



Sensitivity on markets to key data

There was a clear example last week of the sensitivity of financial markets to data releases which form a crucial input into the policy deliberations of central banks. With the main central banks no longer providing explicit forward guidance, markets are more reactive to such data, as investors try to get a sense for the direction and timing of the next moves on the monetary policy front.

The specific example last week was US CPI inflation data for October. The headline CPI rate for October printed at 3.2%, from 3.7% in September, representing a modest undershoot of the 3.3% consensus forecast. Similarly, the core CPI rate eased to 4.0%, from 4.1% and versus market expectations for an unchanged 4.1% reading.

Although, the CPI inflation figures were only slightly below expectations, they prompted quite a reaction across a raft of asset classes. On bond markets, US Treasury yields fell sharply, which led to a fall in yields elsewhere. The 10-year US Treasury yield fell below the 4.5% mark. It had started this month up nearer to 5%.

At the same time, there was a softening in US rate expectations in two aspects. Firstly, the market is no longer assigning any sort of meaningful chance that the Fed will hike again. Prior to the release of the October inflation numbers, the market was attaching around a 30% probability of another rate hike from the US Federal Reserve.

Secondly, futures contracts have moved to price in between 90-100bps of rate cuts from the Fed in 2024, with the first reduction envisaged by mid-year. At the start of last week, the market was anticipating rate cuts in the region of 75bps. Elsewhere, equity markets rallied on the prospect of greater rate cuts and falling yields.

Meanwhile, the dollar's reaction was also noticeable. Against the backdrop of the sharp fall in Treasury yields and a softening in US rate expectations, the greenback fell by over 1.5% against a raft of other currencies.

In level terms, the EUR/USD pair rose from being down near \$1.07, to operating up at the \$1.09 threshold. Similarly, GBP/USD went from trading below the \$1.23 mark, to a high up close to \$1.25.

Over the last 2 years, the dollar has been very much in the ascendancy on currency markets. An aggressive pace of rate hikes from the Fed helped the currency hold the upper hand from mid-2021 and throughout most of 2022.



Meantime, while it had retreated from its 2022 peaks, the dollar's performance year to date in 2023 has seen it remain at elevated levels, aided by the strong outperformance of the US economy and associated high level of US interest rates/ Treasury yields.

Last week's downward pressure though, serves to highlight some potential downside risk facing the dollar over the coming quarters. In a scenario where US inflation remains on track to get back towards the 2% target before the likes of the Eurozone and UK, and if US economic outperformance reverses, it opens up the possibility of the Fed lowering rates at a quicker pace than elsewhere.

This would create a more challenging backdrop for the currency, where incoming macro newsflow and interest differentials work against the dollar, in contrast to much of the last 2 years. At the moment though, the US economy continues to perform solidly and if this persists it could help the dollar to remain at relatively elevated levels against the likes of the euro and sterling.

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