GBPUSD Update

October 2023

Economic commentary

In September, the catalyst for higher Treasury yields shifted from the Fed's 'higher for longer' stance, to an increase in the term premium – the compensation investors demand for the uncertainty of holding longer duration bonds. More recently, yields have risen across all tenors, as the market pushes out the length of time it expects the Fed to remain on hold for, pricing out some of the cuts that were previously anticipated for 2024. Tighter financial conditions will provide the impetus for US growth to slow next year, as inflation recedes, which should result in a weaker Dollar once the dust settles. In the meantime, the data are robust and the Dollar is strong. The issue for the Fed is that it is not clear that policy is sufficiently restrictive, with the economy holding up despite their dramatic tightening. It is notable that much of the language from the Fed suggests another rate hike could be needed unless the data provide dovish comfort.

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

High US treasury supply pushing yields up and steepening curves, with yields continuing to reach post-2007 highs, has defined financial markets in recent weeks. The world must reallocate more of its capital to US bonds, and higher yields do the work, resulting in a stronger Dollar as more capital is either invested in the US or is attracted there from abroad.

The broad Dollar has now risen for eleven consecutive weeks, marking its longest winning streak on record outside of 2014/15. September is often a bad month for risk sentiment after which October sees a bounce and markets are threatening a repeat of last year, where the pace of the sell-off in Treasuries and the rally in the Dollar proved too fast and caused an overshoot, followed by a correction and period of position adjustment, before a return to fundamental drivers. With the US economy consistently beating expectations and UK sentiment poorer, despite output revisions, Sterling will remain under pressure until sentiment improves, particularly as positioning indicators suggest that the market as only marginally long Dollars against Sterling.

Market Forecasts

	As of	Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Median		1.25	1.26	1.27	1.27	1.29	1.29	1.30	1.32
Mean		1.25	1.26	1.27	1.27	1.29	1.30	1.28	1.30
High		1.32	1.35	1.34	1.38	1.40	1.45	1.32	1.34
Low		1.15	1.13	1.11	1.15	1.19	1.20	1.20	1.20
Forward		1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.21
Investec	26/09/2023	1.24	1.25	1.25	1.26	1.26	--	--	--
BNP Paribas	03/10/2023	1.26	1.29	1.29	1.30	1.32	--	--	--
Nomura	03/10/2023	1.16	1.20	1.23	1.27	1.31	--	--	--
JPMorgan	18/09/2023	1.20	1.20	1.24	1.29	--	--	--	--
Barclays	12/09/2023	1.26	1.24	1.25	1.26	1.28	1.29	1.31	1.34
Citigroup	19/04/2023	1.27	1.29	1.32	1.34	1.37	--	--	--

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

FX Strategist commentary

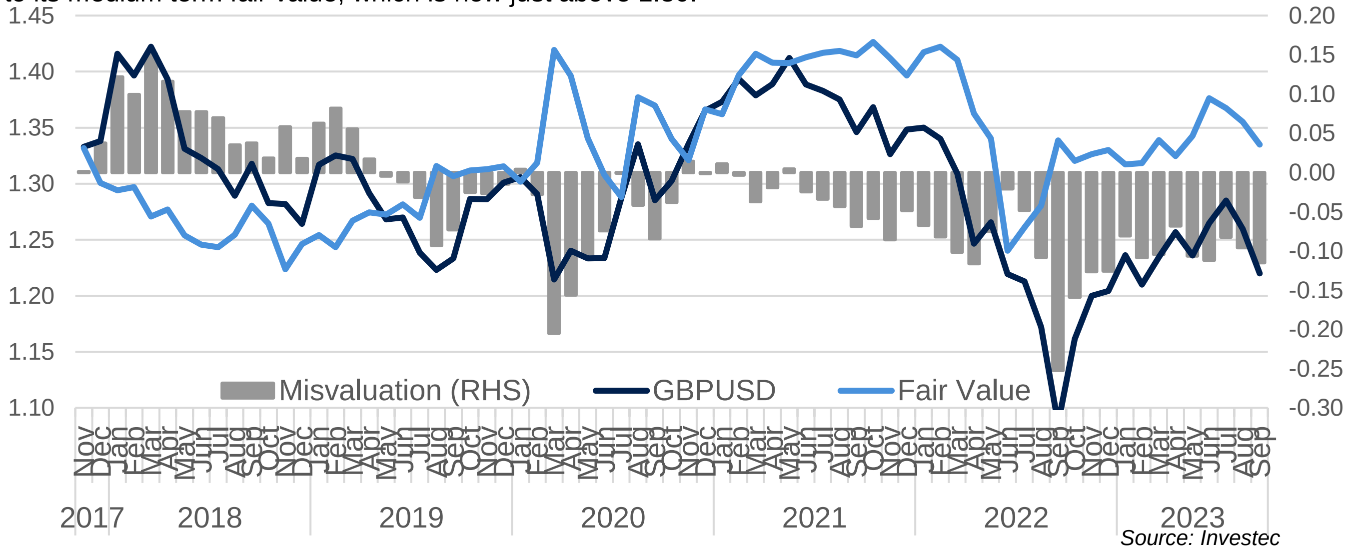
Last month the steady stream of Sterling bearish newsflow fed through to client sentiment and caused a pick up in interest from Dollar buyers in outperformance targeting 1.30. Previously they had been cautious around the amount of long term cover they added at this level, in case the market moved higher. This gave way to an extent as GBPUSD fell to six month lows, as treasurers sought to maintain their current overall hedge rates.

The average tenor of deals increased as this was required to generate the increased outperformance and additionally many Dollar buyers are now occupied with achieving adequate cover for the second half of 2024. On the other side of the market Dollar Sellers remained patient, as the fall in GBPUSD was orderly and well flagged, given the dramatic rise in US yields. Many are awaiting market consolidation or a break below 1.20 before adding new cover. This is typical of past behaviour where Dollar sellers are less quick to add cover when markets move in their favour, because these moves are associated with risk aversion. Uncertainty over the economic outlook and where we are in the economic cycle is high, which prompts caution over forecasting and therefore hedging.

Investec Fair Value Model

September was a lacklustre month for the pound, when it ranked as the worst performing G10 currency. GBPUSD dropped almost 4% as it was dragged down by higher US yields. The Dollar is trading rich compared to long-run averages and the 6% rally in the broad Dollar since mid July is pushing valuations to historically elevated levels.

One positive factor for Sterling, in an environment where exchange rates are heavily influenced by growth expectations, is that forecasts for UK growth are already modest compared to those for the US. This may be sufficient to prevent a fall outside of the longer term GBPUSD range, but the pound could remain undervalued if we do not get any positive surprises from the real economy data soon. It appears likely that the supply-side shocks caused by the pandemic and the war are proving somewhat persistent. Consequently, cheaper Sterling valuations may be necessary to sustain the UK's economic competitiveness, prolonging GBPUSD's continued undervaluation to its medium term fair value, which is now just above 1.30.



Source: Investec

Key events this month

6 October – US Nonfarm Payrolls

12 October – US CPI

17 October – UK Unemployment Rate

17 October – US Retail Sales

18 October – UK CPI

26 October – US GDP