Investec

GBPEUR Update

August 2021

Economic commentary

Although the UK government took the momentous step to fully remove social distancing requirements in July, in reality the normalisation in people's behaviour has stagnated since earlier reopening steps in early June, at levels still below those in the US and the EU. Retail activity in the UK is still somewhat lower than after the initial reopening burst in June, although it is grinding higher again. Yet what is more striking is the decline in workplace activity last month from -20% to -30%, relative to pre-pandemic levels, which is back to where they were over the winter.

Although inflation has risen in the Euro area, it is still just below target for the time being, in contrast to the overshoot in the UK. A less pressing need to adjust policy rates by the ECB may therefore see interest rate differentials move against the Euro for a while, which would continue to hold back the single currency. A new policy framework and updated forward guidance reinforces the view of lower rates being maintained for longer. Our central view is that the ECB will not raise rates until the end of 2023. As a result, we have lowered our EUR forecasts: we now expect GBPEUR to hit 1.16 by the end of 2021 and 1.22 by late 2022.

Trading commentary

Our base case is that the BoE remains on hold this year and next, which is in contrast to market expectations. We still see the risks for 2021 growth remaining to the downside of the BoE's forecasts. This is partially offset by upside risks to the MPC's inflation forecasts and balanced risks to the job market, but this is not enough to change our structurally more cautious outlook on the pound versus other major currencies.

The market has priced in close to 30 bps of hikes by the end of next year, which does not suggest that it sees a return to restrictions in the short term, nor a high chance of restrictions returning in the winter and so leaves the pound vulnerable to any negative shifts in covid developments.

Despite a recovery in Eurozone economic growth (which we believe will be sustained well into 2022 and rising inflation, the ECB's rhetoric remains very dovish. As a result, stronger Eurozone growth and higher inflation will have a limited positive impact on the EUR in the coming months.

Market Forecasts

	As of	Q3 21	Q4 21	Q1 22	Q2 22	2022	2023	2024	2025
Median		1.16	1.18	1.18	1.18	1.19	1.20	--	--
Mean		1.18	1.18	1.18	1.18	1.19	1.20	--	--
High		1.20	1.22	1.28	1.28	1.33	1.28	--	--
Low		1.15	1.12	1.10	1.09	1.08	1.16	--	--
Forward		1.16	1.16	1.16	1.16	1.16	1.15	1.14	1.12
Investec	23/07/2021	1.13	1.16	1.17	1.19	1.21	--	--	--
JPMorgan Chase	13/07/2021	1.18	1.18	1.19	1.19	--	--	--	--
BNP Paribas	05/07/2021	1.19	1.19	1.20	1.20	1.20	--	--	--
Morgan Stanley	05/07/2021	1.18	1.16	1.18	1.19	1.16	--	--	--
Barclays	24/06/2021	1.19	1.19	1.19	1.20	1.22	1.20	1.19	1.18
Citigroup	10/06/2021	1.18	1.20	1.22	1.22	1.23	--	--	--

Data provided by Bloomberg. Correct as of 02/08/2021

FX Strategist commentary

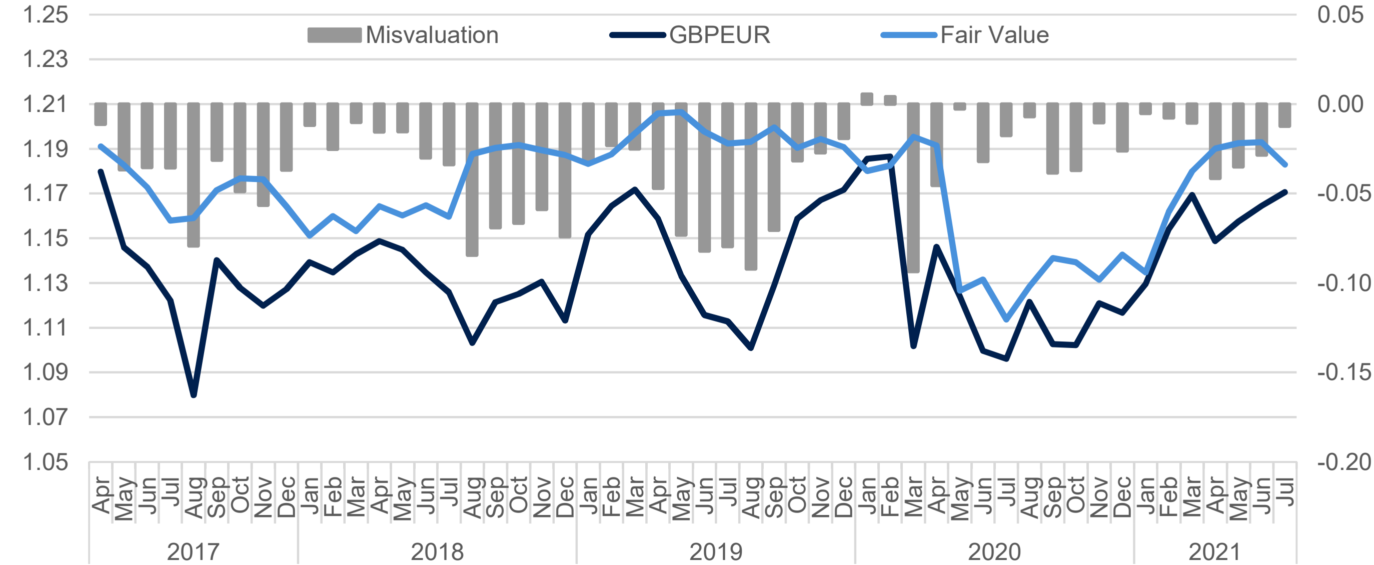
Over the past few month EUR buyers have generally built up their level of hedging so that they are nudging the upper limits of their desired hedge ratios, whilst discretionary EUR sellers have found themselves in the lower end of their desired ratios. The sharp move lower in GBPEUR in July to below 1.16 was enough to prompt a swathe of EUR sellers to top up their hedging, in which they favoured certainty over outperformance. Indeed the low levels of volatility prompted a significant proportion to select outright vanilla options purchases to give them unlimited flexibility in the rate.

Discretionary EUR buyers, who have built up to well hedged positions, had a quiet month, as they continued to wait for a break out above the recent highs, with only more systematic clients looking to top up in line with their frameworks.

Investec Fair Value model

The fall in economist growth forecasts for the UK in 2021, driven by a reduced consumer demand and disruptions caused by a pick up in cases, has meant that the GBPEUR Fair Value has taken a small hit, falling from just above 1.19 down to just below 1.18. Overall this year, however, the Fair Value has been supported by the faster economic recovery in the UK versus Europe, which has been seen in the actual GBPEUR rate, which is once again nudging up against the 18 month highs.

Up until now the model has used growth expectations for 2021 as one of its main inputs, however in the next couple of months it will transition to looking ahead to 2022, as the outcome for 2021 becomes more certain. There still remains a fair amount of uncertainty of the relative medium term outlook for the two economies, which are both expected to have recovered to their pre pandemic levels by the start of next year, which is also expected to coincide with herd immunity being reached, allowing even greater freedom of movement and economic catch up.



Key events this month

5 Aug – Bank of England Bank Rate

12 Aug – UK GDP

12 Aug – UK CPI

17 Aug – UK Unemployment Rate

17 Aug – Eurozone GDP

18 Aug – Eurozone CPI

23 Aug – Eurozone Manufacturing PMI