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Weekly Report

Weekly FX Market Update

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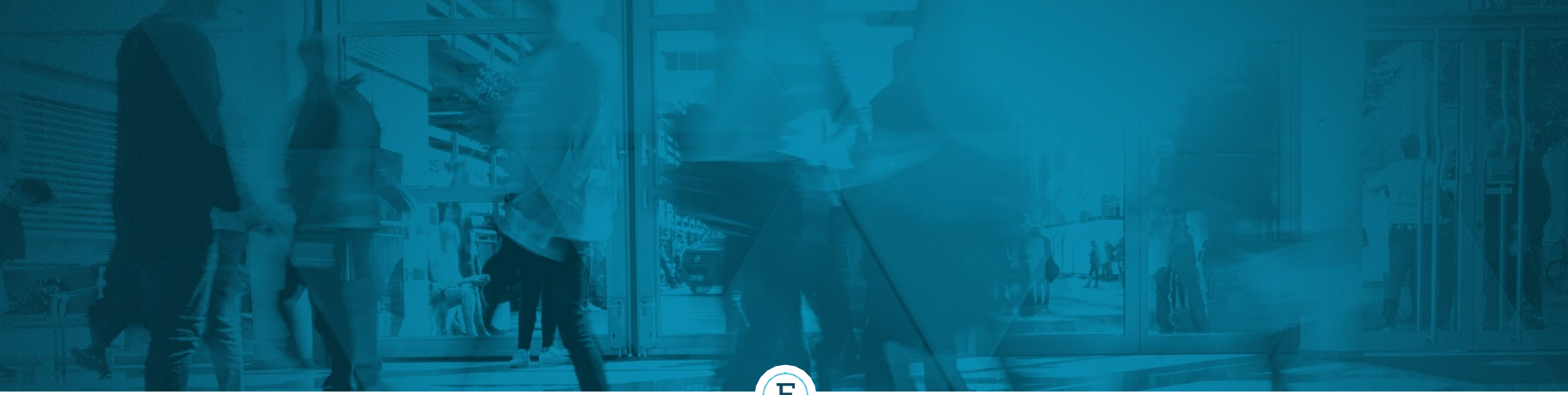


Inflation worries send bond yields higher, dollar lower

Inflation fears were further stoked by a massive upward surprise in quarterly inflation out of New Zealand last week.

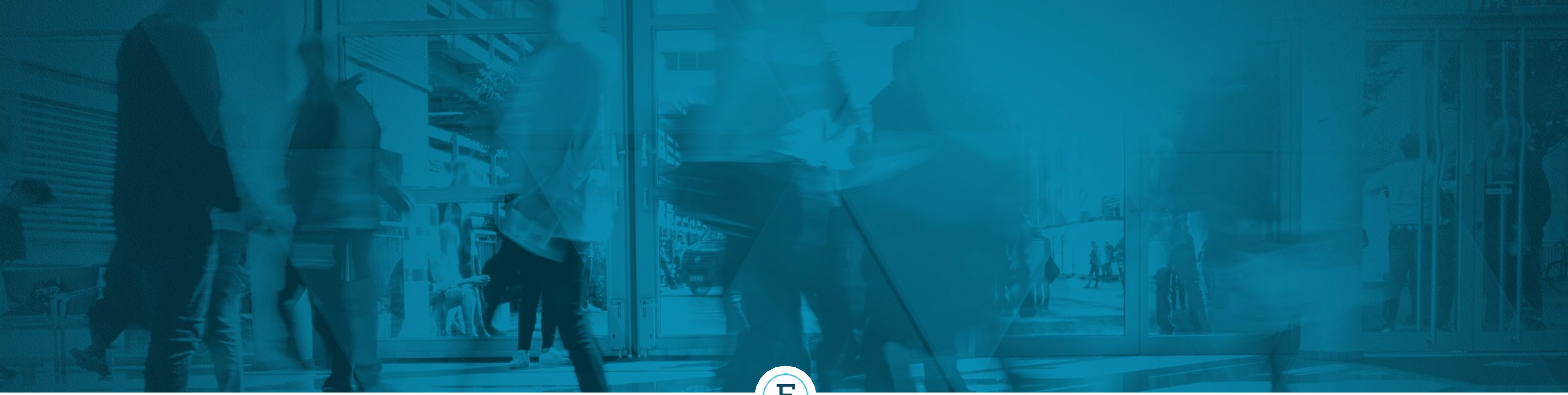
Sovereign bonds worldwide continue to sell-off, but as yet risk sentiment and, in particular, stock prices are proving resilient, as investors bet that corporations are well-placed to pass costs along and benefit from extremely stimulative monetary policy. The dollar's relationship with rising inflation expectations remains uneasy, and the greenback fell against every other G10 currency except the Canadian dollar. The Chinese yuan deserves a special mention, as it continues to ignore real estate troubles in China and rises relentlessly against all of its major peers.

We expect the key event for currency markets this week to be the ECB October meeting on Thursday. Market expectations have been guided downward by recent dovish communications. Any hint that a hawkish faction is developing in the Council could be supportive for the euro. Also key will be the Eurozone preliminary inflation number for October out on Friday, and US third quarter growth and inflation numbers, on Thursday and Friday respectively.

GBP

Bank of England Governor Bailey and Chief Economist Pill suggested last week that a hike in interest rates may be on the cards as early as the next meeting of the MPC in early-November. Futures markets have reacted aggressively, and are now fully pricing in the first pandemi era rate hike at next Thursday's MPC meeting. We expect to see a 15 basis point move in rates, with another 25 basis point hike now looking likely to follow in February.

Strong increases in house prices and overall inflation continued in October and September respectively, while the PMIs also surprised pleasantly to the upside last week, despite ongoing supply shortages. All in all, the rather muted reaction to the positive news in sterling is a bit puzzling, albeit the UK currency continues to trade just shy of its strongest position since mid-September versus the dollar. This week, all eyes should be on the release of the UK government's budget on Wednesday. We will be paying close attention to the impact of sooner-than-expected interest rate hikes on the government's updated growth forecasts.



EUR

In contrast to the US and the UK, the Eurozone PMIs slipped, although they remain at high levels consistent with continued strong growth. The key event for this week is, of course, the European Central Bank's October meeting on Thursday. Once again, no change in policy is expected, and the focus will be on communications from the council, with markets expecting a very dovish ECB.

However, it's worth noting that the gap between the ECB's September projections for future inflation and reality has only widened. Another increase is expected when the October preliminary data is released the day after the ECB meeting. Given market expectations, even a neutral tone from President Lagarde would probably result in a sharp euro rally.

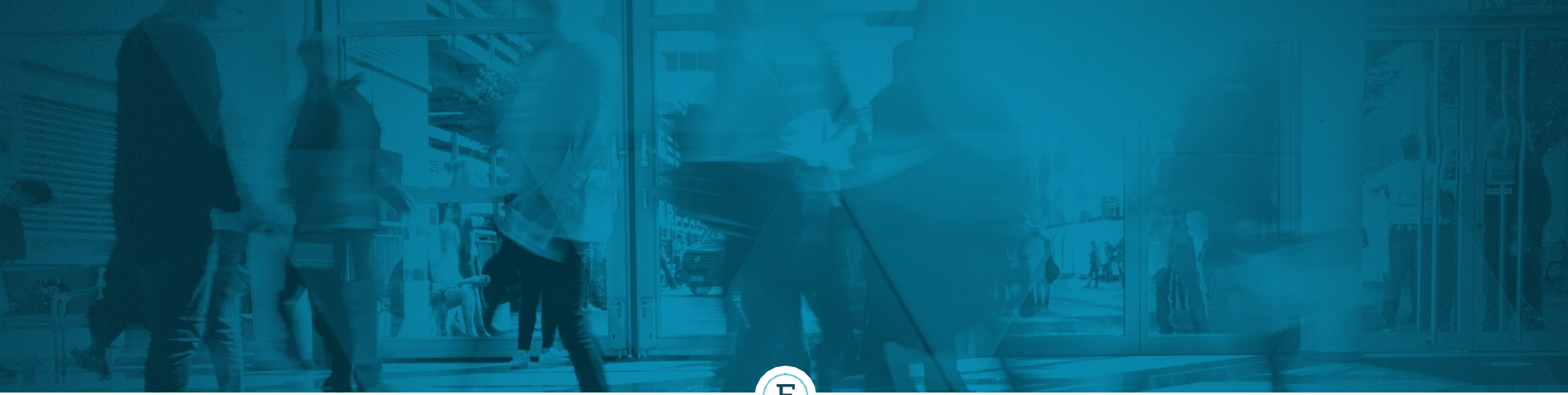
USD

While higher Treasury rates have usually been a positive for the US dollar, on this occasion this backup is being entirely driven by rising inflation expectations rather than hope for better real returns. Chair Powell last week all but confirmed that the taper will begin in November, but this provided little help to the greenback, which dropped against most of its G10 peers.

This week's combination of third-quarter growth and inflation data should provide clarity on the stagflation issue; we are of the view that the current environment is clearly inflationary, but also relatively growth friendly, and expect positive surprises on both fronts. We still see plenty of room for market's projections of Fed hikes to be brought further forward in time, in spite of recent moves in that direction.

CHF

The franc continued to advance against the euro last week, briefly touching its strongest position since July 2020. Relative to its safe-haven counterparts, the Swiss franc has proved remarkably resilient in the past few weeks, even during periods of risk-on trading, which would ordinary see the currency sell-off. We think that this outperformance may perhaps be due, at least in part, to rising expectations for SNB interest rate hikes. Futures markets are now pricing in the first pandemic era rate hike in Switzerland in September 2022, considerably sooner than the Bank of Japan, the fellow safe-haven in the G10.



Thursday's ECB meeting is likely to be a highly important one for the franc, given that the Swiss National Bank has typically followed the Governing Council's example when setting its monetary policy. A hawkish shift from the ECB could further bring forward expectations for SNB hikes, and that could support the franc against most of its G10 counterparts.

AUD

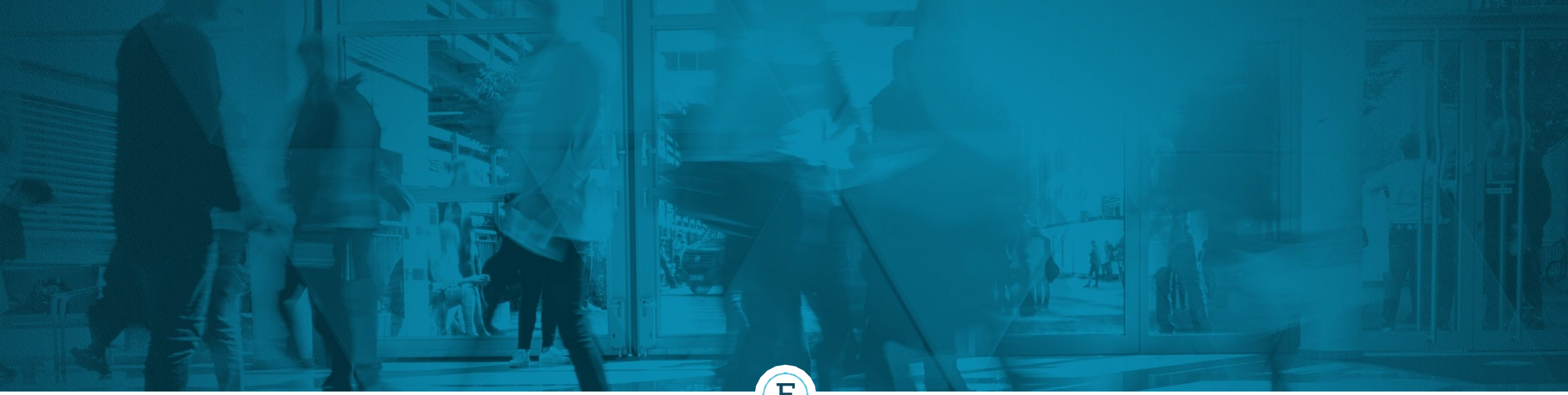
The Australian dollar traded at a more than 3 month high versus the USD last week, driven by strong commodity prices and rising domestic yields, which rose to levels not seen in almost seven months. The RBA's October meeting minutes published last week noted that the outbreak of the delta variant of COVID-19 had interrupted the recovery of Australia's economy, with available data pointing to a contraction in activity in Q3. Policymakers do, however, expect the economy to return to its recovery path in the current quarter and reach pre-delta growth levels in mid-2022. The board reiterated its view of no hike in the 0.1% cash rate until 2024, although markets continue to ignore this, and are betting on interest rate hike as soon as mid-2022.

Meanwhile, Australia's composite PMI rose to a four-month high of 52.2 in October from 46 a month earlier according to the flash estimate published on Friday, the first expansion since June. This Wednesday will see Australia's third-quarter inflation published, followed by the publication of September retail sales on Friday.

CAD

The Canadian dollar traded around the 1.23 mark versu the US dollar last week, close to levels not seen since early-July, as oil prices remained close to multi-year highs. CAD was also supported by Canada's 10-year government bond yields, which rose to levels not seen in almost two years. The annual inflation rate in Canada rose to 4.4% in September from 4.1% in August, reaching its highest level in almost two decades, largely a result of rising transportation costs and food prices. This inflationary environment adds pressure to the central bank's plan to keep interest rates close to zero until the second half of 2022, with market expectations pointing to a rate hike in April. Retail sales, which were published last Friday, increased by 2.1%, more than market estimates of a 2% increase, with sales higher in 9 of the 11 sub-sectors as social distancing restrictions were unwound.

The most important event for the Canadian currency this week will be the Bank of Canada monetary policy meeting on Wednesday. On Friday, August GDP data will be published, although this runs on a lag and will likely be largely ignored.



CNY

The yuan rose sharply at the beginning of last week, with the USD/CNY pair sent crashing below the 6.40 level for the first time since June. Indeed, the weekly gain in CNY was the largest in five months, in large part due to strong corporate dollar selling. Market jitters surrounding the ongoing situation in China's real estate market have also eased of late, which is helping provide a bit of assistance to the yuan. The People's Bank of China has looked to calm market concerns this month by stressing that the risks posed by Evergrande's imminent collapse are 'controllable', and that authorities would both protect consumers and provide financial support to prevent construction disruption. This support our view that the fallout from the crisis will be small, and the impact on the yuan minimal.

With no macroeconomic data out of China this week, we think that the yuan will be driven largely by events elsewhere, notably expectations for next week's November meeting of the Federal Reserve.

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