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Economic activity and inflation data put stagflation fears to the test

It has all been about the US dollar yet again this week, with the DXY index falling back below the 94 handle. As outlined in our October forecasts, we have been expecting this USD correction following the aggressive surge in late September, and it seems that a stabilisation in the macro backdrop this week facilitated it. Dollar downside has been mixed across G10 and EM markets, with the decline in the DXY index not telling the whole story. While the broad dollar index moderated, losses were more sizable outside of EUR and JPY, which account for more than 70% of the DXY weighting. The Kiwi dollar led gains in the G10 space, rallying over 1.4% on the week, while other high beta currencies followed the NZD move higher. In the EM space, moves have been more dramatic at the extremities. The Peruvian sol is set to close the week out over 4% higher against the US dollar, while the Turkish lira continues its freefall as it sits nearly 3% lower on the week as it carves fresh record lows daily. In the central percentiles, EM FX broadly gained against the dollar. INR, CLP and COP are among the major EM currencies sitting lower on the week, but losses are marginal, while PLN, KRW and ZAR all sit over a percentage point higher against the greenback.

Next week, the data calendar revolves around October's preliminary PMI prints, while **China's Q3 GDP data** also scans as one of the more interesting releases. The **focus on activity data is likely to be heightened** given growth concerns over previous weeks and the impact higher input costs are having. This is **especially the case in the eurozone, UK, and China**, where rising energy costs are the most pronounced.

Calendar (all times BST)

Monday – 18/10

European markets will awake to what will likely be a noisy Asian session following the release of China's Q3 GDP data at 03:00 along with September's activity data. China's third-quarter growth is likely to reflect a lot more than a higher base as virus concerns, regulatory tightening and an acute energy shortage take their toll on activity. Expectations sit at a 5% YoY print, marking a slowdown from Q2's 7.9% reading.

Services output and consumption are likely to bounce, with retail sales for September projected to increase from 2.5% YoY to 3.5%, while industrial production is expected to be hampered by government restrictions on energy consumption due to the ongoing shortage. Meanwhile, fixed asset and property investment will likely show the effects regulatory tightening and the Evergrande debacle had on investor sentiment. Following the release of Chinese data, **Polish core CPI data for September is released at 13:00**. Headline inflation for September continued to rise to a 20-year high of 5.9% earlier in the month, forcing the **National Bank of Poland** to surprise markets and hike rates by 40bps.

Markets will heavily examine **underlying inflation drivers** to assess how persistent the inflation overshoot will be.

Shortly after at 15:00, the Bank of Canada releases its Q3 Business Outlook Survey which will likely show improving economic conditions and expectations following the economic reopening. However, the results will be viewed amid a still tentative fourth Covid wave. For those interested in the future of central bank digital coins, **Bank of England MPC member Jonathan Cunliffe will be speaking on the matter at 15:30**.

Tuesday – 19/10

Tuesday is a quieter day on the data front. **Reserve Bank of Australia meeting minutes open the data calendar at 01:30**, but will likely slip under the radar given the placeholder meeting earlier in the month. **Then at 13:00 BST, the Hungarian National Bank take to the stage** where a further 15bps rate hike is expected.

Wednesday – 20/10

Concerns over the stagflation environment will re-emerge on Wednesday when a fresh batch of **CPI numbers come out of the UK at 07:00**. While year-on-year CPI is expected to moderate due to base effects now rising as the government's Eat Out to Help Out expired in September 2020, the market impact is likely to come from the month-on-month data. CPI MoM for September is expected to fall from 0.7% to 0.3%, however, risks are tilted towards an upwards surprise given the increase in petrol prices and the impact of higher energy prices. Any signs of higher prices in September are likely to weigh on the pound as the prospect of earlier BoE normalisation increases, especially given the expected increase in October's CPI data. On the topic of inflation, **South Africa releases CPI figures at 09:00** just prior to the release of the **final eurozone reading at 10:00**. Inflation in the eurozone is expected to come in at 3.4% in September. The inflation focus then shifts to **Canada, where CPI data is released at 13:30**.

An increase in headline inflation from August's 4.1% reading will likely combine with solid labour market data to boost expectations of **another BoC taper in October**, especially if the Bank's preferred core-common index rises closer to the 2% target from the previous 1.8% reading.

At 19:00, the Fed's Beige Book completes the data calendar. Released just eight times a year, the Beige Book will give markets the most up to date assessment of economic conditions, as viewed by the Federal Reserve.

Thursday – 21/10

The focus on inflation is likely to moderate on Thursday as CPI readings are absent on the data calendar. However, the pace of price growth will remain a topic of conversation as the **Central Bank of the Republic of Turkey, who are struggling to contain inflation, looks set to cut rates again at 12:30**. Expectations are for another 100bps cut to the one-week repo rate (more on this below). Prior to the CBRT, however, **Sweden's unemployment rate for September is published at 08:30**.

Friday – 22/10

Friday is by far the busiest day in terms of data next week. To begin with, **Australian preliminary PMIs are released at midnight**, and will provide the latest indication of how the economy is coping with extended lockdowns. While Sydney partially loosened its lockdown over the past weeks, the impact on the overall PMI is likely to be limited. Upwards revisions to the preliminary print are also to be expected, given a further scaling back of restrictions in other provinces is anticipated in the coming weeks. Shortly after **at 00:01, the UK's GfK consumer confidence indicator for October** is released. While this isn't a measure that markets tend to focus too heavily on, it will be this time around as investors view it amid the backdrop of rising consumer prices and the impact price growth is having on consumer sentiment. Shortly after, **retail sales data for October are released** with expectations of a slight rebound, largely due to the panic fuel buying. Excluding fuel, retail sales growth is expected to be a lot more moderate at just 0.1% MoM.

Then, the focus shifts to **Purchasing Managers Indices** with eurozone nations the first to publish the preliminary data. While data drip feeds out of France and Germany at 08:15 and 08:30 respectively, the **eurozone preliminary composite PMI at 09:00** is likely to show the growth slowdown across the block as businesses continue to battle higher energy costs and supply-chain constraints. At **09:30, UK preliminary PMIs are in focus**, with the data likely to exhibit the same themes as their European counterparts. The manufacturing sector is expected to slow from 57.1 to 55.4 due to supply bottlenecks, while higher consumer prices are set to weigh on services activity, with the PMI expected to fall from 56.4 to 55.4. Prior **to US preliminary PMIs at 14:45, Canadian retail sales data is released at 13:30**. With the services sector reopening in the past months, consumption is likely to have continued rotating out of retail spending. However, a still tentative Covid backdrop may mitigate the extent of the rotation.

US PMIs will be the more interesting release for markets, especially after a string of US growth downgrades from sell-side analysts over the past weeks. Both **manufacturing and services PMIs** are expected to hold steady near September's readings, but any negative surprise will confirm economists' **fears of a slowing growth backdrop**.

CBRT Preview

The fall of the lira

The last three years have been a tumultuous ride for the Central Bank of the Republic of Turkey. Four different governors and a string of other staff firings were paired with waves of lira depreciation, inflation, and differing monetary approaches to fight off the depreciation – some more effective than others. Unlike most other countries, decision-making within the CBRT is far from independent. President Erdogan is a strong supporter of loose monetary policy and exerts great pressure to committee members who oppose his views, which so far has translated to systematic dismissals of CBRT governors and other policymakers.

> These policymakers face a tough battle between **tightening policy** to lower inflation and keep the **lira from depreciating**, or maintaining supportive policy to keep their job.

With political pressures around increasing interest rates being substantial, especially at times when additional rate hike are much needed in order for inflation to ease, governors over the years have embarked on fringe tools to ease pressure on the lira and avoid the political backlash of raising rates. These include liquidity measures, back door tightening as opposed to traditional rate hikes, and emptying the treasure chest of FX reserves. Given the Turkish central bank has already started its easing cycle in September by cutting rates by a full percent before this week's wave of firings at the CBRT, market expectations for further easing are significant. However, with inflation sitting above 19% and interest rates already lower at 18%, it is possible the CBRT will opt for additional measures to prevent the inflation problem from worsening excessively. Some of these may revolve around increasing the cost of shorting the lira as continued currency depreciation will only amplify the pressure on price growth.

Chart: Lira at records lows after rate cut, firings and macro backdrop weighed on TRY

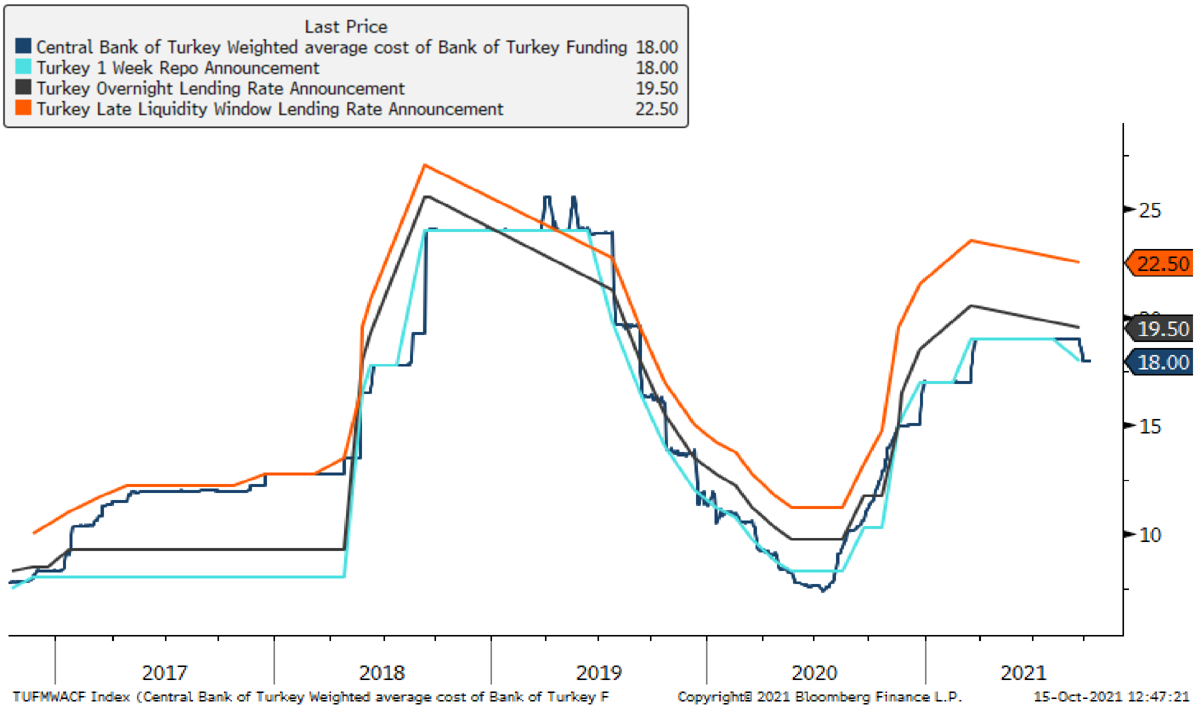
Looking to next week's meeting, the pathway for the CBRT are largely twofold. They could continue on their easing cycle, but aim to limit the impact of the cuts on the lira by holding other policy measures or reducing offshore liquidity. Alternatively, the CBRT could reverse last month's rate hike.

In the first scenario, risks for the lira are substantial, especially given past crises have shown that if these additional measures prove insufficient, the CBRT will ultimately be forced to hike their entire monetary channel more aggressively than they would have if they opted for a rate cut reversal. At the moment, the late liquidity window lending rate and the overnight lending rate – two alternative interest rate measures that were used in past crises to discretely tighten monetary policy – sit significantly higher than the key interest rate, which for Turkey is the 1-week repo rate (chart).

> If the CBRT chooses to cut rates further and continue its easing cycle, which currently is the market consensus, without opting for other measures, this would be the most detrimental scenario for the lira.

Although the market impact would be marginal if the CBRT would add backdoor tightening or liquidity conditions, it would show some commitment by the central bank to appease financial markets. In previous cycles, these more discrete measures had a slight dampening effect on the rise in domestic inflation, but back door tightening did little to appease financial markets. If the CBRT aims to limit the impact of its latest announcement on TRY, drying up offshore liquidity conditions remains its best bet now their FX reserves are depleted.

Chart: one-week repo at the bottom of the corridor

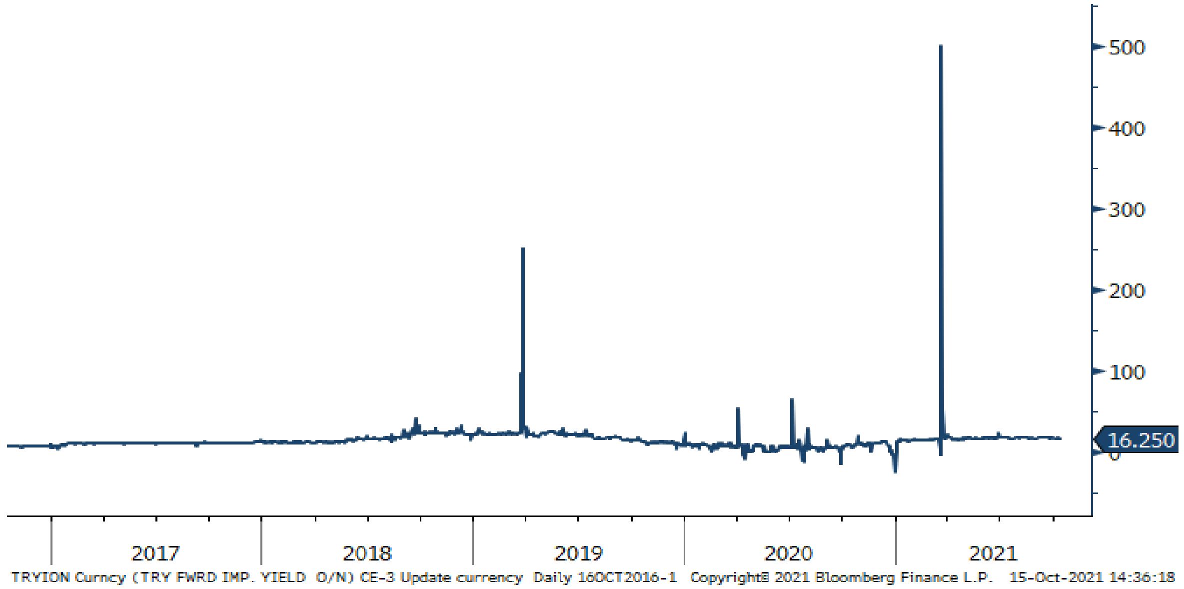


In the second scenario, the CBRT would reverse last month's rate cut. Although this would be the lira's best shot at recovering from all-time highs, it is the least likely scenario given the recent dismissals and the CBRT's confidence that the reasons behind the recent rise in inflation are only temporary. Governor Kavcioglu stated earlier this week that the effect of the strong monetary tightening on loans and domestic demand is slowing and even have a contractionary effect on commercial loans.

Whichever strategy the **CBRT** will opt for, it will be incredibly difficult for the central bank to establish credibility now that markets are once again reminded of the political motivations behind the direction of policy.

One area of consolation for the lira lies in the fact that the rally in US Treasury yields, which EM currencies are sensitive to, seems to have run out of steam for now. In this sense, the broader macro backdrop may serve as a supporting factor for the lira, but domestic developments are unlikely to materially change the volatile and risky TRY outlook until inflationary pressures subside.

Chart: Offshore liquidity measures will be closely monitored next week should the CBRT choose to make short-selling more expensive following a rate cut: Turkish lira overnight forward implied yield.



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