Sterling under the Cosh

Most of the main central banks are no longer providing forward guidance on rates. The main steer on interest rates the market now has from monetary policymakers is that they have a willingness and appetite to raise rates considerably further from their current levels to deal with elevated and persistently above target inflation.

In other words, markets know that official interest rates are going much higher, but they don't know the full extent of the tightening cycle. Central bankers removed more detailed communications on rate hikes to protect their credibility and retain flexibility in deciding the magnitude of rate hikes required, in light of the uncertain inflationary and macro environment.

Indeed, both the US Fed and ECB ended up hiking rates at meetings during the summer by more than they had previously guided to the market. As a result, central banks have adopted a data dependent, meeting-by-meeting approach to their decision on the size of rate hikes.

However, this means that markets are now more reactive to economic news flow and inter-meeting comments from central bankers, as they try to ascertain the size of upcoming rate hikes. This sensitivity to data was clearly in evidence last week when the US CPI inflation report for August surprised to the upside of expectations. Headline inflation printed at a higher than forecast 8.3%, while underlying core inflation rose by more than anticipated, to 6.3%.

The market reaction was swift and aggressive. The policy sensitive 2-year Treasury yield rose by around 20bps. The market moved to fully price in a 75bps rate hike at this week's Fed meeting, with some talk of a 100bps move. On Wall Street, the S&P 500 declined by over 4% on the day, its biggest fall in two years.

Currency-wise, the dollar rallied, gaining around 1.5%. The EUR/USD pair fell from a high of $1.018 to back below parity, to a low of $0.996. At the same time, GBP/USD went from $1.17 to struggling to hold onto the $1.15 mark.

However, while firming rate expectations have been supportive of the dollar, this has not been the case for sterling. Despite, market expectations of at least a 50bps hike and possibly a 75ps rise in rates from this week's Bank of England meeting, as well as anticipating UK rates rising to as high as 4.5% in 2023, sterling has been under sustained downward pressure recently.

It appears currency watchers are more concerned about the very weak outlook and vulnerabilities in the UK economy. In this regard, last Friday's weaker than expected UK retail sales data for August saw sterling fall to a near forty year low of $1.135 versus the dollar, while the EUR/GBP pair traded up to a high near 88p.

The global macro outlook will continue, at least in the near term, to be defined by a heightened level of concern regarding the evolving economic and inflationary environment, with continuing volatility on financial markets. Such a backdrop is usually supportive of the dollar and negative for sterling. From a EUR/GBP viewpoint, this could see the single currency rise further towards the 90p level in the weeks ahead.

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