Authors

Simon Harvey
Senior FX Market Analyst
+44 (0)203 650 6472
Simon.Harvey@monexcanada.com

Olivia Alvarez Mendez
FX Market Analyst
+34 91 198 84 47
Olivia.Alvarez@monexcanada.com

Ima Sammani
FX Market Analyst
+31 (0)20 808 3644
Ima.Sammani@monexcanada.com

Bank of England in focus after inflation overshoots and labour market progress

Summer trading looks like it may have finally arrived in markets considering the below-average levels of liquidity and limited intraday volatility in FX markets despite the deluge of data this week. The first half of the week, headlines around Chinese regulations and equity markets weighed on risk sentiment. The most notable FX moves however occurred in the second half of the week and were centred around the US dollar after the Federal Open Market Committee noted there has been progress in the economic recovery but it wasn't substantial enough to bring forward the discussion of QE tapering. Also in the US, Q2 preliminary GDP figures surprised to the downside relative to analysts' expectations, further applying pressure on the greenback. On the fiscal front, bipartisan Senate negotiators reached a deal on an infrastructure package and the chamber voted to advance it, setting in motion a final vote on the bill in the coming days. Elsewhere, a slip in Canadian CPI figures weighed on the loonie's rally as inflation data begins to moderate and embolden claims that the overshoot is in fact transitory. Next week, the focus will be on the Bank of England to announce its policy decision and comment on the recent inflation overshoots and recovery in the labour market.

Calendar

Monday – 02/08

Monday's data dock will be filled with Purchasing Managers' Index figures from several countries, starting with Russia and Sweden at 07:00 and 07:30 BST respectively. Russia's manufacturing PMI will be key for markets after last month's reading showed a slowdown in momentum. Russia's current Covid wave has so far mildly impacted economic data despite the virus wave being quite severe, and Monday's data will show whether the slowdown in momentum will be prolonged.

Between 08:00 and 09:00 BST, manufacturing PMIs from several euro area countries will be released. France and Germany are set to announce final readings, while for Spain, the Netherlands and Italy it concerns first readings. The figures are expected to remain close to June's levels. **At 14:45 BST, IHS Markit** releases final manufacturing PMIs for the US. Previously, they came in at 63.1.

The **dollar** may be more sensitive to larger downward revisions especially after this week's **Federal Reserve meeting** and the slip in **US GDP data** pushed back on policy expectations for the Fed.

Tuesday – 03/08

The Reserve Bank of Australia announces its policy decision at 05:30 BST on Tuesday. Given the recent virus developments and the reimposition of lockdown restrictions, the Bank is likely to keep policy unchanged until uncertainty has abated, while the growth and inflation forecasts will likely be adjusted to account for the prolonged lockdowns and subdued economic activity. **Markets will then focus on Turkish inflation at 08:00 BST.** The headline figure is expected to print at 18.7% YoY up from last month's 17.5% as a recent fuel tax hike and a weaker currency push up expectations for stronger price growth. The CBRT pledged to keep the policy rate above both actual and expected inflation, which means that with the current benchmark of 19%, the odds for a rate hike during the August meeting are small. **Factory orders and durable goods orders from the US at 15:00 BST** will then be watched by markets. The US dollar could be more responsive to downward surprises given the pushback on policy expectations since Wednesday's Fed meeting.

Wednesday – 04/08

Russia services PMI at 07:00 BST may show the impact of the recent virus wave to a higher extent than the manufacturing figures on Monday, as the services sector is more sensitive to lockdown restrictions and arguably also consumer behaviour when cases rise. **The Brazilian Central Bank meets on Wednesday at 22:30 BST**, with the median consensus pointing at a full-point hike to the Selic rate, following three consecutive 75bp hikes since March. The aggressive hiking cycle in Brazil comes on the back of rampant inflation, which currently sits at 8.35%, up from 2.13% a year ago.

> With the policy rate currently at 4.25%, the **BCB** has still some room left to tighten the policy stance, which is a strong underlying factor behind the real's resilience over the last few months.

Thursday – 05/08

Germany's factory orders will be announced at 07:00 BST and are expected to have slipped in May. Global supply chain frictions have weighed on output in the past months, as shown by the flash estimate of German Q2 GDP, which printed below expectations at 1.5% QoQ. **France's industrial production will then be released at 07:45 BST** after last month's print contracted with 0.3%, with similar supply chain disruptions weighing on the recovery. **At 12:00 BST, the Bank of England will announce its policy decision.** The recent overshoot in inflation and progress in the labour market recovery makes Thursday's BoE meeting a live event. Comments from MPC members Ramsden and Saunders suggest there is greater appetite to now end QE earlier than year-end, but with economic activity stalling since their speeches, we don't think the consensus for halting net purchases earlier will be significant enough for the Bank to change course.

Initial jobless claims will then be on the agenda at 13:30 BST after claims dropped slightly to 400,000 for the week ending July 24 down from a revised 424,000 previously. The drop from that two-month high indicates the underlying trend is likely still downwards, though the spread of the delta variant raises concerns around new layoffs in harder hit states and sectors. **At 17:00 BST, Russian headline inflation is expected to print at 6.6% YoY while the core reading is set to grow further to 6.8%.** Weekly data shows signs of inflation stabilising somewhat after the sharp acceleration seen in recent months. This is due to several aggressive rate hikes from the Central Bank of Russia since March, and the CBR is set to hike rates further in September. For the CBR, the details of the report will be key in gauging if the fading price pressure is reflective of the economy and sufficient enough to soothe concerns over inflation surges.

Friday – 06/08

German industrial production at 07:00 BST is expected to print at 1.0% and will be the final industrial output data from Q2. Supply constraints have likely weighed on output in June and this has been priced in already, which means markets may choose to look past the data print if it undershoots expectations. **Additionally, there will be industrial output figures from Spain and Italy at 08:00 and 09:00 BST**, where the impact of the supply chain disruptions is likely to be visible too**. In the afternoon, all focus will be on the Non-farm Payrolls from the US.** With median expectations pinned for the larger monthly job creation so far this year, a negative surprise cannot be ruled out. However, as markets read into the Fed's patient stance on tapering talks, the downside risks on yields and the USD are relatively limited. More on this topic is explained below.

Bank of England preview

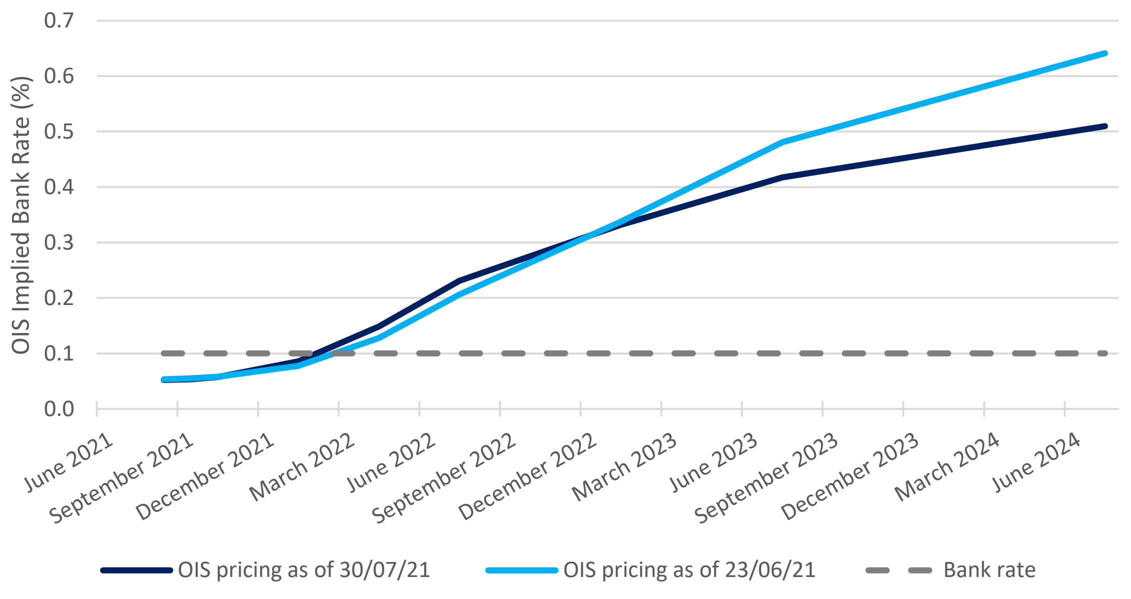
Dissent within the ranks, but not enough to halt QE prematurely

The exit of Chief Economist Andy Haldane after the June meeting hasn't left the Monetary Policy Committee absent of a notable hawk. Since Haldane's exit, both Michael Saunders and David Ramsden have come out in favour of removing some monetary stimulus earlier than the current year-end projection as inflation exceeds both the Bank's target and their May projections in Q2. Of the two, Saunders has come across the most hawkish by stating that it may "become appropriate fairly soon to withdraw some of the current monetary stimulus". On the other hand, Ramsden was less explicit with his messaging, stating that conditions are ripe for merely considering an earlier tightening. With both members altering their stance from their previous voting patterns as inflation rises,

> With both members altering their stance from their previous voting patterns as inflation rises, Thursday's meeting becomes less of a formality for financial markets. The magnitude of the shift in the voting split will be a key area of focus in the rate statement.

Given the rise in Covid cases since both speeches and real-time data suggesting economic activity moderated due to the deteriorating health backdrop, it is unlikely that both Ramsden and Saunders will vote for an earlier tapering of the QE programme. Our base case assumption is that the committee will vote 8-0 in favour of holding rates at 0.1% and 7-1 in favour of completing the existing £875bn programme of bond purchases as opposed to ending net purchases earlier. Given Saunder more hawkish stance in recent communications, we deem him as the most likely to vote against the consensus. However, given the slump in near-term economic activity due to the latest Covid wave, there is a risk that the committee unanimously votes to maintain their current stance until conditions stabilise. This would arguably be net dovish for markets, especially as overnight index swaps are currently pricing in a 15bps hike by the BoE to 0.25% as early as H2 2022.

Market pricing of interest rate lift-off has become more aggressive since June's meeting as inflation data overshoots and the recovery in the labour market exceed expectations



Monetary Policy Report to show inflation forecasts have been upgraded, but Q2 growth upgrade hampered by latest Covid wave

Beyond the voting patterns, financial markets will keep a close eye on any adjustments to the Bank's forecasts. Since May's Monetary Policy Report, inflation has substantially overshot the Bank's previous forecasts, while the labour market recovery has also exceeded expectations. Headline CPI has averaged 2.1% in the second quarter – 0.4% above the committee's forecast in May's MPR – while June's inflation rate shot up to 2.5%, exceeding May's estimate of the peak inflation rate of 2.5% in Q4. The incoming upwards revision in the inflation data was signalled in June's meeting minutes, with officials stating that CPI is likely to exceed 3% for a temporary period.

While financial markets will look through the revisions in the near-term due to policymakers labelling the inflationary overshoot as "transitory", the same can't be said for the medium-term where inflation forecasts are used to signal future policy moves. Any upwards revisions to the 2022 and 2023 CPI readings are likely to result in markets pricing in earlier and more substantive rate hikes from the central bank.

Bank of England's May Monetary Policy Report forecasts

	2021 Q2	2022 Q2	2023 Q2	2024 Q2
GDP	21.5	7.1	1.4	1.1
CPI inflation	1.7	2.3	2.0	1.9
LFS unemployment rate	5.2	4.7	4.3	4.3
Excess supply/ demand	-1.25	+0.5	0	0
Bank Rate	0.1	0.1	0.3	0.6

This will especially be the case if the unemployment rate is revised down over the medium-term too. The chances of which are high given May's 4.8% unemployment rate was well below the MPC's 5.2% modal forecast, suggesting that the peak in the unemployment rate already occurred back in December 2020 as opposed to being on the horizon once the furlough scheme expires in September. The committee could offset this hawkish message by reversing June's upwards revision to Q2 growth, from 5.5% QoQ to something closer to May's projection of 4.3% QoQ. This is to reflect the impact of the Delta variant on recent economic activity.

Sequencing of normalisation may become clearer, but we don't expect staff paper until Q4 at the earliest

Back in February, the MPC asked staff to consider the appropriate strategy for tightening monetary policy. That is, whether raising interest rates to a level at which it is then preferable to reduce the Bank's balance sheet is still the optimal approach, or whether it is optimal to reduce the stock of the Bank's assets before/ while raising rates. Governor Bailey signalled his preference for the latter back in 2020, but with the MPC taking a conservative stance on ending QE thus far, with the potential exception of Saunders and Ramsden, we don't see the need for further forward guidance on the sequencing of monetary tightening given the amount of risks that remain to the economic outlook.

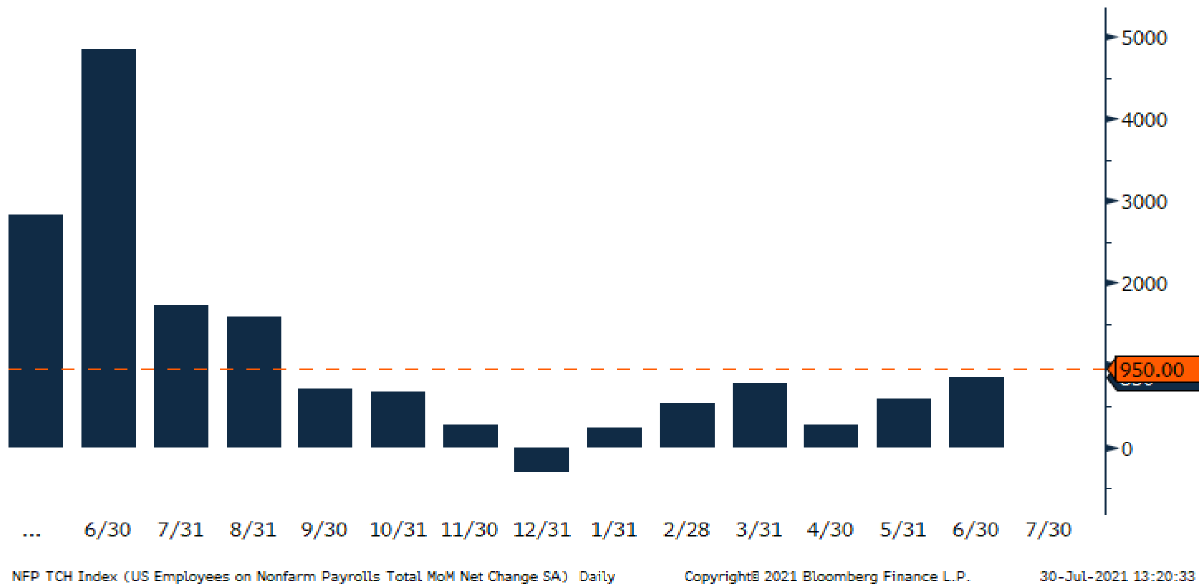
Beyond sequencing, the Bank is likely to update markets on whether negative interest rates are operationally viable.

Alongside which, the MPC may decide to re-evaluate its estimate for the effective lower bound, which in turn may have implications for the rate at which the BoE switches from raising rates to tapering its stock of assets if the same approach to the last period of monetary tightening is deemed optimal.

July NFP figures to set the tone for the tapering debate ahead of Jackson Hole

The highly anticipated Non-farm Payrolls report for July is out on Friday 6th amid a backdrop of lower-than-expected economic growth in the second quarter and a patient stance by the FOMC on the tapering debate. Sentiment across markets regarding longer-term growth has been weaker on the back of rising concerns about the spread of the delta variant, with 10-year Treasury yields trading among the lowest levels since February. Even though the Fed assesses that the current virus wave may have limited effects on economic activity, evidence of a slower recovery than anticipated has weighed on investor sentiment. In this context, a positive surprise in the NFP could boost the attractiveness of the US economic outlook, with a firm print indicating that the new strain is having little impact of the Fed's policy path too. However, a high bar for expectations means the data could easily disappoint, dampening market optimism further. The Bloomberg consensus forecasts a net employment gain of 925.000 jobs in July, far more than realised in any month this year and a 100,000-job increase relative to the previous month. While more people should return to the labour market as vaccinations progress and the economy reopens, lingering virus concerns and broad unemployment coverage is poised to limit the return of labour supply at the moment. For that reason, risks to the median forecast are tilted to the downside in our view.

Yet another high bar of expectations in NFP could be easy to disappoint



On the other hand, after a few disappointing NFP readings over recent months, markets may be desensitised to yet another weak figure, limiting the downside risk for fix income yields and the USD. Any under-delivery in the net employment reading shouldn't come as a huge shock to markets after a prudent communication by Jerome Powell, who highlighted that a large gap in jobs recovery might not be filled until after September, when unemployment benefits are set to fade away.

Even after that, a short period of frictional joblessness might weigh on employment levels, deeming a patient stance on the full labour market recovery as necessary. In the meantime, businesses have reported facing difficulty to fill opening positions, supporting the idea that transient supply restrictions are the main constraint behind the slow employment recovery while capacity remains spare.

Labour data remains key to the prospects of QE tapering being announced later this year, with the July NFP figure being the latest print ahead of the Jackson Hole Symposium on August 26th-28th.

> Even though consensus expectations pin the formal tapering agenda at December's meeting, a sufficiently **strong NFP reading** next week could embolden further calls on the normalization debate in the coming months.