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# Global Scenario- Understanding the Uncertainties

**Significant uncertainties** about the **Global economic and inflation outlook remain, more so in the Euro area than in the US**, which will also strongly impact the course ahead for central banks, resulting into probably large unidirectional moves in FX & Bond markets.

**The US economy- better shielded by the uncertainties of the war**.

* Energy prices have a smaller impact in the U.S., as its economy is largely energy self-reliant, energy prices have risen less in the US compared to the Euro zone. US consumers spend a lower share of their income on heating and electricity compared to European households.

* The trade links between the US and Russia are smaller compared to the links between many European countries and Russia.

* US consumers have a much higher post-pandemic excess savings compared to the European consumers.

* The proximity of Europe to the conflict makes confidence in the Euro area more likely to suffer compared to the US.

As a result, **the war-related uncertainty is likely to have a smaller impact on the Fed than the ECB**, and we expect the Fed to continue with 25bp rate hikes in each of its remaining six meetings for this year, and continue with four more hikes next year.

**We also expect the Fed to decide on its balance sheet measures already at its next meeting in May** (clues from last meeting). The balance sheet reduction should start soon after, at least initially, primarily, as the Fed stops its reinvestments of maturing bonds.

**The ECB- Not ready for rate hikes yet…**

The ECB continued on the path of normalization last week, when it announced an accelerated tapering of its bond purchases. As rate hikes may start after the end of net bond purchases, **the first hike can come in as early as June**.

However, the ECB has emphasized the gradual nature of any rate moves. Such a gradual stance was further supported by the speeches from both President Lagarde and Chief Economist Lane.

**The ECB is expected end its net asset purchases by the end of July**, but amidst the continued elevated uncertainty, **the first rate hike can happen in December** (25bp) and further hikes in March and September 2023.

It will take time for the ECB to be convinced that the inflation will support a rate hike. ECB will especially take time to understand the momentum in wages.

The timing of first hike is subject to notable uncertainty in both directions. Hikes could easily start in September, maybe even in July, if inflation continues to surprise in the upside and the war-related uncertainty clears quickly.

As the ECB has taken steps towards normalization, even in the middle of the Russian invasion**, the direction of its monetary policy looks clear.**

The ECB continues to hold on to ending net asset purchases before starting to raise rates. However, if the ECB members get stuck between the upside inflation risks and financial stability**, the ECB is likely to change its sequencing**.

Also, **it is almost unlikely that the ECB would restart limited net asset purchases after starting to raise rates, and then continuing rate hikes at the same time**. President Lagarde has said that the ECB is ready to "**design and deploy new instruments to secure monetary policy transmission"** as the ECB moves along the path of normalisation.

**The U.S. Curve Inversion…**

**Bond yields have seen enough volatility amidst the uncertainty created by the war.** After safe-haven flows pushed long yields lower after the Russian invasion, lately the course has been clearly upwards. Long yields have already risen above the pre-war levels; as markets see the inflation picture as the primary worry compared to fears about the economic outlook.

The US curve has continued to flatten, with some parts of the curve, such as the 10-5-year Treasury curve slope, already briefly inverting. **The 10-2-year part of the curve remains upward-sloping, and the Fed must be keen to keep it that way**. Inversion of the curve in especially that part is often taken as a signal of a looming recession.

The Fed has a tool to directly try to affect the level of long yields, and it intends to use it. **Powell indicated that the Fed is probably ready to decide on its balance sheet contraction measures already at the May meeting**.

Given that long rates matter more for US financing conditions than shorter ones, it makes sense for the Fed to make sure the long yields head higher.

We expect the 10-2-year part to turn very flat going forward, but think the Fed will seek to avoid an inversion, maybe even with outright bond sales, if necessary.

In the Euro area, the 10-2-year curve has actually steepened this year, as the rise in longer yields has outpaced the pricing of increased ECB rate hikes in the short end of the curve. While we do not expect any sizable flattening in the near term, we do not see much more steepening either, and rather **see the curve flattening later when the ECB starts raising rates.**

**We continue to look for the overall rate levels to increase, with both central banks raising rates.** However, given that the market is already pricing in enough ECB and Fed forecasts for this year, we expect most of the rise to happen later than in the near term.

Both the inflation and economic outlooks is surrounded by a lot of uncertainty. **We think the risk is tilted towards more aggressive action from the Fed in the near term than from the ECB.**

**What's in it for the Dollar?**

**The war in Ukraine has had a huge impact on the FX markets the last three weeks**. We have seen sharp moves in many currencies which were not seen even during the Corona-crisis in Mar-Apr 2020. There has been a typical risk-off pattern. Some currencies have strengthened while most have weakened.

In the last week or so we have seen corrections of the initial large moves that took place after the Russian invasion on 24 February. Some central banks have been active in defending their currencies, while others have left market forces at play.

**The visibility remains low although volatility has subsided**. More and more central banks have moved into hiking mode and while higher interest rates will support the currencies in question, **the different tightening cycles will be an important factor for movements between different exchange rates going forward.**

The outlook for all currencies is very uncertain in the short term as long as we do not know if there will be a further escalation of the war in Ukraine or if we will have a ceasefire followed by a more permanent solution.

**The Dollar has been supported by the high global risk aversion and by solid data and strong rate hike expectations in the US.** The rate hike expectations have been supported by the latest FOMC statement. EURUSD dipped towards 1.08 in early March. We expect the USD to remain well supported in Q2, but expect the EURUSD to revisit 1.08 or lower levels only, if we get another spell of severe risk aversion. Hence, we see EURUSD in a range of 1.08-1.13 the next three months.

**During the second half of the year we expect to see the US economy cooling off and the dollar to trade with light headwind.** The widening of the interest rate differential in favour of the dollar that has been an instrumental part of the sharp increase of the dollar in the past year will not be a key driver for more dollar strength.

That should hold as long as we do not see risk aversion dominating the global markets – risk aversion that would be strong enough to trigger flight to safety and thereby a stronger dollar.

**Sterling can witness a decent recovery too…**

**Pound has been hit by large movements lately and the direction has mainly been to the upside** at least versus the euro. EURGBP traded as low as 0.82 earlier in March. This is a level not seen since before the Brexit vote in Q2 2016.

EURGBP has bounced back above 0.84 after the BoE appeared less hawkish at the previous rate meeting. BoE expressed concerns about the short term outlook because of the war in Ukraine. It did hike though, for a third meeting in a row and more hikes will come later this year.

Hence, **we expect Pound to strengthen versus the euro, probably in the next three months,** if or when we see a pause or a solution between Ukraine and Russia. The BoE has shown that it will act quickly and that it is determined to fight inflationary pressures in the economy. This shall support the Sterling.

## Near Term Outlook

**The Fed concerned not only about high inflation but also tight labour market**

The Fed is not concerned about the strength of the US growth momentum. It is concerned by the risk of overheating. The US labour market is hot. Powell said at the Q&A session Wednesday that the US labour market was at an unhealthy level.

The Fed wants to slow the economy and prevent wage pressures from adding.

The US unemployment rate has fallen to 3.8% and it will soon reach the very low level of 3.5%, which was the low just before the outbreak of the Covid-19 crisis. US corporates are struggling to hire qualified workers without paying up. The number of job openings is at a record-high level. For every unemployed American there are 1.7 unfilled jobs. Such strong demand for labour is a major concern for the Fed.

Hence, we think that the Fed will hike at every meeting this year and continue to hike even in 2023.

**There should be NO second thought for The Bank of England**

The BoE hiked for the third time in a row as it raised the key rate from 0.50% to 0.75%. This move was widely expected. But the BoE surprised traders by not being as hawkish as expected. The wording of the statement was a little softer, with the BoE highlighting risks on both sides. Also, the decision to hike was not unanimous. One member of the 9-member committee wanted to keep the key rate unchanged.

But the BoE should not deviate now. Recent Jobs data showed a tight labour market similar to that in the U.S. The UK unemployment rate has fallen to 3.9% and is very close to the level of 3.8% (the low before the outbreak of Covid-19). Average earnings increased by 4.6% y-o-y, which will add to the mounting inflationary pressure in the British economy.

In the week ahead we will get UK inflation data and the numbers will continue to show higher inflation. The inflation rate has not peaked yet. The BoE expects the inflation rate to peak at around 8% Apr-Jun 2022.

The BoE will have to hike again. It might not be at the next rate meeting on 5$^{th}$ May. A majority of the MPC favours further tightening of the monetary policy to reduce the risk of wage trends and inflation. We expect three or four rate hikes from the BoE before the end of this year.

Report prepared by: Siddhesh Ghare
Head- FX Risk Business sghare@phillipcapital.in
PhillipCapital (India) Pvt. Ltd. +91 99634 87722