09 August 2022

FX Strategy

Expansion, inflation and a strong USD

- **The US economy remains on a strong footing and the Inflation Reduction Act is unlikely to put an end to high inflation.**
- **We expect the Fed to hike to 3.75%, but if short-term inflation expectations do not moderate, it will likely need to hike more.**
- **Tighter monetary policy and the lingering global energy crunch render us confident in our call for EUR/USD to drop back below parity.**

Our brief take on the Inflation Reduction Act is that the US administration is taking ownership of a problem it lacks the tools to solve. There is still too much money chasing too few goods and services in the US economy, which is the root cause of the high inflation. The Federal Reserve has an inflation target and it decides when inflation returns to 2%.

Tackling high inflation risks sending the economy into recession, which might still be in the cards, but we doubt that a downturn hit the economy in the first half of the year, even though GDP shrunk two quarters in a row. Rather, we point to the remarkable feat that GDP almost returned to pre-crisis trend, i.e. fully recovered from the pandemic, and the resilience of private consumption and service production. Hence, we do not expect the drop in GDP to play a role in upcoming monetary policy decisions – they are about inflation.

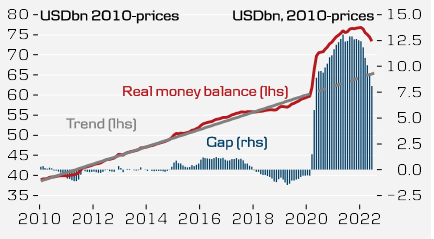
Is the glass half full or is it half empty? Headline CPI inflation likely eased to around 0.2-0.3% m/m in July, while core inflation remained elevated around the 0.5% m/m level. Even if inflation turned out lower than expected in July, we think the body of evidence justifies staying the course of swift monetary tightening, but how much more tightening is left?

In our view, the Federal Reserve needs a positive real interest rate to get inflation back down to 2%. With short-term inflation expectations currently in the range of 4-6% in various market and survey based measures, the Federal Reserve has more interest rate hiking to do. In our base case, another 75bp rate increase awaits in September followed by two additional rate hikes of 25bp in November and December leaving the Federal Funds rate in the 3.50-3.75% range. That is about in line with current market expectations.

However, if short-term inflation expectations do not moderate over the coming months, the Federal Reserve will likely need to hike more and extend the hiking cycle into next year. Hence, we see potential for the Federal Reserve to raise interest rates by more than what the market discounts and in particular on a 3-9M horizon. In contrast, we think the market discounts too many interest rate increases from ECB over this period. Hence, we see upside potential to EUR/USD FX swaps.

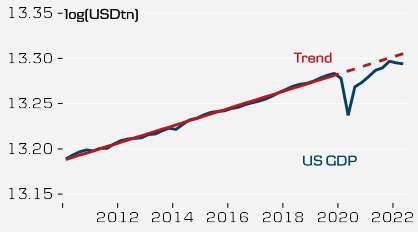
Besides tighter monetary policy, the USD feeds off the positive energy terms of a trade shock to the US economy. As the heating season begins in a couple of months, US LNG exporters sit on the winning end of Russia's threat to shut down natural gas exports to the EU. Consequently, we are confident in our call for EUR/USD to drop back below parity over the coming months. We forecast EUR/USD at 0.95 in 12M.

Chart 1. Big real money balance gap keeps inflationary pressures high



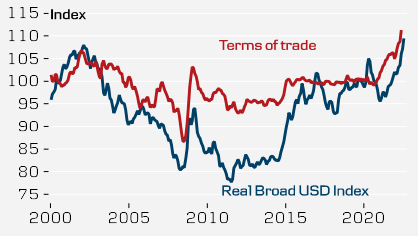
Source: Macrobond Financial

Chart 2. Remarkable return to trend



Source: Macrobond Financial

Chart 3. Big positive terms of trade shock



Source: Macrobond Financial

Chief Analyst
Jens Nærvig Pedersen
+45 4512 8061
jenpe@danskebank.dk

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Jens Nærvig Pedersen, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 9 August 2022, 09:55 CET
Report first disseminated: 9 August 2022, 10:45 CET