GBPUSD Update

March 2023

Economic commentary

How can we explain US economic strength re-asserting itself after the quickest ever pace of Fed tightening last year? Aside from the well known seasonal adjustment problems, January saw unusually warm weather across the highly populated parts of the US. New York City didn't see any snowfall during what is normally its coldest month of the year, which is unprecedented in records going back to 1869 and is one of the main reasons why service sales there rose well above expectations. The recent data does however make us more confident of an economic hard landing, given the boom and bust nature of this cycle, that first emerged with the excessive covid stimulus. This led to a massive spike in the money supply, which brought structural inflation and was always going to require an immense amount of tightening to control. Reliable recession leading indicators still warn of trouble ahead, however, if the pickup in the economy is real, it would suggest that there are upside risks to market pricing of terminal Fed Funds in order to get us there. An immaculate disinflation and soft landing from here would defy historical precedent.

On the topic of the weather, warmer temperatures leading to lower energy prices helped the UK to avoid a recession this winter. Nevertheless, 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

The headline grabbing rise in US front end yields, which have reached the highest levels since the run up to the global financial crisis, was last month matched by increased tightening expectations in the UK, dampening what would otherwise have been a much greater foreign exchange impact. We expect the current GBPUSD trading range to hold as we see a number of factors, beyond relative rates convergence, as repressing Dollar upside momentum. The dollar is strengthening in the midst of still resilient financial markets which act as a brake on Dollar strength, given its negative correlation to broader risk appetite. Additionally terms of trade have improved on the UK side of the equation, driven by lower energy prices.

As a result, despite the recent move lower in GBPUSD, we continue to expect a rangebound trading environment to persist. For Sterling, the scope for independent strength is provided by the starting point in terms of the low GBPUSD level and the already subdued economic expectations baked into the price, which present a lower bar for outperforming expectations.

Market Forecasts

	As of	Q2 23	Q3 23	Q4 23	Q1 24	2024	2025	2026	2027
Median		1.22	1.23	1.24	1.22	1.29	1.33	--	--
Mean		1.22	1.22	1.23	1.23	1.27	1.29	--	--
High		1.28	1.32	1.35	1.28	1.41	1.38	--	--
Low		1.12	1.14	1.13	1.14	1.12	1.14	--	--
Forward		1.20	1.20	1.21	1.21	1.21	1.21	1.21	1.21
Investec	27/02/2023	1.25	1.25	1.25	1.27	1.31	--	--	--
JPMorgan	03/03/2023	1.18	1.16	1.15	--	--	--	--	--
Morgan Stanley	03/03/2023	1.20	1.21	1.21	1.22	1.24	--	--	--
BNP Paribas	14/02/2023	1.24	1.26	1.28	--	1.33	--	--	--
Citigroup	12/01/2023	1.22	1.25	1.27	1.28	1.34	--	--	--
Barclays	09/01/2023	1.24	1.26	1.29	--	1.23	1.25	1.28	1.30

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

FX Strategist commentary

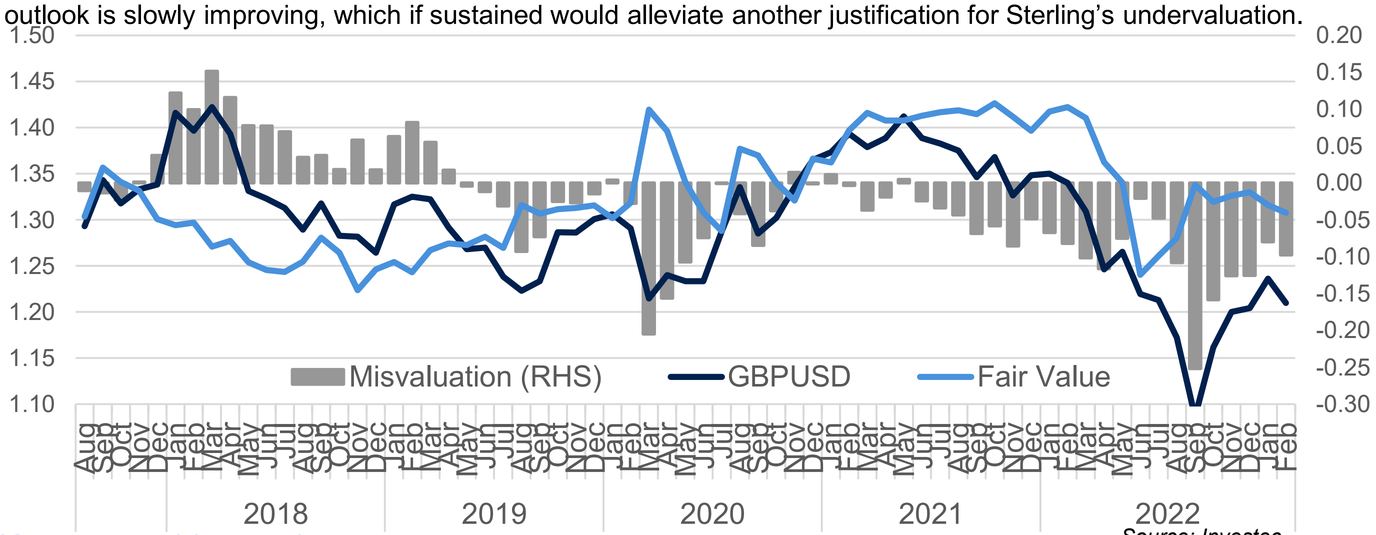
February started with GBPUSD hovering around the 1.24 resistance level that it spent the latter part of January battling against. The outsized US January Payrolls print proceeded to send it lower, down to 1.20 and reversed the outlook of markets. As a result the expectations of Dollar buyers went from a upbeat one hoping for a break higher into a defensive one, where protection at 1.20 was sought, to ensure budget rates could be achieved. The further strong data emanating out of the US last month solidified the impression of US economic exceptionalism, which kept discretionary Dollar buyers on the sidelines, hoping for a change in the narrative to send GBPUSD higher again.

At the same time the bout of volatility gave Dollar sellers renewed confidence that their approach of underweighting their hedge amounts, to leave greater room for participation in favourable moves lower, was appropriate. This now leaves both sides of the market hoping for a break away from current levels, before they look to add more cover. Currently hope around this is higher amongst Dollar buyers who have been placing orders and making assurances to re-engage towards the highs of the recent range, whereas Dollar sellers are less committal and are adopting a wait and see approach.

Investec Fair Value Model

Recently there has been a reduction in the impact of risk appetite on foreign exchange, as bond yields have reasserted themselves as a driver of currency performance. This yield dependence is built into the Investec Fair Value model, however the conformity of interest rate moves in the UK and US last month leaves it settled around 1.30 for another month. The Dollar is inversely correlated to financial market sentiment, but this relationship has weakened as this has proved resilient. Further risk aversion is likely to see the correlation pick up again. The health of the global cycle is another predominant driver and its stabilisation has similarly held back the Dollar's advance.

Relative to Fair Value, the pound fell to around 18% undervalued at its lowest point at the end of September 2022. While around half of that cheapness has retraced, the Dollar remains expensive. The perception of the UK growth outlook is slowly improving, which if sustained would alleviate another justification for Sterling's undervaluation.



Source: Investec

Key events this month

10 March – US Nonfarm Payrolls

14 March – US CPI

22 March – UK CPI

22 March – FOMC Rate Decision

23 March – BoE Bank Rate

30 March – US GDP

31 March – UK GDP