GBPEUR Update

September 2023

Economic commentary

August provided further evidence that the Eurozone services sector is beginning to buckle. Joining a manufacturing sector that has been struggling for over twelve months. In the goods sector, new orders weakened further in July, while the backlog of uncompleted work is diminishing. Tightening credit standards and higher rates are depressing loan demand, which will weaken investment activity, slowing the economy. Nevertheless, there is a silver lining. The marked deceleration of headline inflation combined with tight labour markets and nominal wage growth above 4% is providing support to household consumption. This is acting to offset some of the weakness coming from monetary tightening. Concerns about persistent inflation should keep the ECB in a hawkish stance. However, this is more likely to manifest through the ECB's commitment to maintaining elevated rates for an extended period, despite slowing growth, rather than through implementing further policy tightening.

Dynamics in the UK economy are similar to those in the Euro area and can be characterised as stagflationary, with subdued growth and high inflation. Inflationary pressures remain a concern, not least because wage pressures are running far ahead of productivity growth and are yet to abate. The core inflation trajectory in the UK is higher than in the Euro area, and has not yet displayed the convincing downward trend required for the Bank of England to consider pausing rate hikes. However, the peak in policy rates is coming closer. The likelihood of a contraction in activity in the second half of the year is high in our view. We expect elevated interest rates to dampen activity further, particularly in the manufacturing and construction sector and as passthrough from rate rises filters to mortgage holders and indirectly private-sector tenants as well. We anticipate very limited growth in our forecast horizon, with overall UK GDP expected to expand by +0.3% this year and to remain flat throughout 2024.

Trading commentary

We have been cautious about the market's hawkish outlook on UK rate expectations, which could have significant implications for the GBPEUR level, given the strong correlation between the exchange rate and UK and Eurozone interest rate differentials.

However, the slowdown in Chinese activity underscores potential risks for the Euro, given the close economic ties between the two regions. China's debt issue is significant, but it may not necessarily result in a rapidly escalating systemic financial crisis, as the government maintains tight control over the financial system. Much of the adjustment to slow growth may have already materialised and the state-controlled economic rebalancing should contain spillovers to the Euro area. The strength of China's economy should be even less of a concern for the UK. However, we believe that Sterling should trend lower once the BoE has delivered its final policy rate hike. While sticky wage growth and inflation imply notable interest rate support for a while longer, there is now less scope for outperformance versus the Euro, given incipient evidence of demand damage and job market cooling.

Market Forecasts

	As of	Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Median		1.15	1.15	1.14	1.15	1.15	1.12	1.11	1.09
Mean		1.15	1.15	1.14	1.14	1.14	1.12	1.09	1.09
High		1.19	1.20	1.22	1.18	1.22	1.19	1.14	1.15
Low		1.09	1.08	1.08	1.06	1.05	1.05	1.05	1.03
Forward		1.16	1.15	1.15	1.14	1.14	1.11	1.10	1.08
Investec	24/08/2023	1.11	1.10	1.11	1.11	1.11	--	--	--
JPMorgan	07/07/2023	1.14	1.14	1.15	--	--	--	--	--
Barclays	20/06/2023	1.18	1.16	1.15	--	1.14	1.15	1.16	1.18
BNP Paribas	13/06/2023	1.14	1.14	1.14	--	1.14	--	--	--
Citigroup	19/04/2023	1.10	1.11	1.12	1.14	1.15	--	--	--
Morgan Stanley	03/03/2023	1.05	1.06	--	--	1.12	--	--	--

Source: Bloomberg. Correct as of 01/09/2023

FX Strategist commentary

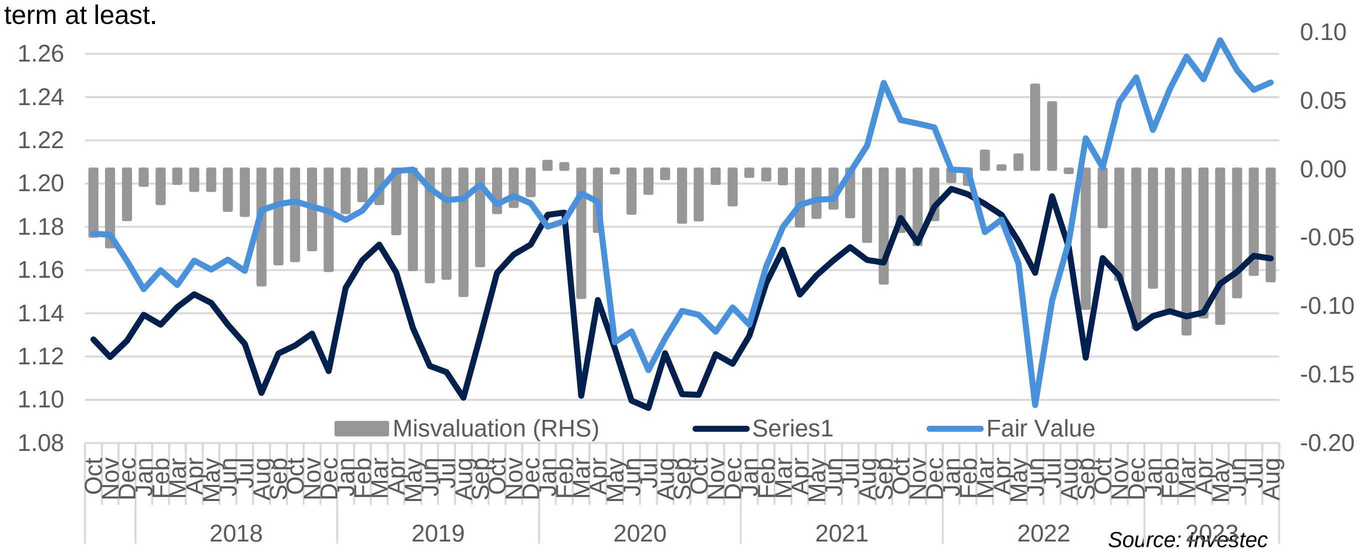
GBPEUR's trading pattern in August was close to a mirror image of July's. The high to low range was even narrower, as volatility continues to remain subdued The ongoing pattern of consistent range trading helps establish a consensus on trading level selection, with Euro buyers becoming active in the 1.17s and Euro sellers in the 1.15s. Our order book reflects this, as clients orders are gathered at the highs and lows of the range. This, in turn, contributes to reduced volatility, by slowing market movements when they approach either side of the range.

Forward hedging made up the largest proportion of client flow in well over a year, as structured hedges struggled to provide levels of flexibility or outperformance that would provoke interest from clients. Among the structured hedging activities observed, a significant portion involved outright vanilla option purchases. These products benefit from the low volatility environment, as clients are able to pay lower premiums for fully flexible protection.

Investec Fair Value Model

One of the less intuitive observations we can make about Sterling is that this year it is proving to be far less sensitive to the external environment. Last year, Sterling showed the third highest correlation to risky assets such as equity markets amongst developed market currencies. Throughout 2023, the pound has exhibited a lower beta than all of these currencies except for the safe-haven Swiss Franc. However, we do not anticipate Sterling to remain indifferent to a further decline in global asset prices. The foreign exchange market is now net long of the pound and the recent rise in energy prices poses a risk to some of the current account improvements that have reduced Sterling's sensitivity to risk, compared to last year.

The Euro continues to screen as rich, with GBPEUR undervalued by 8 cents again this month. GBPEUR has spent the last 3 months in a 1.15 – 1.1750 range, with the end of 2023 interest rate differential priced between 1.7% and 2.4% over the same period. On that basis alone, our forecast of a 150bp differential at the end of Q4 suggests interest rates will not be a catalyst for GBPEUR to close the gap towards its Fair Value in the mid 1.20s, in the near term at least.



Source: Investec

Key events this month

14 September – ECB Refinancing Rate

20 September – UK CPI

21 September – Bank of England Rate Decision

22 September – Eurozone manufacturing PMI

29 September – UK GDP

29 September – Eurozone CPI