GBPUSD Update

November 2022

Economist commentary

The US economy is holding up better than feared a few months ago and underlying inflation is running well above target, as its source has transitioned from fading supply constraints to the very tight job market. This opens up the prospect that the Fed will have to stay on an aggressive tightening pace for longer than previously expected. That is a feat that the Bank of England is unlikely to be able to match, given the UK's weaker growth outlook and the faster passthrough from rate hikes to tighter financial conditions in the UK. A higher for longer message supports the Dollar, as Chair Powell continues to explicitly push back against the view that the peak in US inflation has been reached. When it looks back over economic history the Fed can see that there have been many times when it did not do enough and so inflation re-accelerated, but it cannot find any instances in the past when it did too much to dampen inflation. As a result it is content to risk overdoing tightening, even if this leads to a recession which we expect to arrive in the latter part of 2023, than to allow high inflation to become embedded in the economy.

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 Dollar is supported by a resilient economy, a hawkish central bank and favourable terms of trade, but recent Dollar price action has shown some signs of fatigue and has raised questions about whether the bullish Dollar view is priced in and further upside is likely to be more limited. We would argue to the contrary that many of the reasons for the recent Dollar sell off were transitory. Long Dollar positioning has been reduced and is not likely to be a further source of Dollar weakness. Additionally, the large fall in the wholesale gas price has alleviated a lot of the pressure on the UK balance of payments, which supported the Pound versus the Dollar. However, these gas price falls are unlikely to be repeated, as they reflect a front-end surplus driven by a lack of storage for overflow gas and temporary warm weather led demand reduction. What is more, despite the UK economy showing every sign of having slipped into recession recently, the market still prices UK rates rising to a peak between 4.5% and 4.75% by late spring, and then staying there throughout the rest of next year. Anything seems possible in the turbulent world of UK policymaking, but we would expect that rates will be on a steady downward path from the middle of 2023 onwards and if the market starts to price that in it will be another negative for GBPUSD.

Market Forecasts

	As of	Q4 22	Q1 23	Q2 23	Q3 23	2023	2024	2025	2026
Median		1.10	1.10	1.12	1.15	1.17	1.22	1.25	1.28
Mean		1.09	1.10	1.13	1.15	1.17	1.23	1.21	1.22
High		1.19	1.23	1.24	1.29	1.27	1.30	1.25	1.28
Low		1.00	1.00	1.01	1.06	1.07	1.10	1.10	1.10
Forward		1.15	1.15	1.15	1.15	1.16	1.16	1.15	1.15
Investec	26/10/2022	1.15	1.17	1.21	1.22	1.22	--	--	--
JPMorgan Chase	17/10/2022	1.05	1.08	1.10	1.11	1.16	--	--	--
Barclays	11/10/2022	1.13	1.13	1.15	1.18	1.21	1.23	1.25	1.28
Morgan Stanley	26/09/2022	1.00	1.03	1.05	1.06	1.07	--	--	--
Citigroup	20/09/2022	1.13	1.17	1.20	1.22	1.23	--	--	--
BNP Paribas	15/09/2022	1.14	1.13	1.13	1.16	1.18	--	--	--

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

FX Strategist commentary

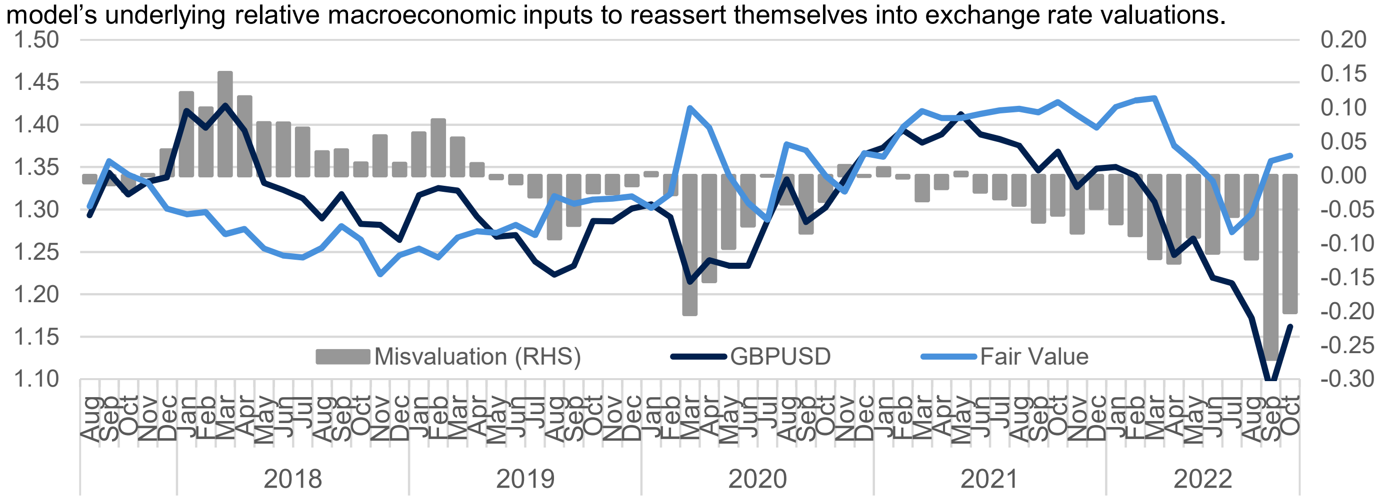
The disparity between the hedging activity of Dollar Buyers and Dollar Sellers grew again last month with Dollar Sellers primarily only looking to book short dated contracts as they remain well covered for the entirety of their hedging profiles. This client set will be mindful that their hedged rates remain a good distance away from current market rates, being on average in the mid 1.20s. Also with their hedge ratios at the upper bounds they have limited ability to benefit from further moves lower in GBPUSD. Therefore they are typically holding tight, at least until we see a move back down to the recent lows, before they look to supplement their longer term hedging.

In contrast to this discretionary Dollar Buyers remain towards the bottom end of their desired hedge ratios and continue to employ longdated outperformance structures to achieve Enhanced Rates at 1.20 and above. Systematic Dollar Buyers favour flexible protection over outperformance and are typically content to protect rates above 1.14, in return for also allowing themselves to participate in favourable moves up until the low to mid 1.20s.

Investec Fair Value Model

The Investec GBPUSD Fair Value model shows that since last month a sizeable amount of the structural undervaluation of GBPUSD has reduced as the UK government continues to enact a sizeable fiscal u-turn to restore economic credibility. However, the gap between the model value and the market rate is still amongst the largest in recent history. The surprise policy announcements and subsequent u-turns have left Sterling trading in a more structural manner, rather than following cyclical developments, such as relative interest rates. This was evident in the aftermath of the mini-budget, when Sterling fell significantly while gilt yields jumped. Since then Sterling has recovered despite UK yields falling back more quickly than in the US, confounding the model assumptions.

The Dollar is trading significantly rich relative to the model's estimate of its medium fair value. This is driven in part because global investors are overweight US assets and foreign exchange hedge ratios on these assets are at low levels. The bar for the Dollar to enter the structural bear market the model points towards is a high one though. It will need European energy markets to normalise, reduced risk aversion and less volatile financial markets in order for the model's underlying relative macroeconomic inputs to reassert themselves into exchange rate valuations.



Source: Investec

Key events this month

3 November – Bank of England Rate

4 November – US Nonfarm Payrolls

11 November – UK GDP

10 November – US CPI

16 November – UK CPI

16 November – US Retail Sales

30 November – US GDP