JULY 2023

Q2 REVIEW

THE SECRET ECONOMIST

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Q2 Headlines:

The US dollar seems to have come full circle this quarter, despite some significant changes. What we really want to know is, why?

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

The last quarter has been a bumpy ride. We've seen some dramatic events and some significant movements in the FX market. However, as Q2 draws to a close, many of the major currency pairs are looking pretty similar to where they began - with one notable exception (more on this later!)

But the big question remains the same: Has inflation been tamed?

If it has been, then the latter part of the year could see much more volatility than we saw in H1.

- Geopolitical risks – Rising tensions in the Middle East have added to the concerns over the Russia/Ukraine conflict. The China and US trade war also ramped up during the quarter - despite late efforts to calm both sides, which have not yet seen any results.

- Market risks – We saw yet another bank rescue in the US regional banking system - this time prompting regulatory change.

- US debt ceiling deal – The deal between the Democratic-led White House and the Republican-led House of Representatives put a significant squeeze on non-defence spending. It has also left Biden's administration with little room for big announcements this side of the 2024 Presidential Election.

- The Fed heads for a unilateral pause – Recent decisions on monetary policy suggest US interest rates differentials with the UK and Euro Area will narrow (we've already seen such moves in bond markets).

- Upgrades to UK forecasts, but weakness in the US and Euro Area data – There are signs recently that the Euro Area and US economies are turning down, but that comes at the same time as big upgrades to UK growth forecasts from the IMF and OECD.

US and Euro Area inflation is heading down, but growth also hits the buffers

Consumer price inflation headlines

- US: US headline CPI inflation fell from the 6% reading in February to 4% by the May reading, but core inflation has been much less responsive so far, only falling from 5.5% to 5.3% over that same period.

- UK: Headline CPI inflation fell from 10.4% in the February reading, to 8.7% in April before flatlining at 8.7% in May. Core inflation, on the other hand, has continued to rise, from 6.2% in February to 6.8% in April and 7.2% in May.

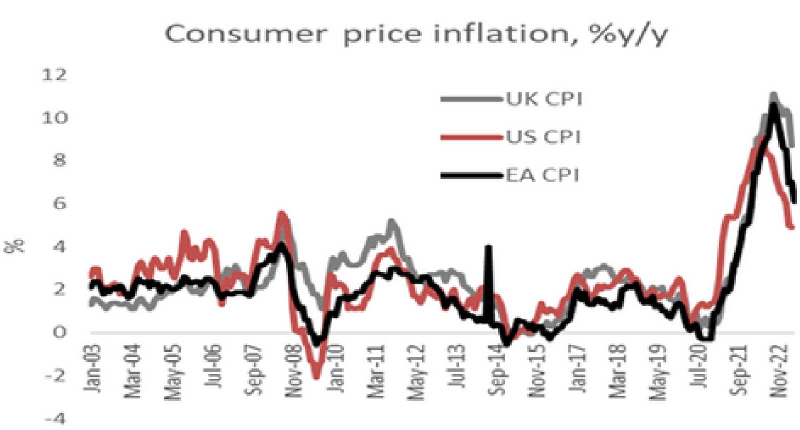
- EU: Euro Area headline CPI inflation fell from 8.5% in February to 6.1% in May, and core inflation dropped from 5.6% in February to 5.3% in May, peaking at 5.7% in March.

There has been a marked improvement in global energy prices despite OPEC's attempts to push oil prices up with two reductions in supply in recent months. Global food price inflation also appears to have peaked and is slipping back down.

While the war in Ukraine continues, geopolitical risks do not appear to be increasing in a way that continues to disrupt the global supply chain. This seems to be the global consensus, with European and Asian industrial production data signalling that inventory run-downs are replacing last year's trend towards overstocking (stockpiling).

This reduction in global trade activity could push inflation rates down more quickly in H2 '23 and into 2024.

Latest inflation graph



Figures quoted from Bloomberg

Growth numbers

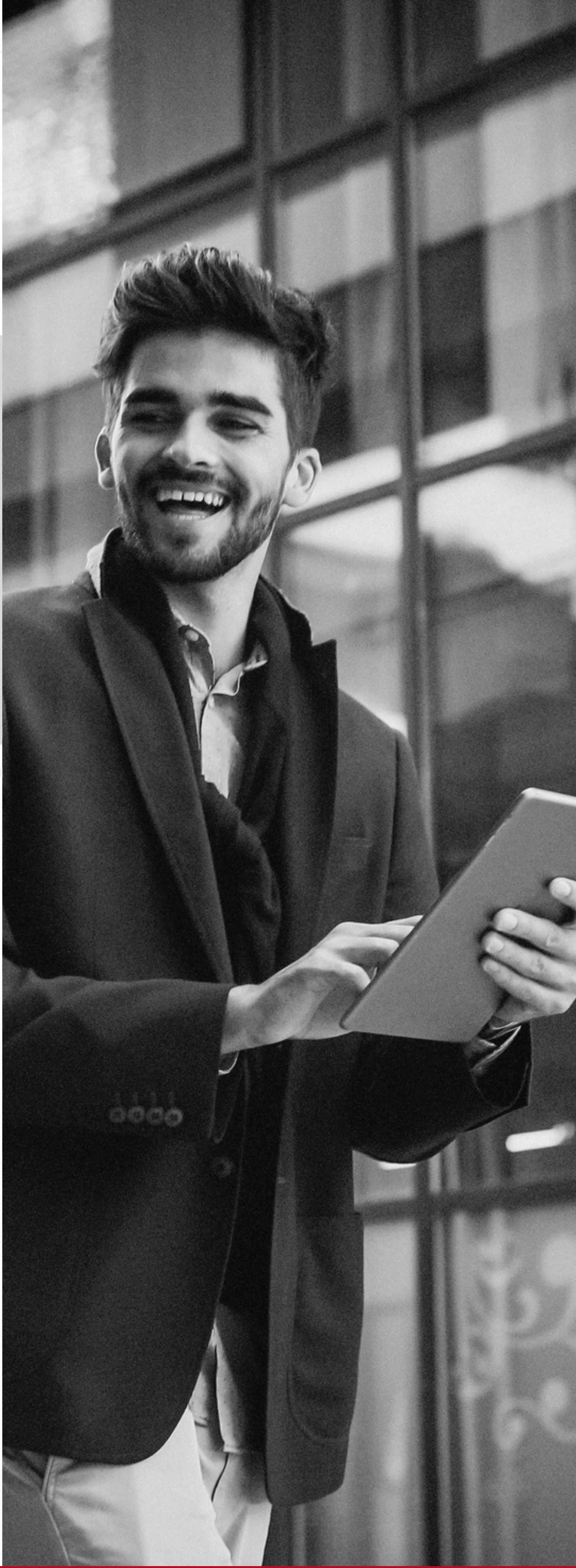
The IMF and OECD have both had to revise up expectations of UK GDP in 2023 after forecasting it would contract this year. In the International Monetary Fund's case, the UK had two upward revisions that took the economic outlook back into growth.

Growth headlines (taken from IMF Spring Meetings 2023)

- The US is predicted to grow by 1.6% in 2023 and 1.1% in 2024.
- The Euro Area is forecast to grow by 0.8% in 2023 and 1.4% in 2024.
- The UK is predicted to expand by 0.3% in 2023 and 1% in 2024.
- Global GDP is forecast to grow 2.8% in 2023 and 3% in 2024.

As far as the labour markets are concerned, the increase in interest rates and tightening in monetary conditions across the entire Western hemisphere has yet to negatively affect demand. Labour supply remains tight as the aftermath of COVID on healthcare, historical effects of low birth rates, and employees retiring earlier exert ongoing pressure.

The problems in US regional banking claimed another victim in Q2, with First Republic being acquired by JP Morgan Chase after it was unable to stem the outflows of deposits. The authorities announced a change to the deposit protection scheme funding, with banks facing a 0.125% fee per annum to replenish the Deposit Insurance Fund after the failures of regional banks, including SVB and Signature. There have also been additional signs of a credit squeeze, with deposit balances not recovering in Q2, having fallen sharply in Q1.



Figures quoted from Bloomberg

Interest rates at the end of Q2

- EU: 4%

ECB (2x25bps increase in Q2) – Last decision = 25bps hike

- US: 5.25%

Federal Reserve (1x25bps increase) – Last decision = no hike

- UK: 5%

Bank of England (1x25bps increase, 1x50bps increase) – Last decision = 50bps hike POST 22nd June meeting

All the major central banks are hinting at further rate hikes; the Fed is suggesting it will hike another 50 basis points; markets are predicting the Bank of England will hike rates a further 1%, and another 50 basis points of hikes from the ECB are priced in.

This is all at a time when risk appetite is under pressure and the signs of a credit squeeze are increasing. The central banks risk breaking more things (just like the UK LDI crisis in October ’22 and the US regional banking woes of Q1 and Q2) if monetary tightening persists.

The markets were pricing in rate reductions as soon as H2 from the likes of the Federal Reserve, but that confidence has been shaken, such that the first interest rate cuts now come in H1 ’24. Over the coming quarters, the markets may be disappointed in terms of where interest rates peak, which could compel FX valuation changes in those quarters also.

Equity Markets

- Dow Jones Industrial Average: High = 34,.588.68, Low = 32,764.65 Close = 34,407.60
- FTSE 100: High = 7,914.13, Low = 7,446.14, Close = 7,531.53
- Eurostoxx-50: High = 4,412.88, Low = 4,218.04, Close = 4,399.09

Q2 saw European and UK equity indices outperform the Dow Jones for most of the quarter, with the Dow suffering under the weight of an ongoing adjustment of tech stock prices and downward pressure on bank valuations. However, late in the quarter, optimism around AI and its adoption across a variety of sectors prompted a tech-led rally. What will Q3 bring? Perhaps a lot more volatility and downward pressure?

In the world of commodities, energy prices fell throughout much of the quarter, albeit natural gas prices rose towards the end of the period, as hot weather prompted a heightened use of air conditioning in commercial and residential properties. Oil prices continued to drop despite OPEC production cuts, leaving Brent crude prices around 4% lower than at the end of Q1.

Figures quoted from Bloomberg

UK

Bank of England hikes to 5%, but the markets appear to be overpricing for additional tightening

Q3 headlines:

- Bank of England hikes to 5%, but the markets appear to be overpricing for additional tightening
- The Bank of England raised interest rates to 5% (from 4.25% at the end of Q1)
- Core CPI inflation rising to over 7% and headline strength in labour markets and pay (average earnings growth in April was 6.5%).
- GDP growth up 0.1% in Q1 figures, a better-than-expected outturn versus Euro Area.

Figures quoted from Bloomberg

Concerns over financial stability remained in Q2 but faded over the quarter. The UK economy was the beneficiary of upgraded economic growth forecasts from the Bank of England, OECD, and the International Monetary Fund, which combined with higher inflation, prompted significant upward revisions to GBP valuations against other major currencies. The pound even hit a 7½ year high against the yen.

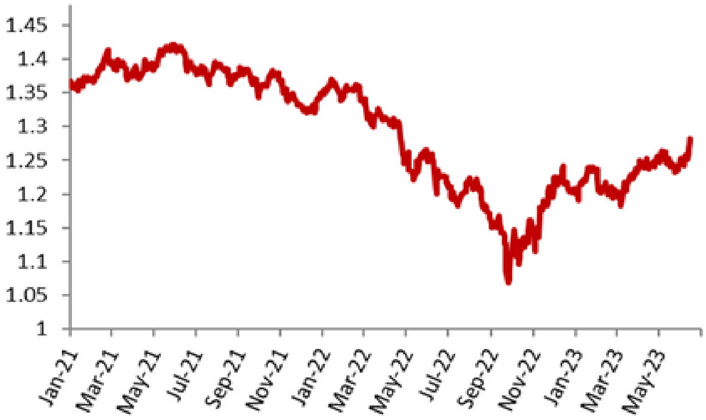
However, the BoE has been forced to commission a review of its inflation forecasting methods after MPs and the media questioned them given how poorly they appear to be tracking reality. What is more troubling is that we are a fall in the UK money supply (M4* money supply is 2.1% below its September peak) and also falling mortgage lending. Is the pain for borrowers only likely to increase, and what will that mean for investment and discretionary spending?

Q2 saw UK interest swap rates surging again. The 2-year swap rose from 4.28% at the end of March to 5.09% at the end of June. 5-year rates climbed from 3.78% at the end of Q1 to close the quarter at 5.09%, and the 10-year swap rate moved from 3.43% to 4.36%.

The pound's performance during Q2 took us by surprise. On a trade-weighted basis, it gained a further 3.7% after a rise of 2.5%. Against the US dollar, the bounce in the pound was 2.9%, whilst against the euro, it was 2.25%.

*M4 money supply is the measure of coins and notes in circulation and in bank accounts.

Chart 1: £/$ exchange rate – daily chart



Source: Bloomberg

The big questions for the pound to answer in Q3:

1. Can it stand up against a US dollar revival, given the Federal Reserve appear in no hurry to cut interest rates?
2. Will the UK's financial stability risks intensify?

US

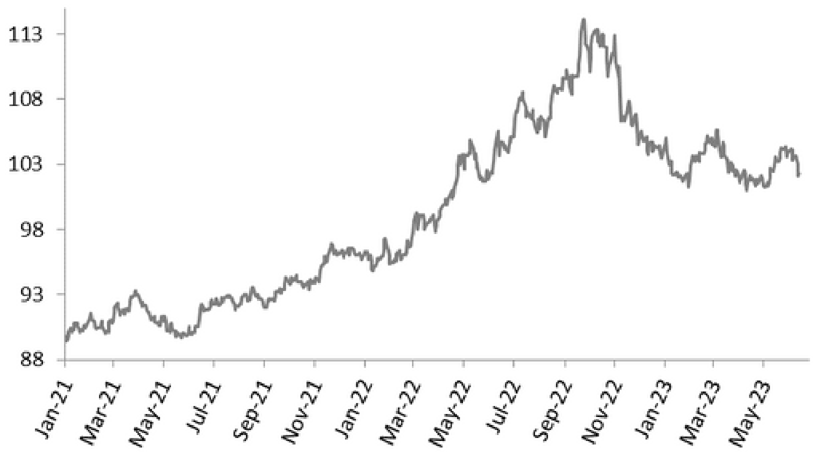
- The Federal Reserve raised the Fed Funds rate from 5% to 5.25% (upper bound) but paused at the June meeting.
- US CPI headline inflation dropped from 6% YoY in February to 4% in May. Core CPI inflation has also come down but is proving to be stickier than the headline rate.
- US GDP increased by 1.3% QoQ annualised in Q1 figures, but there are signs of a slowdown in activity with weaker retail sales and industrial production lately.
- The US avoided debt default, but as a result, the US government will be constrained in spending. Non-defence spending is expected to be flat in 2024 and grow by just 1% in 2025.
- US M2 money supply** is 4.6% lower on a YoY basis in April figures.

The Fed pause but warn of more hikes to come

The US dollar’s bumpy ride continued in Q2. On the dollar index (DXY), it began the quarter at 102.506, and it ended the quarter fairly close to that level. However, it lost ground to the likes of the UK pound, euro, Swiss franc and Canadian dollar but made gains against the Chinese renminbi and Japanese yen (more than 5% versus the yen). The US dollar has struggled to hold onto any progress in Q2, and Q3 could see a similar pattern emerge. Risks at the beginning of the quarter are more US dollar losses.

** M2 money supply is the U.S. Federal Reserve’s estimate of the total money supply, including cash, deposits in checking accounts, savings accounts, and other short-term saving vehicles.

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



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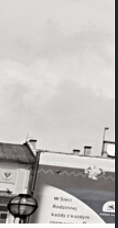


Euro Area

Signs of weakening in data towards the end of Q2 after Q1 signals a recession for the Euro Area

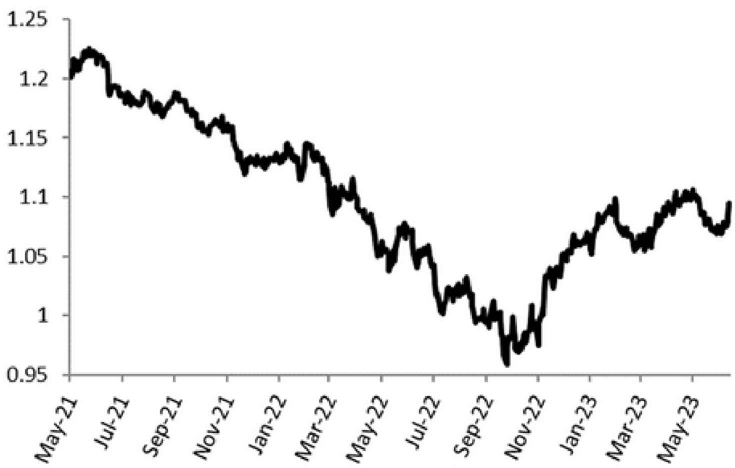
The Euro Area Q4 headlines were as follows:

- European Central Bank hikes refinancing rate to 4% from 3.50%.
- Q1 GDP fell on a quarter-on-quarter basis, signalling a technical recession.
- Euro CPI headline inflation falls back to 6.1% YoY in May (from 8.5% in February). Core CPI inflation fell to 5.3% in May from 5.6% in February.
- Euro inflation expectations dropped back sharply in April, undermining the central bank's confidence in the need for many more rate hikes.
- Industrial production fell sharply in March and recovers only around a quarter of the lost output in April.

Q2 saw more hikes from the European Central Bank but also a decrease in both headline and core CPI inflation rates. There were also signals from data and surveys of a loss of economic momentum. Concerns around Europe's banking sector have faded, but money supply growth is virtually non-existent, which could signal an impending credit squeeze.

The euro struggled for much of Q2. Against the pound, it shed around 3% of its value, and whilst it gained versus the US dollar, that was more dollar weakness than euro strength. Even the prospect of higher Euro Area interest rates in Q3 may prove insufficient to support a euro rally. Certainly, the confidence of European central bankers around the economy was misplaced, with the recession that they thought wouldn't happen confirmed when Q1 GDP data got revised sharply lower in late Q2.

Chart 3: €/$ exchange rate – daily chart



(source: Bloomberg)

Key messages for Q3 '23

- Can the UK sustain its positive momentum? Currency volatility could be increased by greater economic uncertainty as the rate increases continue to bite. Will we see the pound peak around \$1.30 and €1.1850?

- Are predictions of higher interest rate peaks unrealistic? Across the major Western economies, the doubters over the sustainability of restrictive monetary policy are getting louder.

- Expect a further drop in energy prices. Supply chains are no longer restrictive, and OPEC is behind in its production cuts, given the drop in global demand.

- Do we hit \$1.15 or \$1.05 in €/\$ first? I think the risks are more to the downside.

- Keep an eye on both the renminbi and yen versus the US dollar. The Chinese currency could weaken beyond ¥7.35, and the Japanese yen could head back through ¥147.50.

Thank you for reading

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