Investec

GBPEUR Update

November 2022

Economist commentary

Inflation in the Eurozone hit 10.7% in October, up from 9.9% the previous month, with the core rate edging higher by 0.2%, to 5.0%. Both new record highs and above the consensus forecasts, painting a picture of little relief for the ECB. Recently approved European government spending rises for next year bolster our view that fiscal policy will remain a pillar of support for economic growth and in turn contribute to sustained higher interest rates. In the near term headwinds continue to mount for the economy ahead of winter as inflation, uncertainty and weakening demand continue to take their toll. Given measures to reduce energy demand and seek alternative supply we still expect that a gas shortage scenario will be avoided. Nonetheless, we still forecast the Eurozone to suffer a mild recession this winter given energy price pressures. It should emerge from this in the spring, but as a result of restrictive monetary policy and a subdued global growth backdrop we see a second recession occurring in late 2023.

With UK CPI Inflation at 10.1% and the unemployment rate falling to a 48-year low of 3.5%, the MPC looks almost certain to raise interest rates by 75bp this month to 3% as it seeks to shore up its inflation fighting credentials. However, it is very likely that from then on the MPC downshifts the pace of hikes, with fiscal policy now poised to do more of the heavy lifting in bringing down inflation, as the Treasury lays the ground for further tax rises in the Autumn Statement. We continue to see a 4% peak bank rate. The government spending U-turns have moved fiscal and monetary policy in a more coherent direction, however, we would also stress that they cannot change the fact that the UK needs to absorb a sizeable adverse real trade shock. All told, we remain negative on the UK economic prospects. While calmer financial markets and less monetary policy tightening is a net positive, a period of fiscal austerity coupled with lingering political uncertainty suggests the outlook remains subdued.

Trading commentary

The UK is expected to experience the weakest GDP growth of the G10 economies in 2023 at the same time as having the second largest current account deficit. Europe’s Achilles Heel remains the tail-risk coming from either a cold winter or an ugly twist in the war in Ukraine, but the base case of weak growth is well priced in already. The Euro has stabilised thanks to rising bond yields, along with some easing in energy market pressures, as European gas prices recently hit a four-month low.

Although both the UK and Eurozone economies face similar challenges, the UK economic outlook is marred by the prospect of spending cuts and higher taxes in order to plug the budget black hole, whilst Eurozone fiscal policy is more supportive over the medium term. The UK's external financing needs remain large and on current market pricing, inflation adjusted gilt yields are too low, compared to other major currencies. This backdrop does not bode well, because as global growth slows and rates rise across the world, attracting capital is getting more difficult. Considering these elevated funding needs, exacerbated by the BoE’s gilt sales and tighter monetary policy at a time of economic slowdown, Sterling may again need to act as the release valve.

Market Forecasts

	As of	Q4 22	Q1 23	Q2 23	Q3 23	2023	2024	2025	2026
Median		1.14	1.14	1.14	1.14	1.14	1.12	1.06	1.10
Mean		1.12	1.12	1.12	1.12	1.12	1.11	1.08	1.09
High		1.19	1.20	1.22	1.23	1.25	1.16	1.15	1.15
Low		1.05	1.00	0.98	0.98	1.02	1.02	1.02	1.02
Forward		1.16	1.15	1.15	1.14	1.14	1.11	1.10	1.09
Investec	26/10/2022	1.16	1.17	1.19	1.17	1.16	--	--	--
JPMorgan Chase	17/10/2022	1.11	1.20	1.14	1.08	1.12	--	--	--
Barclays	11/10/2022	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.15
Morgan Stanley	26/09/2022	1.08	1.09	1.09	1.08	1.06	--	--	--
Citigroup	20/09/2022	1.12	1.14	1.15	1.15	1.15	--	--	--
BNP Paribas	15/09/2022	1.14	1.12	1.11	1.11	1.11	--	--	--

Source: Bloomberg. Correct as of 02/11/2022

FX Strategist commentary

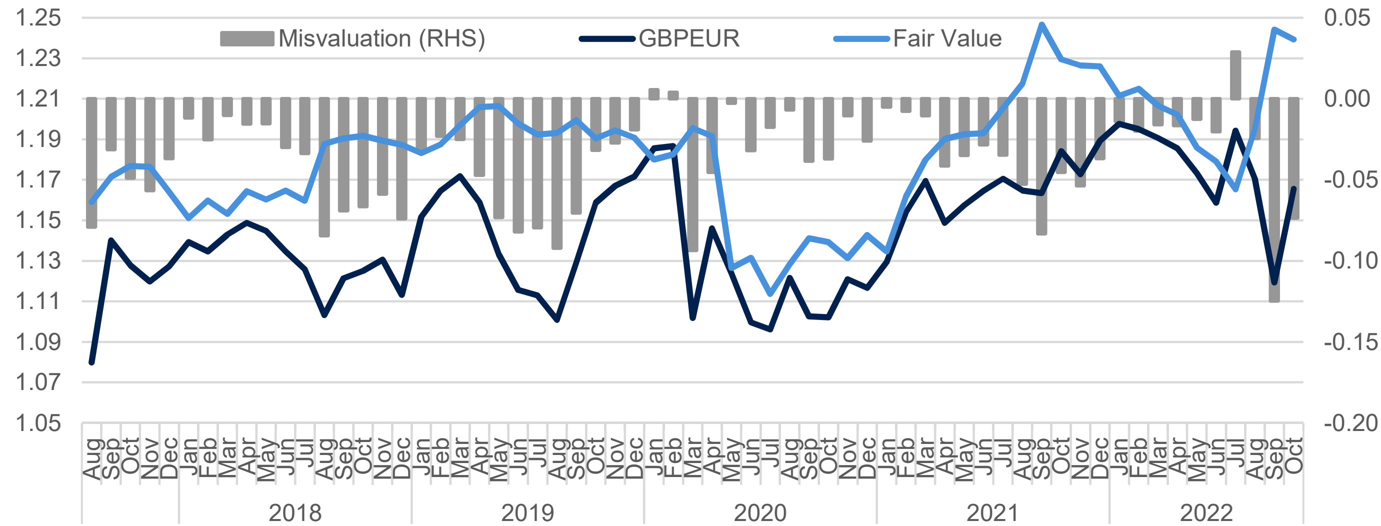
After the extreme gyrations we saw during the previous month, GBPEUR was by contrast relatively rangebound in October. The exchange rate responded positively to the UK government's U-turns over its fiscal plans, to leave it trading near the 2022 average of 1.16 by the end of the month. The sharp falls in September saw most Euro Sellers capitalise in the immediate aftermath whereas discretionary Euro buyers chose to be patient. In general these Euro Buyers find themselves at the lower range of their hedge ratios and as a result they dominated client activity in October, following the recovery in GBPEUR.

Discretionary Euro buyers compensated for the still steep costs of locking in forward Euro deliveries by employing outperformance, whereas systematic buyers opted for guaranteed protection combined with limited participation in favourable moves. The combined Euro buying activity paints the picture that clients currently see somewhere between 1.18 and 1.19 capping GBPEUR's upside over the medium term.

Investec Fair Value Model

GBPEUR has reduced its undervaluation to the Investec Fair Value by almost 50% since last month, although the relative macroeconomic fundamentals driving the model value are not that much changed. The Fair Value remains just above 1.23 with the gap closing coming about entirely from GBPEUR appreciation. Sterling is benefitting from a structural market reassessment, as more credible government fiscal policy has restored investor confidence and reduced the downside tail risks.

At a time when high inflation means rates are rising globally, regardless of growth, relative nominal rates which drive the model valuation are a less reliable indicator of where currencies are going. Whilst this link to interest rates is weaker, looking at growth expectations, another model input, now matters more. The consensus for both the UK and Eurozone is that they will downshift to negative growth next year. However, we are more pessimistic than most on the UK, which if played out would be supportive of the Euro versus the pound.



Source: Investec

Key events this month

3 November – Bank of England Rate

11 November – UK GDP

15 November – Eurozone GDP

16 November – UK CPI

23 November – Eurozone manufacturing PMI

30 November – Eurozone CPI