, the latest Fed interest rate predictions or dot plots were released. These indicated a peak in the US targeted Fed Funds rate of 5.25% (upper bound), with a sizeable minority of officials seeing 5.5% as the peak. You can probably throw a soft landing out of the window for the US, with the risks of a recession building throughout Q4.

The Fed's preoccupation remains with the US labour markets. Payroll growth continued to expand healthily in the releases throughout Q4, and there were signs of a pick-up in average earnings growth in the year's final data release. However, other labour market data point to a sharp increase in layoffs, labour market indicators tend to lag the general performance of the economy, and US labour force participation is still well below where it was heading into the pandemic.

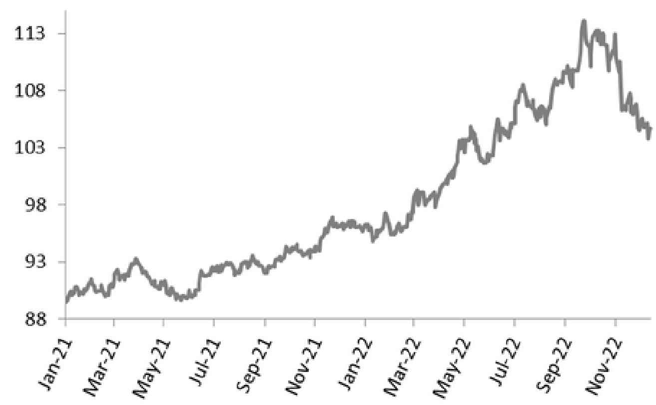
Is this a sign of long COVID, or is it driven by the US workforce looking to exit the labour force earlier, or a combination of factors? Average earnings growth continues to track underneath the headline and core inflation rates, and wage inflation could slow in key areas as the output takes a dive.

The US dollar gave back its gains over the fourth quarter, but only after seeing some notable new highs against a few currencies. Versus the Chinese renminbi, the dollar rose to a high of 7.3274, the highest level $/CNY has been at since December 2007. The dollar also made further gains against the Indian rupee, hitting an all-time high of 83.2925 rupees towards the end of October.

Q3's US dollar gains were largely reversed in Q4, but the US dollar has still had a good year against most majors. The US mid-term elections failed to give the Republicans the red surge they had hoped for, as they only narrowly won the House of Representatives and lost ground in the Senate.

While the loss of the House still gives the President some headaches, it could have been a lot worse. The dollar strength that epitomised the first three quarters of 2022 disappeared in the year's final quarter, just as some of the US data releases were turning around. Early 2023 will prove tricky for the FX markets to keep selling the dollar if macroeconomic performances elsewhere are weak, or even negative.

Chart 2: USD index – daily chart



(source: Bloomberg)

EURO AREA

EUROPEAN CENTRAL BANK MAKES GOOD ON ITS PROMISE TO TIGHTEN MORE AGGRESSIVELY IN Q4 AND WARNS OF MORE TO COME

The Euro Area Q4 headlines were as follows:

- European Central Bank hikes refinancing rate to 2.50% from 1.25%.
- Q3 GDP outperforms again. Euro Area grows 0.3% versus the second quarter when it grew 0.8%. Q4 expectations are for a contraction.
- Euro CPI headline inflation rises to a peak of 10.6% in October but drops back to 10.1% in November.
- Russia threatens the West with nuclear weapons and launches a strike near Ukrainian nuclear facilities as Ukraine makes significant counteroffensive gains.
- Euro recovers against the US dollar to briefly test above $1.07.

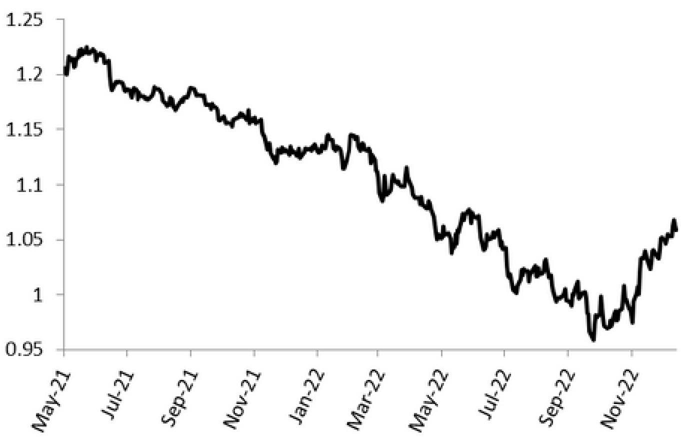
The European Central Bank made good on its promise to hike interest rates more aggressively in Q4. Rates climbed by 75 basis points in October and then 50 basis points in December to reach a 2.5% refi rate) by the end of 2022. The ECB has promised to hike further in 2023, or at least at the beginning of the year, with the prospect of at least another 50 basis points being added to borrowing costs in February.

The economy's outperformance against expectations came whilst Germany was acting as a significant drag on economic performance. France, Italy, and Spain managed to more than compensate for Germany's troubles. The German police and intelligence officers also foiled a plot to overthrow the government late into the fourth quarter.

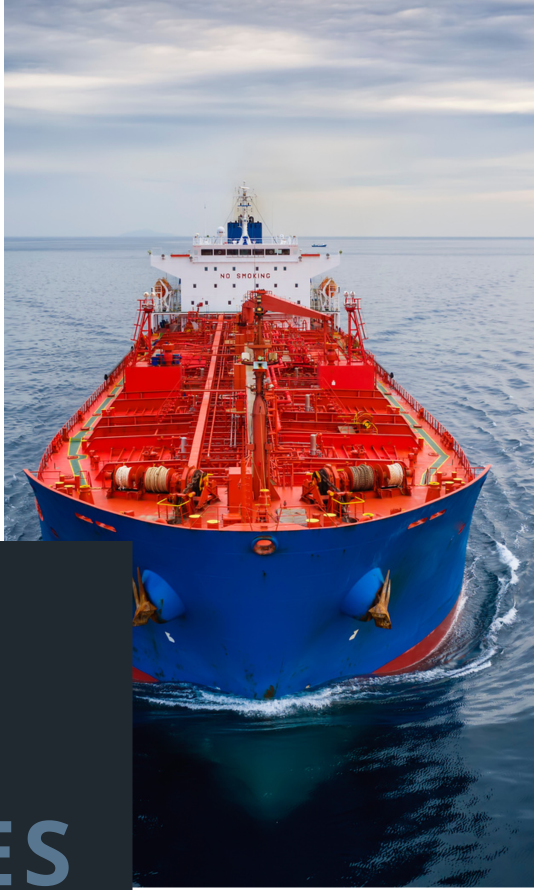
The Euro Area has perhaps suffered the most in the energy supply crisis. This could act as a significant drag on activity as the West enters a period of high energy usage, with the risks of power outages remaining elevated throughout winter.

In Q4, the euro managed to reverse most of its losses against the US dollar seen in Q3. However, it struggled to make headway against other majors, indicating strongly that this was just a US dollar sell-off. For the coming year, the euro will have to fare better against the pound and yen to demonstrate its own momentum.

Chart 3: €/$ exchange rate – daily chart



(source: Bloomberg)



KEY MESSAGES FOR Q1 '23

The UK is at risk of a larger and deeper recession than other major economies. GBP underperformance remains the risk.

US dollar could rebound if global macroeconomic downside risks intensify or if there is another escalation in geopolitical threats.

Global supply chain issues likely to persist —commodity prices to remain volatile.

Further weakness of the rupee and renminbi could be a feature of early 2023.

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