Economist's Weekly Market View

Tuesday, 18th January 2022

Solid Sterling

The dollar and sterling made good gains in the second half of 2021, on the back of a firming of rate hike expectations in both their economies. The dollar made significant ground against a broad range of currencies, rising by more than 5% on a trade-weighted basis. The euro fell from $1.22 last June to a low of $1.12 in November. Meanwhile, sterling strength was less pronounced, though, the euro has declined to below 84p from around 87p in the middle of 2021.

The general view had been that both the dollar and sterling would remain well underpinned in 2022, with the US Federal Reserve and Bank of England embarking on rate tightening cycles. Rates are expected to rise by close to 100bps in both economies in the coming year. Sterling has been firm over the past month, with the euro dropping towards a key support level of 83p in early January.

The dollar, though, has lost some ground against a broad range of currencies since the start of the year. The EUR/USD rate has risen a $1.14-1.15 range, while sterling has climbed to $1.37 from $1.32 before Christmas. One explanation is that the market ended 2021 very long the US currency. Traders may now be looking to exit dollar positions after the gains made since mid-2021 and with the market having moved to price in a considerable amount of Fed tightening over the course of 2022-23. It is also the case that rates are rising in other countries as well, lessening the dollar's attractiveness. Indeed, some central banks have already started to tighten policy.

It could also be a more general signal by markets that the worst of the Pandemic is behind us. The dollar is typically a counter-cyclical currency, which strengthens at times of stresses in the world economy and loses ground as global growth recovers. Expectations that the risks to economic activity posed by Covid-19 are abating, resulting in solid global growth, should reduce demand for safe-haven currencies, like the dollar.

Headwinds for the dollar, such as concerns about the large US fiscal and balance of payments deficits can also come to the fore in such circumstances. We don't envisage a major fall in the dollar though, as it should be supported by higher US interest rates. Thus, the EUR/USD rate may trade in a $1.13-1.17 range in the coming months.

Sterling has not been a popular currency in recent years as a result of concerns over Brexit, but it did stage a good recovery in 2021 as these worries subsided. Market positioning was still quite short the currency entering this year, so it is no surprise that it has appreciated further recently. It could continue to outperform in the coming months while market positioning adapts to the more hawkish policy stance by the Bank of England.

The 83p level is a strong support level for the euro, though, which will be a challenge for sterling to overcome. Furthermore, there are mounting risks to UK growth from the spring onwards as a result of a tightening of both monetary and fiscal policy, including higher taxes, as well as further increases in energy bills. This could limit the upside for the currency.

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