CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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Dollar on the defensive

While global trade and fiscal policies were very much front and centre of market discourse and action last week, there were also important developments in relation to monetary policy. Specifically, the European Central Bank (ECB) cut rates by 25bps at its March Governing Council meeting, lowering the Deposit rate to 2.50%.

With the cut to rates fully priced in by markets, the key point of interest for investors, was what guidance, if any, would be forthcoming from the ECB on the future path of official rates. In this regard, the meeting statement continued to emphasise that the central bank will follow a "data-dependent" approach. However, there was a significant change to the statement, with the ECB now stating that "monetary policy is becoming meaningfully less restrictive".

In other words, the extent of further rate cuts is likely to be limited. On top of this, ECB President Lagarde stated that, "if the data points to a pause, we will pause, if the data points to a cut, we will cut". Thus, while the ECB maintains a willingness to cut rates again if warranted, the direction of monetary policy has become less clear.

In terms of market expectations, futures contracts suggest traders anticipate around 40bps of further policy easing from the ECB over the remainder of this year. This would see the Deposit rate end the year near 2%.

From a currency perspective, the euro shrugged off any potential downside from the ECB rate cut. Instead, the standout mover on Forex markets last week was the dollar, which lost between 2-4% on the exchanges.

Since the autumn, US growth outperformance and interest rate differentials have underpinned the dollar. However, these drivers have reversed in the last week or so amid trade policy uncertainty and softer US macro data. The market is now envisaging a greater degree of rate cuts from the US Federal Reserve.

At the same time, the euro has benefitted from a number of developments. The recently announced European Union plans to increase defence spending and a seismic expansionary shift in Germany in relation to defence and infrastructure spending, has seen Eurozone swap rates/yields move significantly higher. These spending plans have also improved medium-term growth prospects for the region, although the near-term outlook remains challenging.

In level terms, the weaker dollar and stronger euro was reflected in the EUR/USD pair trading up above the $1.08 level to its highest mark since November. It had started this month below $1.04. Likewise, dollar weakness was evident in GBP/USD moving up into $1.29 territory. Meanwhile, the euro also made gains versus sterling with the EUR/GBP pair moving back up to the 84p threshold.

These sharp moves, over the last week or so, highlight the increased sensitivity of currency markets to geopolitics and global trade newsflow. With no sign of any let up on these issues in the near term and given the monetary policy outlook has become less clear, volatile trading conditions may persist on the currency front.

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