GBPUSD Update

August 2021

Economic commentary

Supply side constraints limited US growth in Q2, somewhat offsetting the impact of the considerable fiscal stimulus flowing through the economy. However, we still estimate that real GDP will have expanded at a robust 2.4% q/q rate in Q3 and look for this pace to continue in Q3 as supply constraints ease, before a likely slowdown in growth in Q4 and beyond as fiscal stimulus wears off. We still estimate 2021 growth at 7.3% which would be the strongest growth since 1984.

Beyond that spending related to the infrastructure bill we expect to pass late in the year should help keep GDP expansion above trend at 4.8% y/y in 2022. We expect inflation to remain above 2% through until the end of 2022 but to slow markedly from the high pace seen in Q2 2021. We also believe a signal on tapering from the Fed will come in September, with actual reduction in bond purchases beginning in January and rate hikes only coming in Q1 2023.

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.

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.

The approach of Fed tapering has allowed markets to begin pricing more confidently for Fed rate hikes, and the resulting un-anchoring of US front-end rates is likely to be supportive for the Dollar. As we move into H2, some of the vulnerabilities that have weighed on the currency over the past year, including very negative US real yields and very low carry and hedging costs on Dollar short positions, will begin to ease. Therefore, we think Q2 2021 will likely have been the point of maximum US Dollar vulnerability in the current cycle.

Market Forecasts

	As of	Q3 21	Q4 21	Q1 22	Q2 22	2022	2023	2024	2025
Median		1.40	1.40	1.40	1.41	1.43	1.43	--	--
Mean		1.39	1.40	1.40	1.41	1.43	1.44	--	--
High		1.44	1.47	1.52	1.52	1.56	1.50	--	--
Low		1.34	1.28	1.24	1.22	1.23	1.35	--	--
Forward		1.39	1.39	1.39	1.39	1.39	1.39	1.39	1.40
Investec	23/07/2021	1.35	1.42	1.44	1.46	1.53	--	--	--
JPMorgan Chase	13/07/2021	1.39	1.38	1.38	1.38	--	--	--	--
BNP Paribas	05/07/2021	1.40	1.39	1.40	1.39	1.38	--	--	--
Morgan Stanley	05/07/2021	1.43	1.40	1.41	1.41	1.43	--	--	--
Barclays	24/06/2021	1.40	1.40	1.40	1.40	1.40	1.41	1.42	1.43
Citigroup	10/06/2021	1.43	1.43	1.43	1.43	1.43	--	--	--

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

FX Strategist commentary

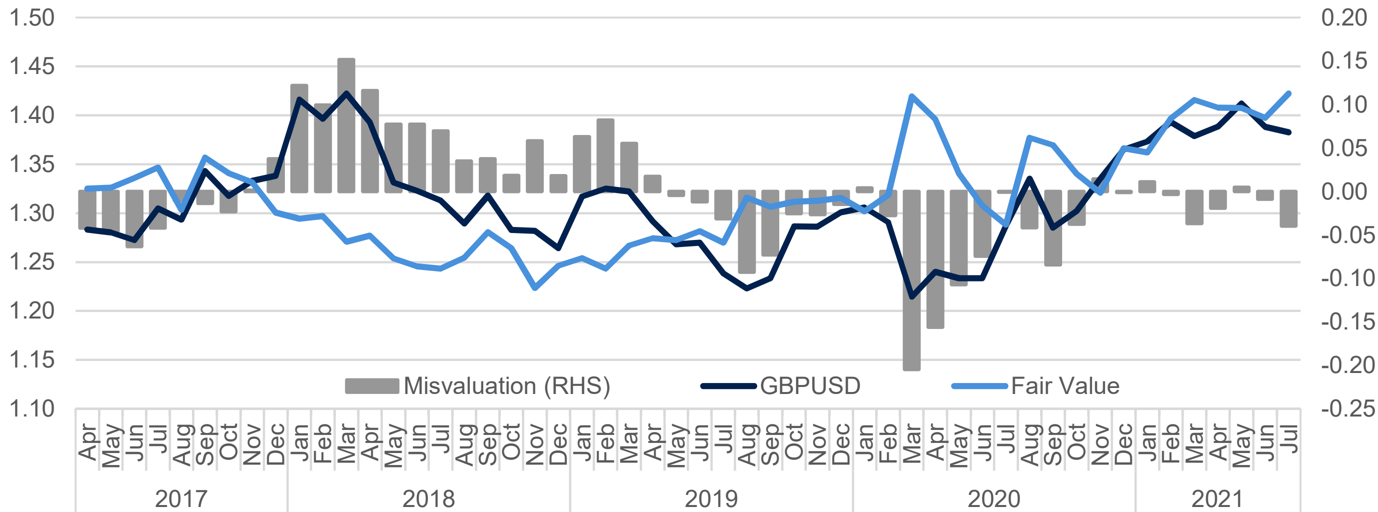
In most months we observe that it is Dollar Buyers that are quick to react to favourable moves and trade tactically as opportunities present themselves, whilst Dollar Sellers are less sensitive to market levels. July therefore stands out as unusual, because it was Sellers who dominated on the sharp move down to below 1.36, after suffering through several months of stubbornly elevated rates.

Treasurers employed a mixture of outperformance and imitated participation trades, reflecting the expectation that the fall in GBPUSD would not continue significantly further, so achieving the best possible rates of protection or outperformance was prioritised. US Dollar buyers who have found themselves well hedged for last few months were more circumspect, only committing to much shorter and smaller rounds of additional hedging.

Investec Fair Value model

Fed doves gained the upper hand in July, pushing back rate hikes further into the future with a corresponding greater drop in long term bond yields in the US than those in the UK, which was enough to push GBPUSD's Fair Value higher by a couple of cents, up to 1.42. The move was more muted in shorter term rates, which are not an input to the model, which is designed to reflect medium term Fair Value and so may be why the actual GBPUSD rates has not moved up to the same sort of level.

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

6 Aug – US Non-Farm Payrolls

11 Aug – US CPI

12 Aug – UK GDP

12 Aug – UK CPI

17 Aug – US Retail Sales

26 Aug – US GDP