GBPEUR Update

March 2023

Economic commentary

The fastest rise in core inflation since the formation of the single currency has added to the growing evidence that Europe's inflation problem has long since broadened out from just being an energy issue. The latest reading will embolden the hawks on the Governing Council to keep arguing for taking rates higher. We see upside risks to our 3.25% terminal rate forecast with a higher and later terminal rate becoming likely. The economic outlook for the region has improved, with activity proving more resilient than previously expected, supported by the considerable tailwind of falling natural gas prices, which have more than halved over the last three months, leading to a sustained improvement in the current account balance. At the same time the labour market remains tight and the latest indicators have bolstered expectations for continued resilience. There has been much less of labour supply shock in the Eurozone, compared to the UK, that could help explain the labour market tightness. While participation in the UK has suffered due to long-term sickness and more early retirement, the Eurozone's has actually improved since the pandemic. With Eurozone bond yields continuing higher and asset availability improving, due to the end of the ECB's quantitative easing, we expect portfolio inflows into the Eurozone to continue, supporting the Euro.

The UK data has struggled to help the pound gain traction, as much of it has contained something for hawks and doves alike. Inflation is high, but falling. Wages growth is elevated, but there are some early signs of job market loosening. More pertinently, we are only just beginning to see some upside surprises on activity relative to consensus. The BoE hopes it is close to the end of its tightening cycle. At its February policy meeting the committee altered its forward guidance towards a bias for no further hikes, unless there was evidence of "more persistent" price pressures. We think the continuing strength in wages makes further rate rises the most likely outcome. It seems improbable that a supposedly data dependent BoE can continue to ignore the job market and focus on energy price base effects and the tightening already delivered, to justify a case for not raising rates higher.

Trading commentary

Replacing the fears of the gloomiest forecasts with expectations of lengthy stagnation is about as much as can be hoped for the UK at the moment. Sterling has remained weak versus the euro as the limited extent of positive data surprises has held back the currency. The less gloomy UK picture does however mean we view it as appropriate to moderate the degree of weakness we expect in GBPEUR and now project it to stabilise around 1.12. We do however view the risks to this less bearish outlook as skewed to the downside. Should sentiment turn sour, which we envision unfolding over the medium term, Sterling would suffer given it has a high correlation to risk appetite.

While the MPC continues to leave the market second guessing around its future intentions, because it struggles to make its mind up itself, the ECB's resolve is more clearly aligned around its inflation fighting mandate, which prevents us from having a constructive view on GBPEUR, despite the less negative economic outlook.

Market Forecasts

	As of	Q2 23	Q3 23	Q4 23	Q1 24	2024	2025	2026	2027
Median		1.12	1.12	1.11	1.10	1.12	1.12	--	--
Mean		1.12	1.12	1.11	1.10	1.12	1.12	--	--
High		1.16	1.18	1.18	1.14	1.19	1.18	--	--
Low		1.08	1.08	1.05	1.06	1.04	1.04	--	--
Forward		1.12	1.12	1.12	1.12	1.11	1.10	1.09	1.09
Investec	27/02/2023	1.14	1.12	1.12	1.11	1.11	--	--	--
JPMorgan	27/02/2023	1.08	1.08	1.06	--	--	--	--	--
Morgan Stanley	03/03/2023	1.08	1.08	1.05	1.06	1.12	--	--	--
BNP Paribas	14/02/2023	1.12	1.12	1.12	--	1.12	--	--	--
Citigroup	12/01/2023	1.10	1.09	1.10	1.11	1.16	--	--	--
Barclays	14/12/2023	1.15	1.15	1.15	--	1.15	1.15	1.15	1.15

Source: Bloomberg. Correct as of 03/03/2023

FX Strategist commentary

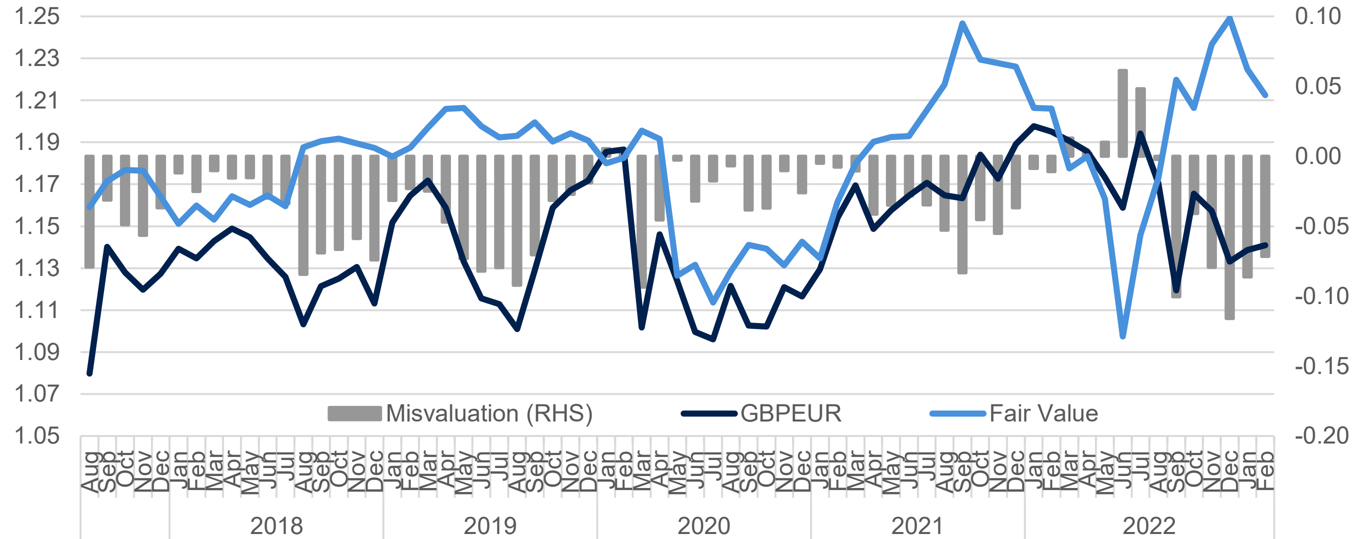
Discretionary Euro buyers were largely kept quiet in February, as GBPEUR levels remained subdued, with only those clients that have been willing to walk down more bullish target rates, stemming from the 2023 budgeting process, in a position to achieve their hedging objectives. The persistent decline in GBPEUR implied volatility and diminishing expectations of a shift out of this low volatility regime has further supported the sense that the pair is likely to remain rangebound. This is feeding into client behaviour that largely floats between the desire for certainty or outperformance, with few clients prioritising in-built flexibility in new hedges.

Euro sellers, who benefitted from the most favourable GBPEUR levels since late September, had limited desire to complicate hedging and largely opted for forwards to top up their cover and improve their averages. Longer term outperformance trades allowed them to achieve levels below 1.10. However, the focus of the majority of Euro Sellers was instead centred on achieving certainty around their short to medium term requirements.

Investec Fair Value Model

Our medium term Fair Value model suggests equilibrium levels of 1.21 in GBPEUR, belying the continued weakness of the pound. GBPEUR's undervaluation is partly driven by still subdued sentiment towards the UK and vulnerability stemming from its current account amid the global slowdown. Sterling's correlation with central bank pricing has rebounded sharply from negative, following the mini-budget breakdown, to around +70% currently as markets have normalised. Although the short term interest rate moves were fairly synchronised last month we expect that they will reassert themselves as a differentiating factor in coming months.

We note that shorter-term estimates of GBPEUR fair value do, admittedly, suggest much less cheapness. This may limit the degree to which the pound can outperform, especially given the Euro is experiencing a similar growth-inflation reversal as the UK.



Source: Investec

Key events this month

8 March – Eurozone GDP

16 March – ECB Refinancing Rate

17 March – Eurozone CPI

22 March – UK CPI

23 March – BoE Bank Rate

24 March – Eurozone Manufacturing PM

31 March – UK GDP