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Macro backdrop of slower growth and rising inflation set to dominate FX markets

This week, markets have been fixated on rising energy prices and the impact it is having on inflation, and in turn the global growth outlook. The dollar has reigned supreme in this environment, with the DXY index rising to the top of its new range throughout the week as yields are driven higher by breakeven rates. Even the short-term increase to the debt ceiling failed to support the risk environment towards the end of the week ahead of key labour market data from Canada and the US. Amid this background, central bank commentary generally had a limited market impact. Hawkish tones from the Bank of England's Chief Economist Huw Pill failed to give the pound much direction, while rumours that the ECB is set to create a new QE programme to limit the impact of the PEPP expiration only partially weighed on eurozone yields. However, the National Bank of Poland did surprise markets with a 40bps rate hike on Wednesday, which resulted in the Polish zloty rallying over a percentage point against the euro.

Next week, the relatively light data calendar focuses on output data in Europe, with **euro-area industrial production and UK GDP** for August pencilled in, and central bank policies in Asia. While in the US, **inflation data** occupies the data calendar.

Calendar (all times BST)

Monday – 11/10

The week starts on a light note given North American markets are closed for the day. In Canada, market participants will be celebrating Thanksgiving, while US markets are closed for Columbus day.

The sole data point of note for the day is **Norwegian CPI for September at 07:00**. The Norges Bank expects headline inflation to rise from 3.4% to 3.9% YoY due to higher energy prices, but underlying inflation to also rise from 1% to 1.2%, reflecting higher capacity utilisation, stronger wage growth and second round effects of higher energy costs. Any upwards surprise in underlying inflation may promote speculation of faster tightening by the Norges Bank.

Tuesday – 12/10

The data calendar picks up on Tuesday with **UK labour market data for August at 07:00**. The lagged data for the 3-months up to August is likely to show a continued decrease in the unemployment rate, with 200k rolling quarterly net employment gain expected. However, the data won't give markets any indication as to how disruptive the expiration of the furlough scheme was to the labour market recovery until December/ January. Then at **10:00, Germany's ZEW survey results are released for October**, with the sentiment gauges in focus for markets given the expectations index has been in freefall for four successive months and industrial production data continues to show the impacts of supply chain disruptions. To round off the day, the **NFIB business optimism measure for September is released at 11:00**. The series has been hovering around the breakeven 100 level for the past two-months as health concerns and supply bottlenecks linger.

Wednesday – 13/10

Westpac's consumer confidence index for October is released in the early hours at 00:30 BST and is likely to show increased confidence going forward as vaccine rates pickup and reopening comes closer into sight. Then, the focus shifts to UK GDP for August at 07:00. The activity data is expected to show increased momentum in August, with economists broadly expecting growth to come in at 0.5% MoM following a near stagnation in July. The data is unlikely to have a large market impact, however, as traders focus on the risks to the economic recovery from the current energy crisis and supply disruptions. **At 13:30 BST, US CPI data for September is released**. The median expectation supplied to Bloomberg suggests sequential momentum in the inflation data is set to remain stable at 0.3% MoM, leaving the headline rate at 5.3%. Following this release, **Bank of England MPC member Jonathan Cunliffe then speaks at SWIFT's SIBOS 2021 "view from the top" event at 15:30**, before the focus then shifts to the release of **FOMC meeting minutes at 19:00**. The Fed is likely to be the more interesting of the two events given September's meeting saw Chair Powell announce that November's meeting is likely to be when the Fed begins its taper process, with a termination date of mid-2022 the target.

> Fed watchers will scan the minutes for further details on the tapering process along with the viability of a rate hike next year now the dots display a 50:50 split. At some point in the day,

China's trade balance data is released for September. Indicators suggest that exports are likely to continue declining as global demand pressures ease, while the rising cost of commodities is likely to inflate the import bill.

Thursday – 14/10

Beginning the day is the advanced reading of Singapore's GDP data for Q3 at 01:00. The economy is expected to expand by around 6% in the third quarter, down from the overly inflated Q2 reading of 14.7% - which was buoyed by base effects.

The GDP reading is likely to show the economy had strong momentum heading into fresh virus curbs in Q4 and could support tightening by the **Monetary Authority of Singapore**, who are set to announce their second bi-annual policy decision at the same time the GDP data is released.

The central bank is largely expected to hold off from tightening policy until April 2022, but a strong GDP reading could result in the central bank shifting to a modest and gradual appreciation in the S$NEER rate.

Focus remains in Asia, with **Chinese CPI and PPI data for September released at 02:30**. Consumer price growth is set to remain modest below 1% YoY, lending itself to a loosening of PBOC policy, while producer prices are expected to show the impact of higher energy costs and supply disruptions. PPI is expected to rise from 9.5% YoY to 10.6%. On the topic of inflation, **Swedish CPI data for September is released at 08:30**, with monthly price growth expected to pick up from 0.5% to 0.7%. On an annual basis, this should lead to headline CPI rising from 2.1% to 2.7%. **US PPI is then released at 13:30** and similar to China it is likely to show the cost associated to difficulties in procuring inputs. To round off the day, **Banxico meeting minutes are released at 16:00** and will provide further detail on why rates were lifted by a further 25bps back in September.

Friday – 15/10

Poland's final CPI figure for September is due at 09:00 BST. The zloty should be well shielded from any deviation in the inflation data given last week's NBP surprise. Rounding off the week is **US retail sales data for September at 13:30**. Health concerns and rising costs are likely to attribute to the slowdown in retail sales, with the headline figure expected to fall from 0.7% MoM to -0.3%. Stripping out auto sales, which have been weighed down by semiconductor shortages, sales growth is expected to remain positive, but print at a slower rate of 0.5%.

Inflation…

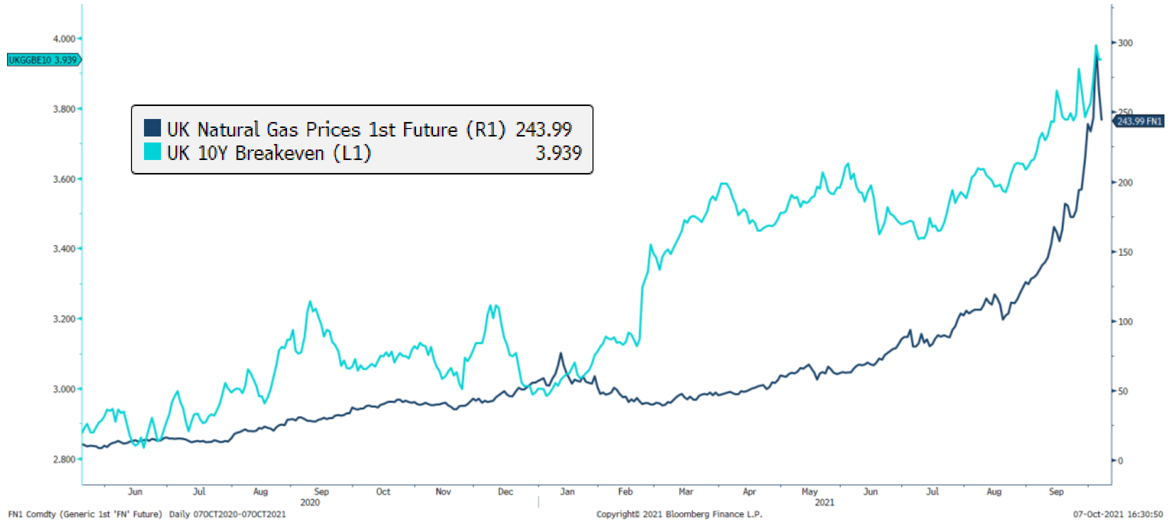
Concerns over inflation set to continue driving market sentiment

The word on everyone's lips right now is inflation. Whether it is driven by supply-chain disruption, rising energy prices, or being discussed in the context of inflation expectations and climbing bond yields, investors are finding it increasingly more difficult to avoid the topic. Last week was a perfect example of this; the ongoing energy crunch in Europe was all markets seemed to care about, even with the risk of the US debt ceiling not being lifted in time to avoid a default lingering in the background.

The reason for the level of concern is that inflation is now in demand destroying territory and is thus starting to weigh on the **global growth outlook**.

The evolution of the inflation backdrop into a broader macroeconomic concern was best illustrated by Thursday's price action; while inflation concerns were largely limited to European markets, it prompted a broad-based risk-off move across multiple global markets. The mix of lower growth and higher inflation poses a unique problem for DM central banks, more specifically the ECB and the Bank of England. Despite traditional monetary policy measures being a blunt tool when addressing supply-side inflation dynamics, central banks can't stand idle to sustained overshoots in inflation, especially if inflation expectations become unanchored. However, higher interest rates will only exacerbate the social imbalances caused by climbing consumer prices in this environment, and will further weigh on domestic growth outlooks at the margin.

UK gas prices soar due to supply concerns, raising market based inflation expectations in the process



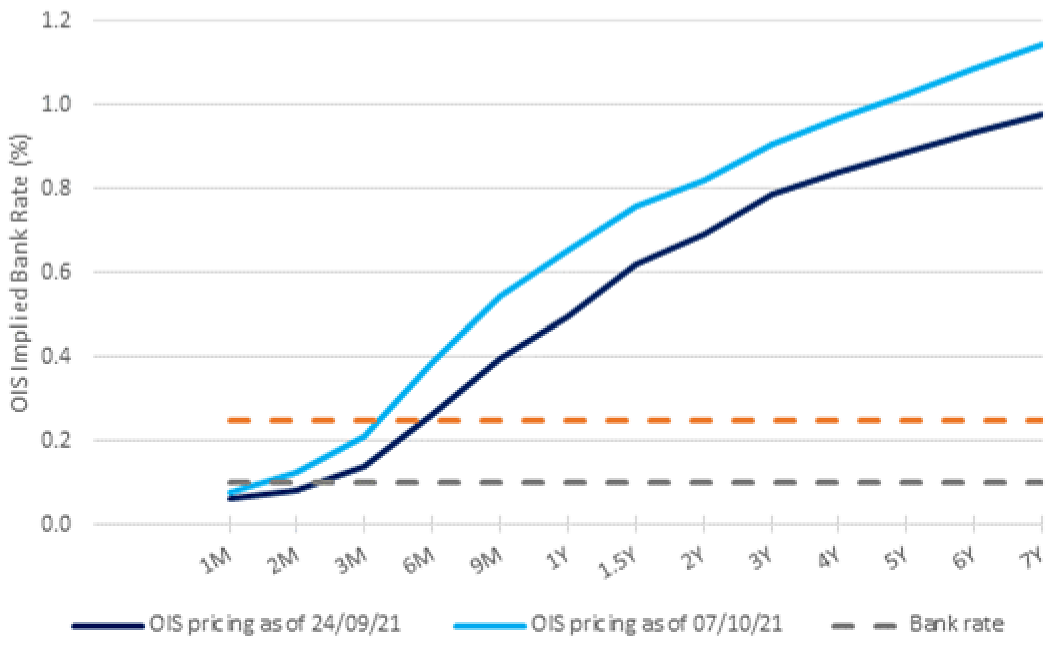
Despite the negative externalities associated with tightening monetary policy in this environment, financial markets continue to bet that this will be the likeliest reaction by monetary authorities.

> This is a stark turnaround given that central banks, like the **ECB**, have spent much of this year telling markets that the inflationary overshoot will be transitory. Now, their messaging is starting to change.

BoE become more concerned about the inflation outlook

This week, the new Bank of England Chief Economist, Huw Pill, stated that "the balance of risks is currently shifting towards great concerns about the inflation outlook, as the current strength looks set to prove more long lasting than originally anticipated" when making his first public appearance. Comments by Pill followed the recent rise in gas and coal prices, which have already led to numerous energy suppliers going out of business over the past month, and pre-existing concerns over labour and input shortages. The market implied probability of an interest rate hike by the BoE has now been brought forward substantially, even when compared with pricing after the last BoE meeting (23/09), which in itself struck hawkish tones.

With inflation expectations rising, money markets begin to price the probability of a 15bps rate hike this year, while a February hike is fully priced in.



The future of ECB QE will be determined by inflation dynamics

Up until now, the European Central Bank has signalled many drivers of the recent inflation spike are temporary and due to fade in the next year. ECB President Christine Lagarde blamed much of the increases on supply disruptions and said inflation should stabilise next year, adding that most of it is related to energy prices.

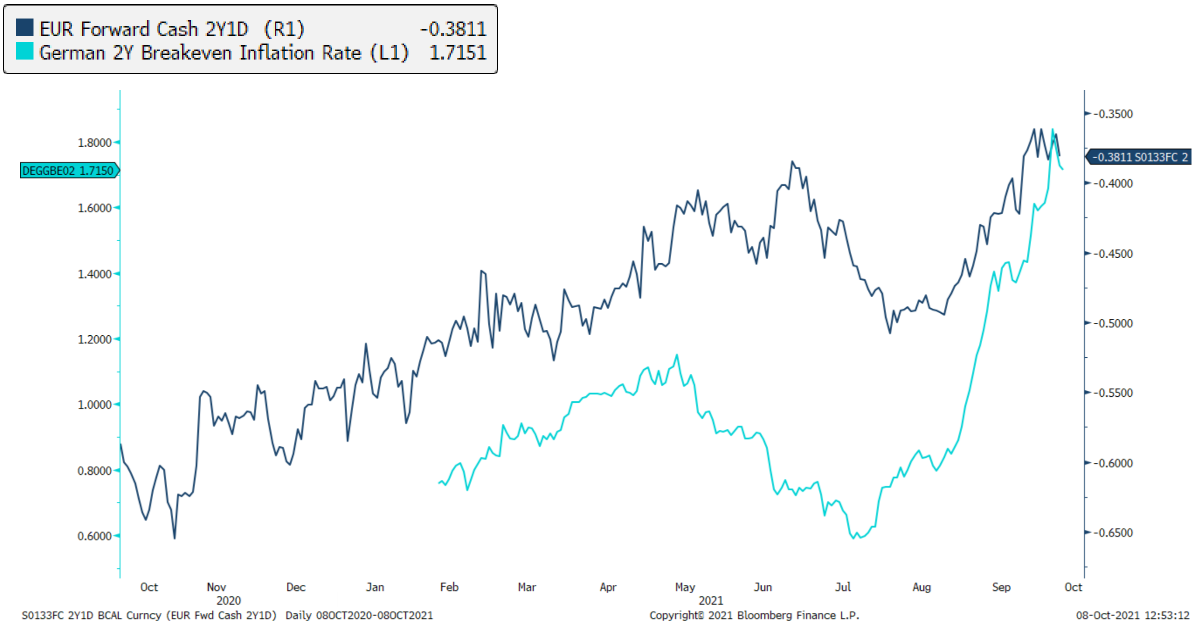
While Lagarde is not wrong, it should be noted that the upside risk to inflation has become more pronounced recently, especially with weather experts warning of a greater risk of cold winter weather this year, which threatens to spark greater demand and keep prices elevated for longer.

This is especially a risk given European gas is stored at levels well below usual storage levels.

If inflation expectations fail to moderate in the coming months and rise further, this could potentially mean the ECB will need to take their foot off the gas faster than initially thought at the September meeting, causing the Pandemic Emergency Purchase Programme (PEPP) to be tapered at a faster rate.

Beyond PEPP, the ECB's ability to continue keeping favourable financing conditions via QE altogether could be undermined by the inflation outlook. This comes at a time when the central bank is reportedly looking at a new QE programme to ease the transition from PEPP to APP to begin with.

Eurozone rate hike expectations increase with inflation breakevens



Given the risks associated to the current inflation environment and the continued volatility in energy markets, developments in the broader macro environment are likely to continue driving FX price action next week, especially amid a limited data calendar.

> Headlines pertaining to the Russia's gas exports to Europe, China's ability to ramp up coal production, and overall supply chain disruption for production inputs will be key sources of broader market volatility.