Investec

GBPUSD Update

May 2022

Economist commentary

The US dollar rallied to its highest level since the height of the pandemic last month, bolstered by expectations that the Federal Reserve will lift interest rates aggressively to tame inflation. The world reserve currency is also benefitting from the weaker global economic environment and in particular the disruption originating from Ukraine and China. Q1 US GDP data showed that the economy contracted 1.4% on the quarter, however, most of the drag came from an anticipated fall in volatile components such as trade and inventories. In contrast, signals about underlying demand conditions looked very solid, with final sales by domestic final purchasers registering a very strong 3.7% quarterly rise, driven by a 2.7% increase in consumer spending.

Recession warnings are burning brighter in the UK, given the historic squeeze in disposable incomes facing households over the coming quarters, including the combination of fiscal and monetary policy tightening. We expect Q2 GDP to contract by 0.2% on a quarterly basis, driven by a drop in government health spending, higher taxes, the big jump in prices and the extra June bank holiday. However, we think a negative Q2, will likely be followed by a modest rebound in Q3 of around 0.3%. We then see a flat or slightly negative Q4, weighed by another bout of inflationary pressures. Ultimately, we think strong household balance sheets and consumers tapping into their savings should help avoid an outright drop in household spending or recession. Household balance sheets are the strongest they have been since before the global financial crisis – at least in aggregate. Also, the job market is historically tight, so any potential slowdown in demand will likely result in a more muted impact on unemployment.

Trading commentary

The UK rates market is pricing the Bank of England raising rates from 0.75% to 2.25% by the end of the year, not too far behind the US Federal Reserve. However, while there is a legitimate claim that the US economy is overheating, the UK is in a very different place. UK inflation may be over three times the BoE’s target, but it is mostly driven by increases in the cost of wages and raw materials rather than higher demand and supply shortages as in the US. The BoE will be wary about applying too many tightening levers simultaneously with energy, food prices and interest rates all rising alongside reduced credit availability. We doubt whether the UK economy can withstand higher rates without falling into recession and given the desire to avoid crashing the economy think it is unlikely the BoE raises rates much beyond 1.5%, let alone the 2.25% that is priced in.

The Fed cycle has been supportive for the dollar, but increasingly, geopolitics, market stress and contagion of foreign exchange moves is extending its strength. Sterling shorts are also above the mid point of the highest levels we have seen historically, which is a sign of moderate stress and a rationale for the pound’s fall to reverse. We view the dollar as being in overshoot territory, but the reasons for that are plain to see with the threat of an escalation of the conflict in Ukraine and global economic growth faltering, which leaves us loathe to catch the falling knife.

Market Forecasts

	As of	Q2 22	Q3 22	Q4 22	Q1 23	2023	2024	2025	2026
Median		1.32	1.34	1.35	1.36	1.40	1.42	1.42	--
Mean		1.32	1.33	1.35	1.35	1.39	1.40	1.40	--
High		1.37	1.38	1.42	1.48	1.55	1.45	1.45	--
Low		1.25	1.26	1.25	1.24	1.25	1.33	1.31	--
Forward		1.31	1.31	1.31	1.32	1.32	1.33	1.34	1.35
Investec	27/04/2022	1.28	1.30	1.32	1.34	1.37	--	--	--
BNP Paribas	31/03/2022	1.29	1.31	1.33	1.34	1.40	--	--	--
Barclays	30/03/2022	1.31	1.35	1.39	1.39	1.40	1.41	1.42	1.43
Morgan Stanley	18/03/2022	1.30	1.32	1.34	1.33	1.31	--	--	--
JPMorgan Chase	14/03/2022	1.31	1.33	1.34	1.34	--	--	--	--
Citigroup	19/09/2021	1.42	1.42	1.42	1.43	--	--	--	--

Source: Bloomberg. Correct as of 02/05/2022

FX Strategist commentary

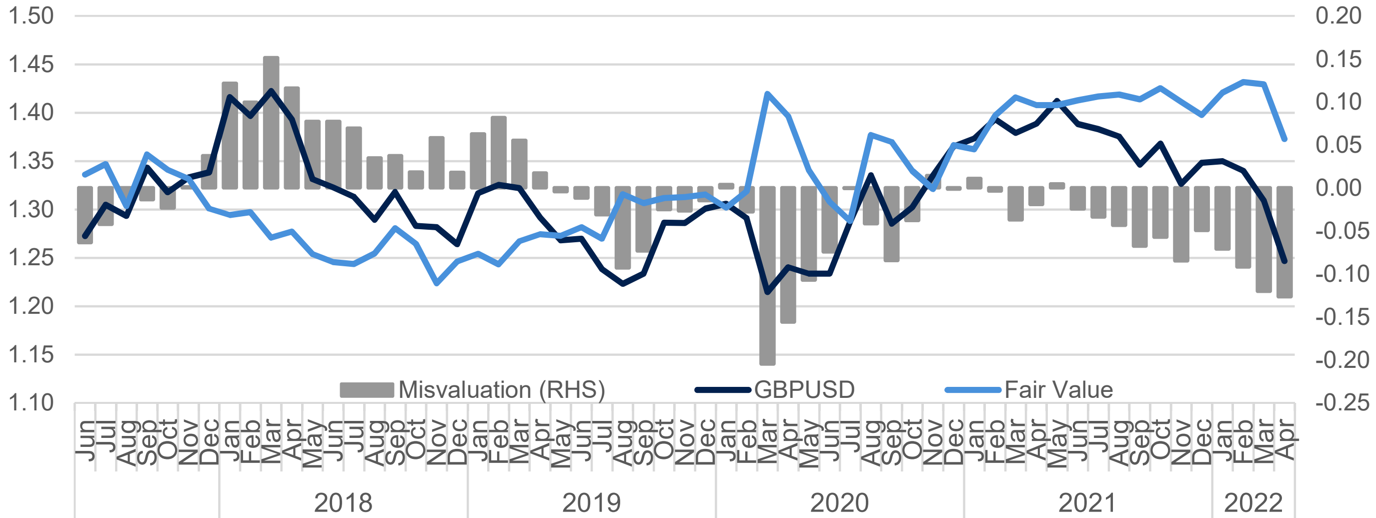
For most of last month GBPUSD was impressively range bound, trading closely around 1.31, during which time hedging activity was dominated by US dollar buyers, who continued to employ outperformance to achieve Enhanced Rates in the mid 1.30s. The outperformance deals they had booked previously would not be expected to last as long at the lower levels of GBPUSD, prompting the desire to layer in additional cover.

The sharp fall in the rate at the end of the month was the prompt for an upsurge in dollar selling activity. As we noted in last month's report, many US dollar sellers had initially held off from jumping on board the fall in GBPUSD from the mid to low 1.30s, caused by the start of the Ukraine conflict, over concerns that the move could extend further. With the move into the mid 1.20s the majority have now stepped in to extend cover over the medium and longer term. Much of this activity was driven by the desire to improve older, now under water deals, to take advantage of the improved levels.

Investec Fair Value model

The market is piling into the dollar, driving it up in sync with yields, because the most drastic change in monetary policy in response to inflation has come from the Fed. They are also downgrading growth estimates for other developed market economies such as the UK where stagflation fears are rising. US bond yields have rocketed over the past month, mainly as markets have reassessed the Fed's policy response. 10 year yields have risen by 35bps, to reach 3% with real (nominal minus inflation) yields in positive territory for the first time in two years.

All of this has put pressure on the Investec GBPUSD Fair Value, which saw a steep fall in April from the high to mid 1.30s. Nevertheless, the fall in the GBPUSD market rate matched this and so the large undervaluation of GBPUSD indicated by the model has remained in place. This suggests it is factors beyond the fundamental macroeconomic picture that are driving GBPUSD's low level, such risk aversion, fears over the war in Ukraine and contagion of market moves stemming from Japan and China.



Source: Investec

Key events this month

4 May – US FOMC Rate Decision

5 May – UK Bank of England Rate

6 May – US Nonfarm Payrolls

11 May – US CPI

12 May – UK GDP

18 May – UK CPI

26 May – US GDP