GBPEUR Update

October 2023

Economic commentary

The latest bank lending figures showed a sizeable fall in loans to the Eurozone private sector, indicating that monetary tightening is being felt. However, the forward-looking component of the survey bounced back significantly and we expect the Eurozone will narrowly avoid a technical recession, with a contraction expected only in Q3. On the structural side of the economy, there is little evidence in Europe's balance of payments data of a permanent loss of competitiveness following the energy shock, despite the struggles of the German manufacturing sector. The Eurozone current account is only moderately lower, as the energy deficit has narrowed again. It has now returned to a level close to that before the outbreak of the Ukraine war. Barring surprises in the data, we expect that the ECB is now done with hiking and will stress going forward its plan of restrictive rates being maintained for 'a sufficiently long duration'. However, if inflation evolves as in our forecasts, cuts could be appropriate from mid-2024.

The UK economy has shown resilience to the numerous challenges it has faced, but the cracks are now clearly showing. The services PMI dropped below 50 in August and slipped a little further in September and unemployment is rising, with the unemployment rate at 4.3%, compared to 3.6% a year ago. Layer on top the clear signs of headwinds from slowing credit growth and a challenging period looks to be in store. Sterling was previously supported by relative interest rates but is now vulnerable to further dovish revisions of 2024 rate cut expectations. The market is pricing in an 80% chance of a hike at some point by February, whereas we think the recent pause signals the peak. Although BoE rate cutting cycles are traditionally much more rapid than hiking cycles, going forwards we would expect a milder pace than usual, in the absence of a major shock, as the BoE retains caution on the risk that inflation may take longer to return to target than in its baseline forecast.

Trading commentary

Sterling's interest rate support has been cut back and while there is still scope for the economy to perform less badly than the consensus gloomy expectations, we anticipate a continued gradual decline in GBPEUR over the medium term. With both the ECB and BoE likely already at their terminal rates, we foresee a tighter interest rate spread moving forward, which should prove supportive to the Euro. We also continue to view the flow of capital as supportive for the Eurozone. The current account has normalised and is now in a comfortable surplus, which implies that the Euro is positioned to weather a slowdown in global growth – and portfolio flows reflect this surplus is not being recycled abroad, as has been the case in the past.

In the near term, we expect GBPEUR to remain within its recent narrow range, as both the UK and European economies experience similar domestic challenges that do not warrant a breakout from the levels observed over the summer. The pair's 200-day moving average provides the closest major technical support for the pound, a level we have remained above since May.

Market Forecasts

	As of	Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Median		1.15	1.15	1.15	1.15	1.15	1.14	1.14	1.14
Mean		1.15	1.15	1.15	1.14	1.15	1.12	1.12	1.12
High		1.19	1.20	1.22	1.22	1.22	1.20	1.16	1.18
Low		1.12	1.08	1.08	1.06	1.05	1.05	1.05	1.05
Forward		1.15	1.15	1.14	1.14	1.14	1.11	1.10	1.09
Investec	26/09/2023	1.16	1.16	1.15	1.15	1.13	--	--	--
BNP Paribas	03/10/2023	1.18	1.16	1.15	1.15	1.15	--	--	--
Nomura	03/10/2023	1.14	1.15	1.16	1.18	1.19	--	--	--
JPMorgan	18/09/2023	1.14	1.14	1.15	1.15	--	--	--	--
Barclays	12/09/2023	1.16	1.15	1.15	1.15	1.15	1.15	1.16	1.18
Citigroup	19/04/2023	1.10	1.11	1.12	1.14	1.15	--	--	--

Source: Bloomberg. Correct as of 03/10/2023

FX Strategist commentary

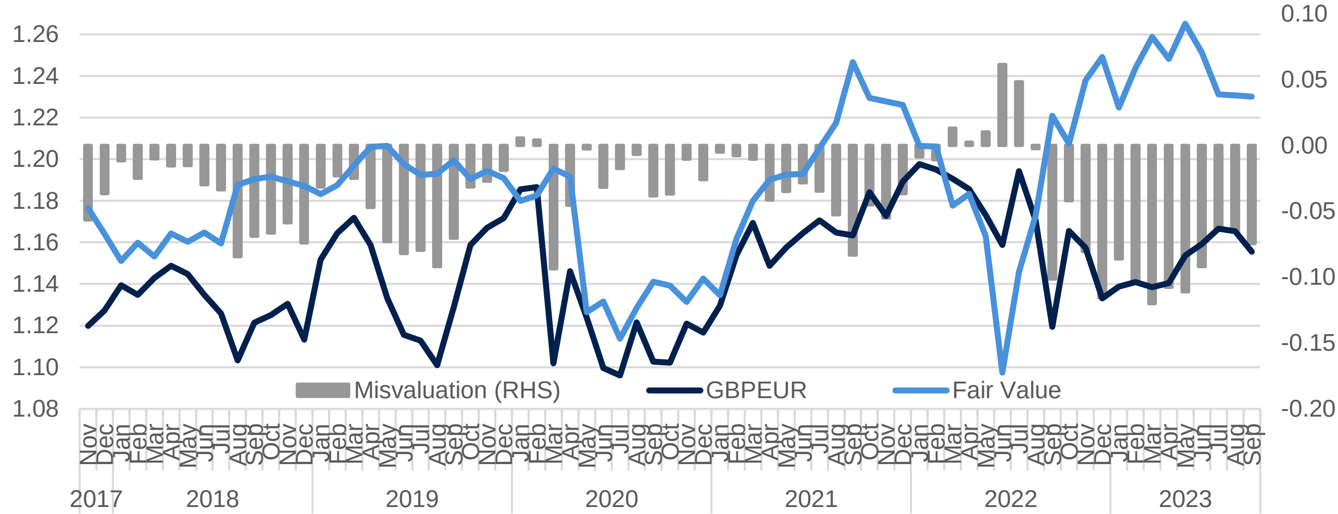
GBPEUR remained within the 1.1500 – 1.1750 range established over the summer again last month. However, it exhibited a clear downtrend, as UK rate rises were priced out of the curve, in the face of the challenging macro environment and a fall in the rate of core inflation. The overall effect was to reduce client activity, as we moved from levels that attract Euro buyers, towards levels that start to encourage Euro sellers to re-enter the market.

Despite the uninspiring levels we observed a continuation of recent pattern of Euro sellers purchasing flexible protection and Euro buyers layering in outperformance deals, as they sought to maintain their hedge rates at close to 1.17. A move below 1.15 would see a decisive shift towards more Euro selling, as below that level sellers would be able to improve on their existing hedge rates. For now, with hedged amounts within their target ranges, they are content to remain patient.

Investec Fair Value Model

The recent extraordinary move up in yields has largely been consistent across different economic regions, leaving little change in rate differentials, with the exception of the UK, which diverged from the recent trend, as the hawkish expectations for the MPC were significantly reduced. The last quarter of 2023 marks a turning point for markets. After more than a year of aggressive tightening, nearly all central banks are now entering pauses. In the near term, this may well mean a continuation of the low foreign exchange volatility environment. But in the medium term, this significant shift is creating opportunities for new trends to emerge.

In the G10, we believe that central banks will be less dominant in shaping currency trends than they were six months ago and in that regard, the long end of the yield curve will matter more than short term policy rates. 2020 - 2022 saw politics dominate Sterling trends, however, there is now a clear shift towards relative growth differentials, resulting from the differentiated impact of monetary tightening, being a key foreign exchange driver ahead. Notably, forecasts for economic growth in 2024 have been on a downwards trend in both the UK and the Eurozone so far this year.



Source: Investec

Key events this month

17 October – UK Unemployment Rate

18 October – UK CPI

24 October – Eurozone manufacturing PMI

26 October – ECB Refinancing Rate

31 October – Eurozone GDP

31 October – Eurozone CPI