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Week Ahead: The US Dollar and Fed's Tightening Cycles

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What happens to the USD when the Fed tightens its monetary policy? Will higher US rates drive the dollar higher? History tells a different story. But we argue that this time is different – every cycle is unique.

*"Let's put it this way. The dollar is the international currency in which all the forces of global finance converge and set the price" – A*lan Greenspan

We have released **new financial forecasts**. We expect the Federal Reserve to be aggressive. This year we look for four rate hikes, and the same next year. And the Fed is expected to let its balance sheet shrink from the middle of this year. During the same period we expect the ECB to end its PEPP programme in March and slowly phase out the APP programme during the next 12 months. However, a rate hike from the ECB might not materialise until the end of 2023. Hence, we foresee a significant widening of the interest rate differential in favour of the US dollar and call for more dollar strength this year.

But is it always the case? Does **the dollar** always strengthen when the Fed tightens its monetary policy? A quick glance at the tightening cycles over the past 30 years indicates that this might not be the case. It appears that EUR/USD has moved more up than down during tightening cycles.

Tightening cycles are not frequent. During the past 30 years there have been four tightening cycles. And they have all taken place under very different circumstances. Circumstances that are very different from the current situation. Hence, we argue that this **time is different**. Below we take a closer look at EUR/USD and the last four tightening cycles from the Fed.

The four cycles are different in terms of duration and magnitude of the rate hikes. The four cycles have lasted between 11 and 36 months and the range of Fed Fund rate hikes has been 175-425bp.

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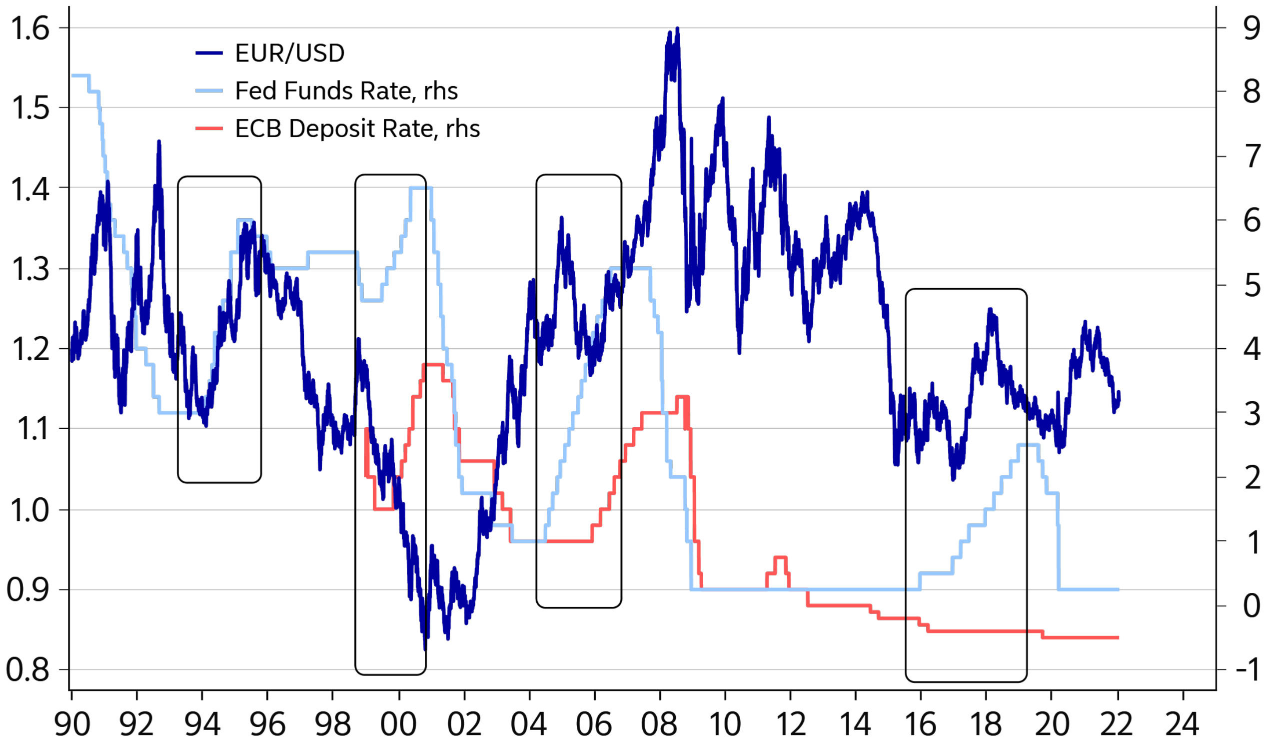
Chart 1 Fed tightening cycles 1990-2022



Source: Nordea and Macrobond

chart1

Cycle Dec 2015 to Dec 2018 – tightening by 300bp

The last tightening cycle back in 2015/18 was the longest of the four, but not the most aggressive one. EUR/USD went down from 1.15 to 1.06 before the first rate hike in December 2015. The exchange rate moved back up to 1.15. But before the second hike the rate was down below 1.05. Below 1.05 the dollar was very strong (i.e. the euro was weak) and when ECB President Mario Draghi made an optimistic speech in March 2017, it triggered violent repricing of the euro and EUR/USD surged from below 1.05 to 1.25, leaving no positive impact on the dollar from five rate hikes from the Fed. However, during the latter part of that tightening cycle in 2018, EUR/USD fell back below 1.15. Hence, during the whole cycle there was no strong and positive correlation between the USD and US rate hikes, but it was also a long period where different key drivers were in play.

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Chart 2 Fed tightening cycle 2015-2018

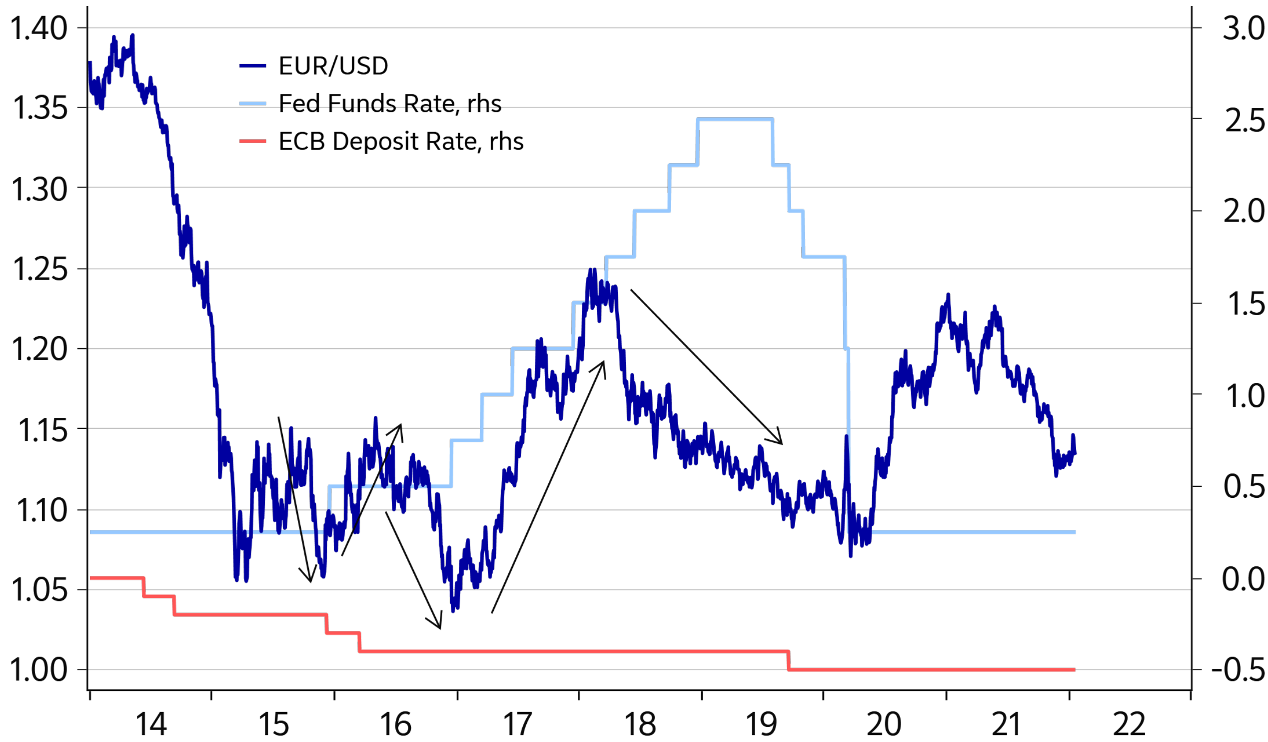

chart2

Cycle June 2004 to June 2006 – tightening by 425bp

The cycle back in 2004-2006 was the most aggressive one when it comes to the magnitude by which the Fed Funds rate was hiked. This tightening cycle happened during a period when there was one single key driver for the USD. And that was concern about the US trade deficit – widespread concern. That was the single most important factor that took EUR/USD from below 0.90 in 2002 and all the way up to above 1.50 before the financial crisis in 2007/08. During this period the key focus was the monthly trade data and TIC data from the US. And it is not possible to detect a positive impact on the USD when the Fed embarked on a tightening cycle in June 2004.

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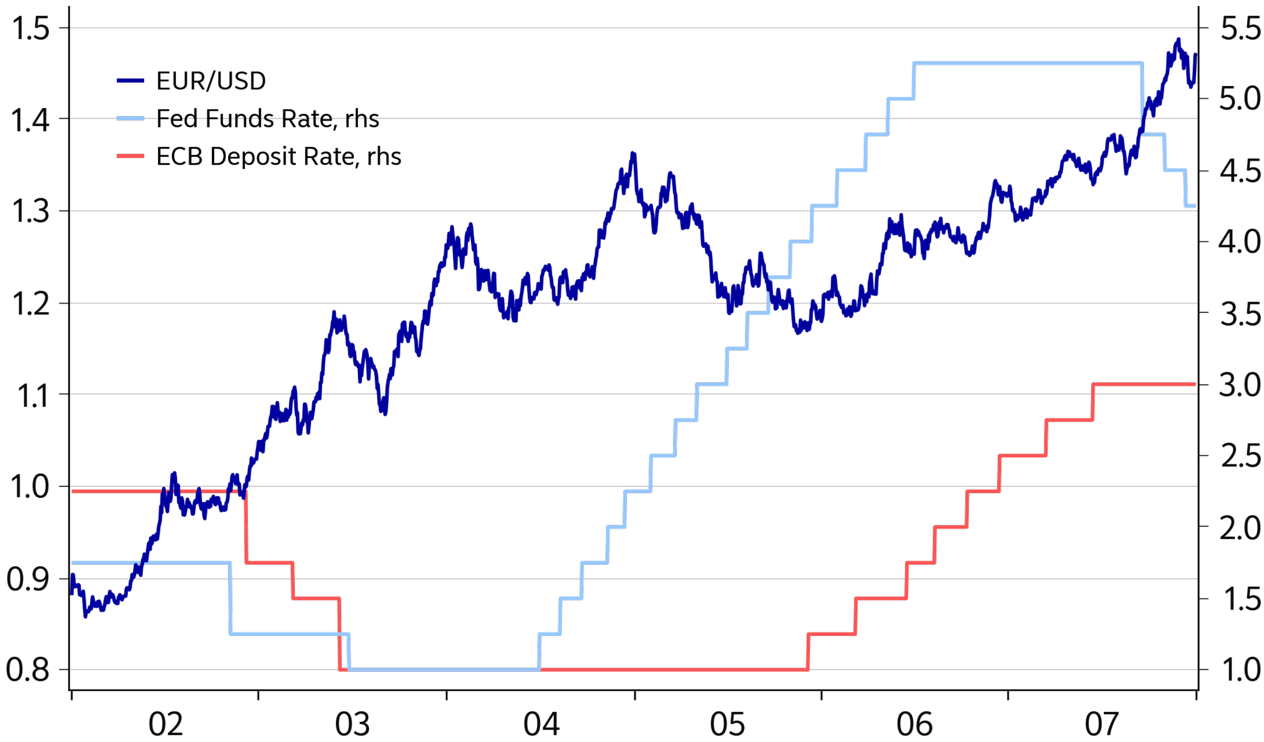
Chart 3 Fed tightening cycle 2004-2006



Source: Nordea and Macrobond

chart3

Cycle June 1999 to May 2000 – tightening by 175bp

The cycle back in 1999-2000 was the shortest and least aggressive one. EUR/USD fell sharply during this cycle, which could lead to the conclusion that the tightening cycle had a positive impact on the dollar. Nothing could be more wrong. In 1999/2000 there was one dominant market theme forcing EUR/USD lower. From the beginning of 1999 (the launch of the euro) and until late 2000, EUR/USD fell from 1.20 to below 0.90. It was all a question of when the euro would collapse. Every time ECB President Wim Duisenberg appeared on the wires, dealers yelled: ***sell the euro!*** Concerted intervention helped stabilise the euro in late autumn 2000. The Fed participated reluctantly.

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Chart 4 Fed tightening cycle 1999-2000

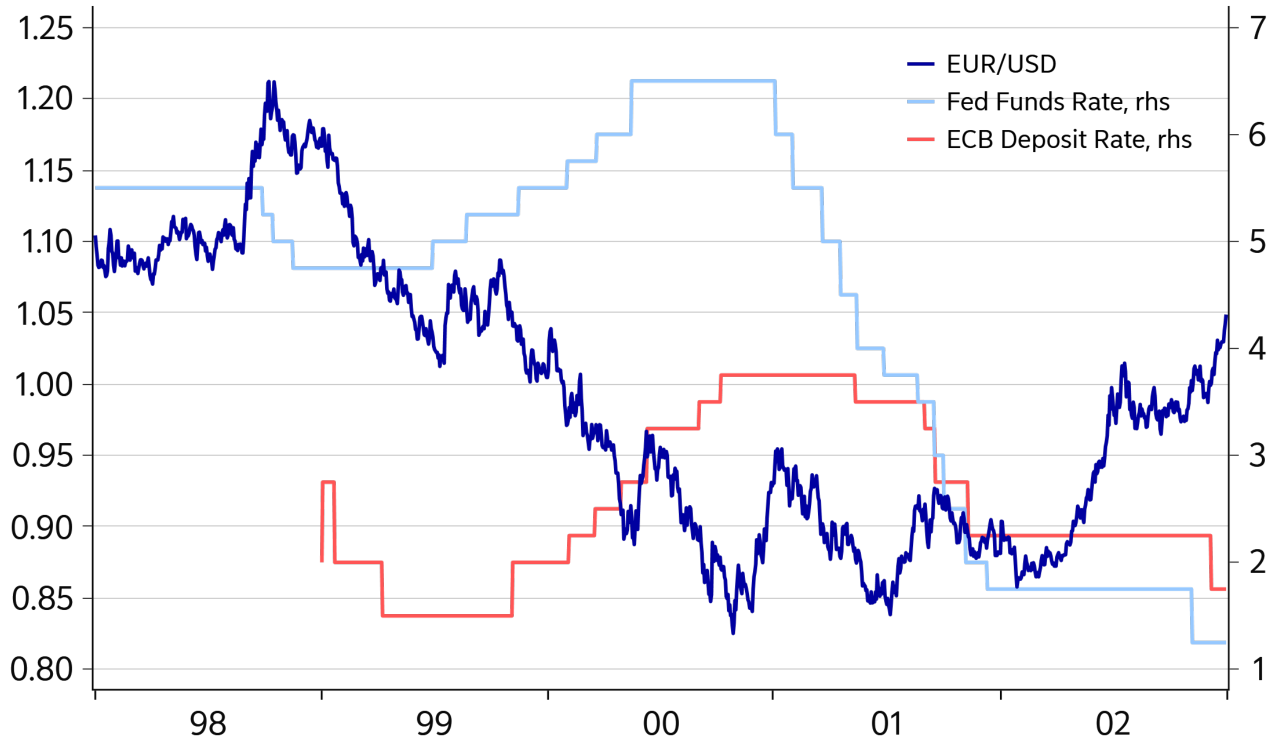

chart4

Cycle Feb 1994 to Feb 1995 – tightening by 300bp

In a way, it does not make much sense looking at the tightening cycle back in 1994/95 when trying to figuring out the impact on the USD from Fed's hiking cycles. Back then there was a different regime on the global FX markets. There had just been a big crisis in the European Monetary System in 1993 and banks were laying off FX dealers as they were looking into the disappearance of 10-15 European currencies later in the decade. And the D-mark was on top, outperforming the USD during the cycle in 1994/95.

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Chart 5 Fed tightening cycle 1994-1995

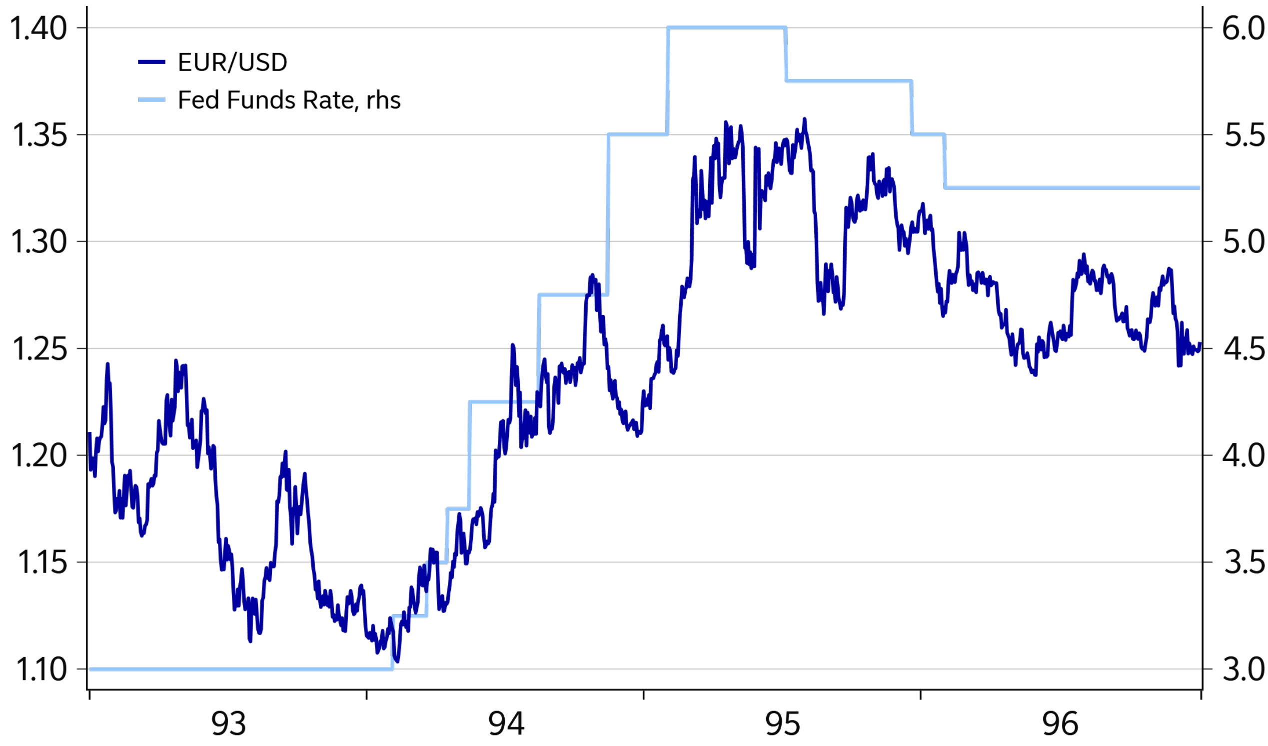

chart5

This time is different

When it comes to the impact on the USD from the Fed's hiking cycles the conclusion is: **every cycle is different**. It will always be a question about key drivers at the given time. Nordea expects that the interest rate differential will be a key driver for EUR/USD again this year, as it was last year. Other factors might enter into the equation and affect EUR/USD the coming year. New Covid-19 variants could cause havoc on the financial markets and affect the USD. Global investors could decide suddenly to abandoned US equities, which could trigger a sharp decrease in the USD. At one point, we are likely to be looking into a repricing of the euro. Nordea expects the latter to happen next year. But this year we look for dollar dominance once again and expects EUR/USD to fall towards 1.08 by the end of the year.

What's most important in the week ahead

All eyes will be on the **FOMC meeting** concluding **Wednesday** evening. Even so, this week will feature a full slate of economic data from the US and the Euro area. Monday kicks off the week with important **PMI figures** for **services** and **manufacturing** from the **US** and the **Euro** a**rea**, which will be accompanied by more regional Fed manufacturing figures from Dallas (Monday), Richmond (Tuesday), and Kansas (Thursday). Last, but not least, we have the **Fed's favorite PCE inflation** measure out Friday. Besides that, we expect the BoC meeting to strongly signal a hike lift-off in March mirroring the Fed. In the Nordic countries we will have a busy week in Sweden with several important data releases.

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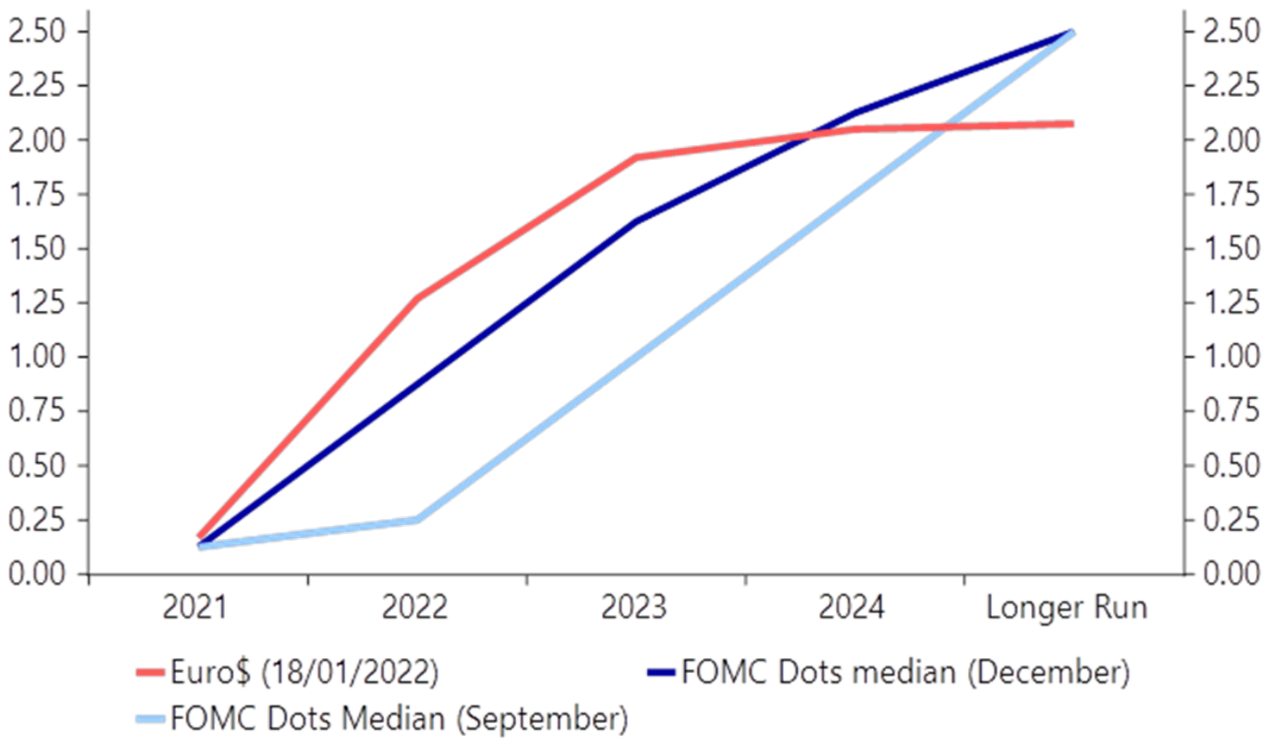
The **Fed** has been catching up with market expectations, turning more hawkish by the day. The December FOMC meeting and the subsequent minutes have us believe that a **March lift-off is a done deal.** While the Fed has been catching up to the market, we find it unlikely that they will exceed the market by raising the Fed Funds rate by 50 bp in March. Our base case is that the March SEP will show four hikes during 2022.

Chart 6 The Feds still has catching up to do



Source: Macrobond and Nordea

Others have argued that the Fed should hike five to seven times this year, but we think the **Fed** will be more cautious in speeding up its rate hikes and **focus** more on the **excess liquidity** in the **system**. The Fed has already shown an increased concern regarding the low duration spreads in the yield curve. The 2s10s has already flattened c. 75 bp during 2021, which leaves 2s10s with c. 80 bp before curve inversion. Fed chatter around QT as well as Fed research put emphasis on its impact on the yield curve, which is why we expect balance-sheet drawdown to commence during the summer. At the press conference Chairman Jerome Powell will be drilled on a March lift-off and to a larger degree the timing and magnitude of the balance-sheet drawdown.

Moving on to economic key figures, Monday's focus will be directed towards the **Euro area PMI**, which in line with our expectations has been on a declining trend. The cocktail of government restrictions on the heels of Covid-19 cases and rising inflation and abnormally volatile energy prices is manifesting itself in the economy and the activity level. The PMI print this week is unlikely to print higher. The current situation in the German ZEW index has entered negative territory and the leading and lagging parts of the Swedish manufacturing PMI – a gauge for the Euro area – indicate more downside than upside risks.

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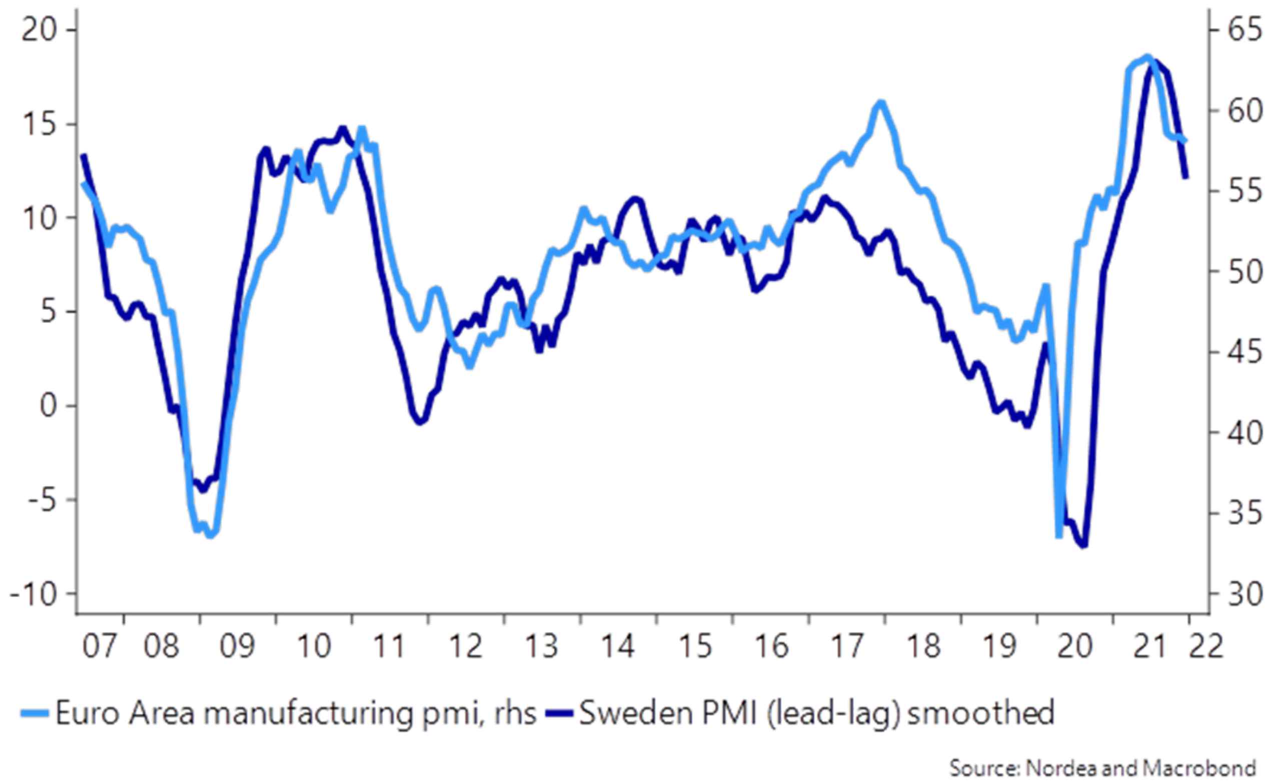
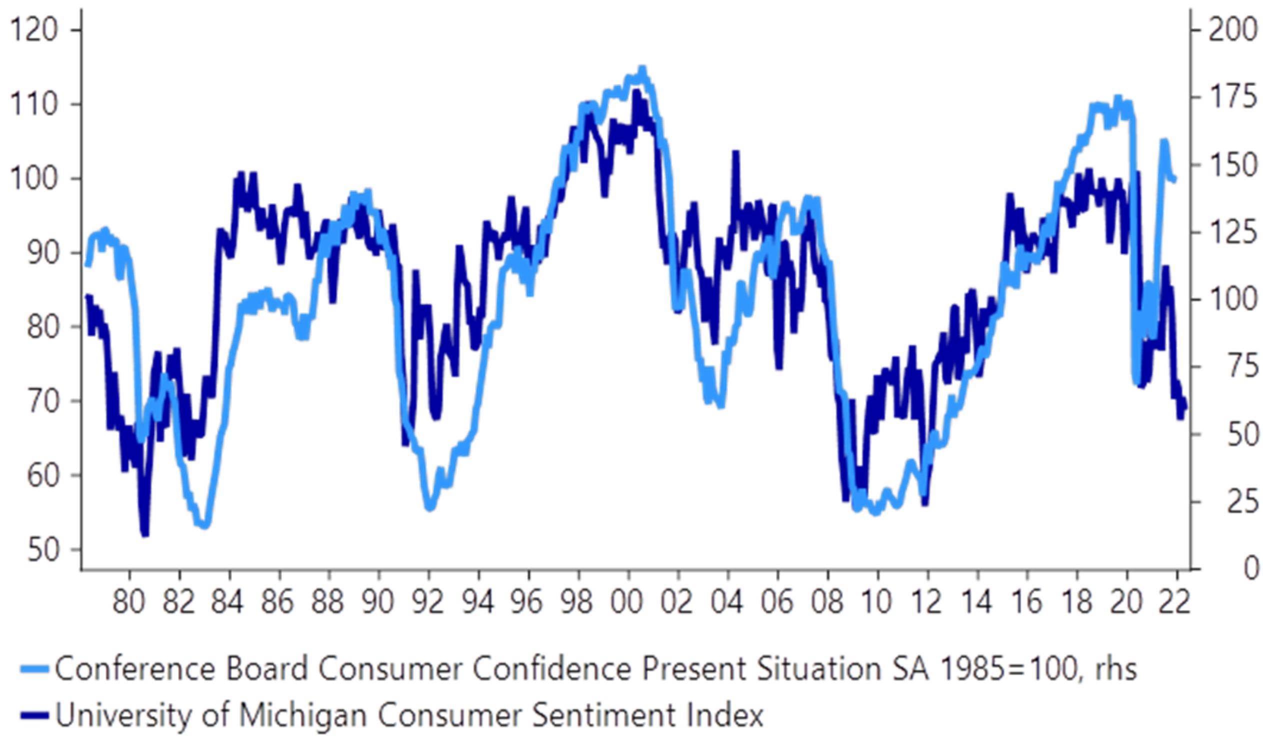
Chart 7 Euro area slowing



Turning to the US, the **Conference Board Consumer Index** is likely to mimic the surprising plunge of the University of Michigan Consumer Confidence index, which at the start of January fell to a decade low. While the tight labor market has been accompanied by some wage gains, higher inflation rates have eroded consumers' purchasing power. Lower real wages and surging Covid-19 cases should mean that we will see the Conference Board Consumer Confidence index edging lower also.

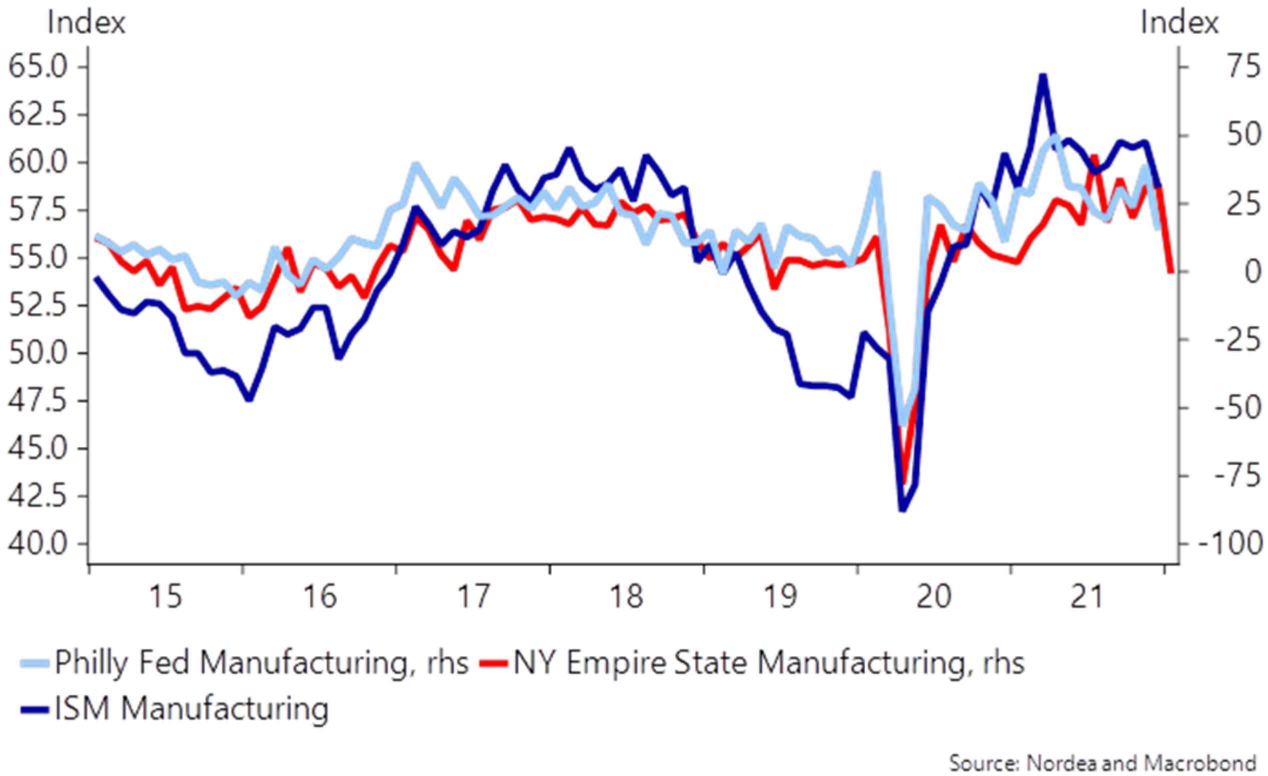
Chart 8 Consumer sentiment should drag



Source: Nordea and Macrobond

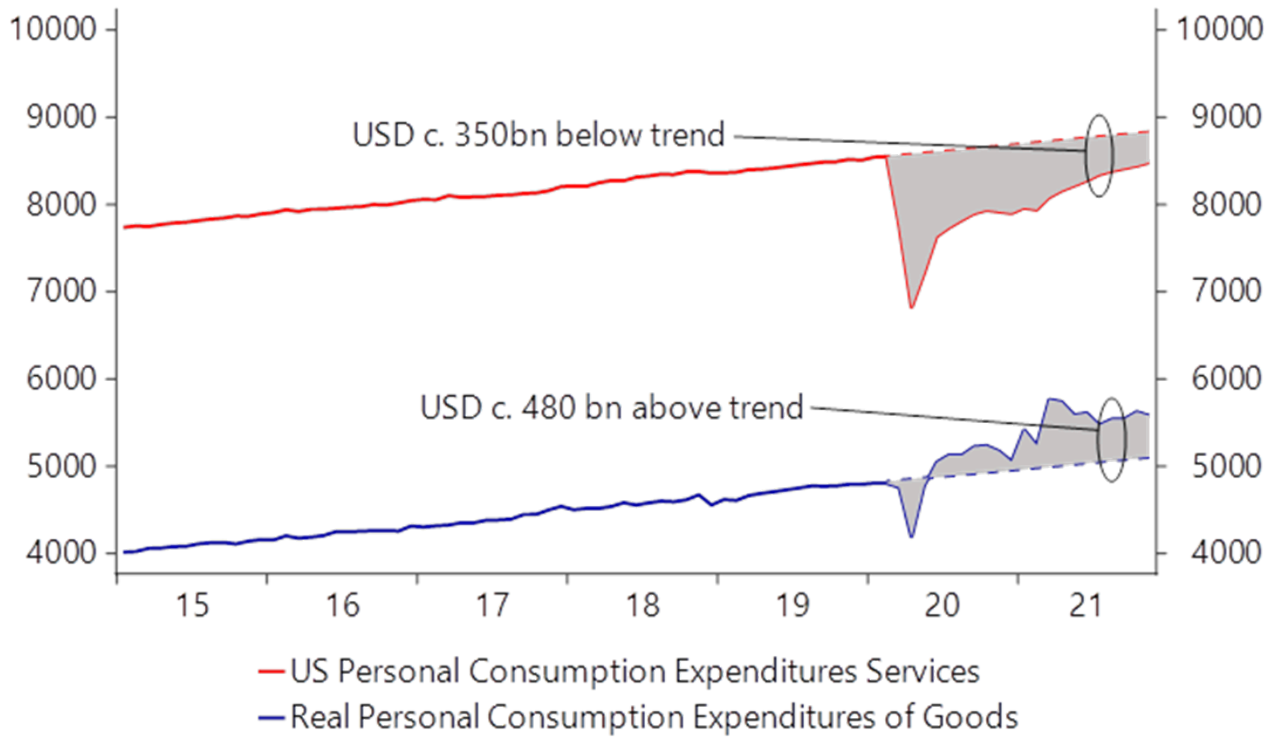
Consumer sentiment is not the only part of the US economy starting to show signs of slowing. The **US manufacturing PMI** is also likely to move lower as it has done the past five consecutive months. So far this year, the ISM and the Philly Fed Manufacturing index have lost momentum and last week the NY Empire State Manufacturing dropped like a stone – into negative territory. The manufacturing indices show little damage to the supply side and a larger impairment of the demand side. This could be an early indication that Covid-19 cases in the absence of stimulus could dampen the inflation – or at least support normalisation of supply and demand balances. So far the PMI is above the 50 mark but loss of momentum points to slower growth down the road, as the Fed is set to start its hiking spree in March.

Chart 9 Cyclical slowdown



Lastly, we have a round of fresh **PCE inflation prints** out of the **US**. We expect PCE Core inflation to trail the CPI measure, rising to 4.8% for December. While prices are indeed rising, real consumption normalised in November. We would expect normalisation to occur during this year as rising consumer prices erode purchasing power and demand, which at the start of the pandemic were boosted by fiscal stimulus checks. In December the saving rate declined to 6.9% , the lowest level since 2017, which supports the argument, that we will see trend-like demand for growth and services this year. If so, this could alleviate the retail industry and allow for inventory building, in turn setting the scene for lower price pressure.

Chart 10 Normalisation of consumer trends



Source: Macrobond and Nordea

In the Nordic countries focus will be on **Sweden** with a busy week for key figures. The Prospera monthly survey is due out on Tuesday, which probably will show that money market players' inflation expectations climbed further. Home prices for December (HOX/Valueguard) are released on Wednesday. The flash for Q4 GDP is out on Friday. The growth trend has been strong up to and including November, and although GDP probably edged down in December, growth for Q4 was healthy at around 1% q/q and 5.5% y/y, we think. Last but not least, the NIER's quarterly Tendency Survey is due Friday, packed with growth and price indicators such as companies' inflation expectations and price plans.

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Calendar for next week

Monday	24/01/2022		Period	Consensus	Prior	Unit
09:15	FR	Markit Mfg Flash PMI	Jan		55.6	Index (diffusion)
09:30	DE	Markit Mfg Flash PMI	Jan		57.4	Index (diffusion)
09:30	DE	Markit Service Flash PMI	Jan		48.7	Index (diffusion)
09:30	DE	Markit Comp Flash PMI	Jan		49.9	Index (diffusion)
10:00	EZ	Markit Mfg Flash PMI	Jan		58	Index (diffusion)
10:00	EZ	Markit Serv Flash PMI	Jan		53.1	Index (diffusion)
10:00	EZ	Markit Comp Flash PMI	Jan		53.3	Index (diffusion)
10:30	GB	Flash Composite PMI	Jan		53.6	Index (diffusion)
15:45	US	Markit Comp Flash PMI	Jan			Index (diffusion)
15:45	US	Markit Mfg PMI Flash	Jan			Index (diffusion)
15:45	US	Markit Svcs PMI Flash	Jan			Index (diffusion)
Tuesday	25/01/2022		Period	Consensus	Prior	Unit
01:30	AU	CPI QQ	Q4		0.8	Percent
01:30	AU	CPI YY	Q4		3	Percent
08:00	DE	GDP Flash QQ SA	Q4			Percent
08:00	DE	GDP Flash YY NSA	Q4	0.5		Percent
10:00	DE	Ifo Business Climate New	Jan	3.3	94.7	Index
10:00	DE	Ifo Curr Conditions New	Jan	0.5	96.9	Index
10:00	DE	Ifo Expectations New	Jan	3.6	92.6	Index
14:00	HU	Hungary Base Rate	Jan	0.2	2.4	Percent
14:00	HU	O/N Deposit Rate	Jan	1.9	2.4	Percent
16:00	US	Consumer Confidence	Jan		2.1	Index
Wednesday	26/01/2022		Period	Consensus	Prior	Unit
08:00	DK	Retail Sales YY	Dec		1.5	Percent
16:00	US	New Home Sales-Units	Dec		744 K	Number of
16:00	CA	BoC Rate Decision	26 Jan		0.25	Percent
20:00	US	Fed Funds Tgt Rate	26 Jan		0.125	Percent
Thursday	27/01/2022		Period	Consensus	Prior	Unit
08:00	DE	GfK Consumer Sentiment	Feb		-6.8	Net balance
08:00	NO	Labour Force Survey	Nov		3.6	Percent
14:00	ZA	Prime Rate	Jan		7.25	Percent
14:00	ZA	Repo Rate	Jan		3.75	Percent
14:30	US	Durable Goods	Dec		2.6	Percent
14:30	US	Initial Jobless Clm	17 Jan, w/e			Person
14:30	US	Jobless Clm 4Wk Avg	17 Jan, w/e			Person
Friday	28/01/2022		Period	Consensus	Prior	Unit
00:30	JP	CPI Tokyo Ex fresh food YY	Jan		0.5	Percent
00:30	JP	CPI, Overall Tokyo	Jan		0.8	Percent
07:30	FR	GDP Preliminary QQ	Q4		3	Percent
07:30	FR	GDP YY Prelim	Q4		3.3	Percent
08:00	SE	Retail Sales MM	Dec		0.9	Percent
08:00	SE	Retail Sales YY	Dec		6	Percent
08:00	SE	Unemployment Rate	Dec		7.5	Percent
08:00	SE	Unemployment Rate SA	Dec		8.3	Percent
08:00	NO	Retail Sales Ex. Auto	Dec	-0.1	-0.1	Percent
09:00	ES	Estimated GDP QQ	Q4		2.6	Percent
09:00	ES	Estimated GDP YY	Q4		3.4	Percent
09:00	CH	KOF Indicator	Jan		107	Index (diffusion)
09:00	SE	Overall Sentiment	Jan		117.1	Net balance
09:00	SE	Consumer Confidence SA	Jan		98.7	Net balance
09:00	SE	Manufacturing Confidence	Jan		127.3	Net balance
10:00	NO	Reg'd Unemployment NSA	Jan		2.2	Percent
14:30	US	Core PCE Price Index MM	Dec		0.5	Percent
14:30	US	Core PCE Price Index YY	Dec		4.7	Percent
14:30	US	PCE Price Index MM	Dec		0.6	Percent
14:30	US	PCE Price Index YY	Dec		5.7	Percent
16:00	US	U Mich Sentiment Final	Jan		68.8	Index

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