GBPUSD Update

September 2023

Economic commentary

The US economy is holding up better than expected. At the same time, core inflation has decreased over the past two months, while excess demand for workers has been slowly falling. The September employment report showed a slowdown in wage growth and an increase in labour-force participation, underscoring a gradually moderating job market. Taking this into account we could envision a path leading to an eventual soft landing, however, we still consider it the less likely scenario. Monetary policy is now clearly restrictive. Moreover, the cumulative effect of the sharp tightening is not yet fully reflected in economic activity and our expectation remains that the US will fall into a mild recession around the turn of the year. The recent resurgence in economic activity raises the likelihood that inflation will not come down in a straight line and that the Fed will be slow in reversing its stance. Despite the considerable uncertainty surrounding this, we expect enough economic slack will emerge to maintain the trend of slowing inflation and allow the Fed to implement around 125bp of easing next year.

Dynamics in the UK economy 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 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

The link between relative interest rates and foreign exchange levels remains strong, but the lack of a big divergent trend in UK and US rate expectations, despite the continued surge in yields in August, contributed to GBPUSD registering its fifth-narrowest monthly trading range in the last two decades. Foreign exchange markets have had to contend with 10 year US inflation adjusted yields breaking out of their cycle highs. These yields are now approaching 165bp, their highest since 2009, which is keeping the Dollar on the front foot.

US rates will remain pivotal for currency markets and the Dollar, although we anticipate their significance will diminish somewhat. This is because, while US yields can increase further, we foresee limits on how high they can go, given already stretched Treasury bond valuations. Simultaneously, weakness in certain aspects of UK economic data and the additional impact on activity of the ongoing inflation battle have become more of an upside constraint for the pound, limiting a move above 1.30. We therefore continue to expect GBPUSD to largely trade sideways in the near term.

Market Forecasts

	As of	Q4 23	Q1 24	Q2 24	Q3 24	2024	2025	2026	2027
Median		1.27	1.27	1.28	1.31	1.30	1.32	1.28	1.27
Mean		1.27	1.27	1.28	1.30	1.31	1.31	1.27	1.27
High		1.37	1.40	1.43	1.34	1.43	1.45	1.32	1.34
Low		1.13	1.16	1.18	1.26	1.20	1.20	1.20	1.20
Forward		1.27	1.27	1.27	1.26	1.26	1.25	1.25	1.24
Investec	24/08/2023	1.25	1.24	1.26	1.27	1.28	--	--	--
JPMorgan	07/07/2023	1.19	1.23	1.29	--	--	--	--	--
Barclays	20/06/2023	1.29	1.29	1.29	--	1.30	1.33	1.36	1.40
BNP Paribas	13/06/2023	1.27	1.28	1.31	--	1.34	--	--	--
Citigroup	19/04/2023	1.27	1.29	1.32	1.34	1.37	--	--	--
Morgan Stanley	03/03/2023	1.21	1.22	--	--	1.24	--	--	--

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

FX Strategist commentary

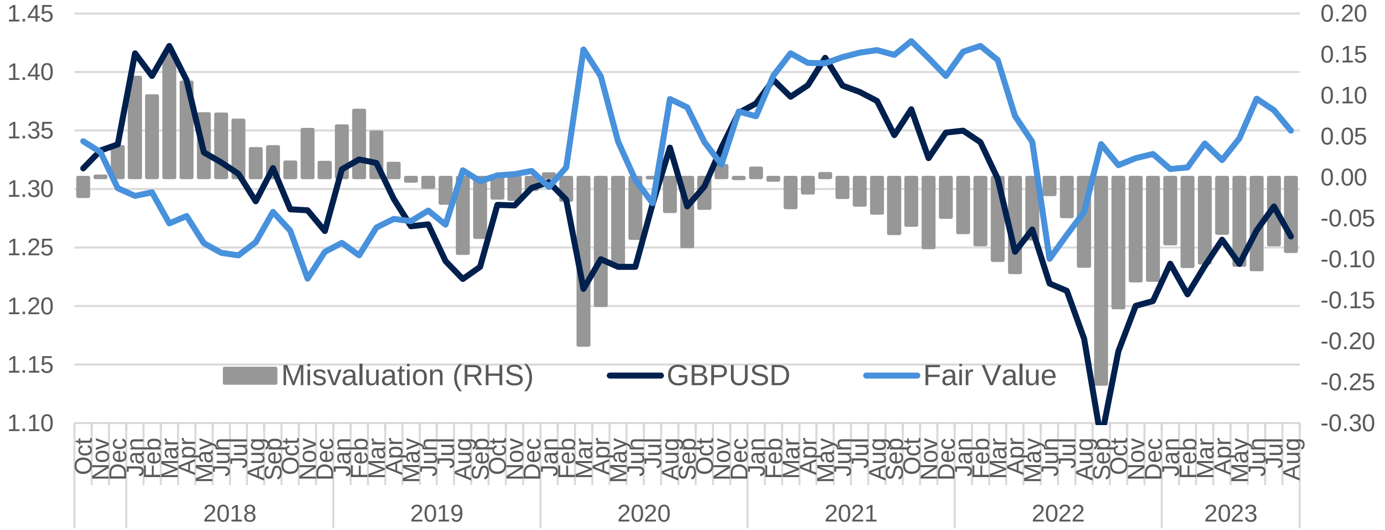
August was a relatively slow month in terms of totally new client hedging activity. However, the calm market conditions provided clients with the opportunity to conduct more comprehensive reviews of their foreign exchange portfolios. In many cases, this led to the decision to restructure deals, to better align with them with their hedging objectives. Having adopted tapered hedging profiles, which front load hedging into the earlier quarters, because of uncertainty over the forecast horizon and because of the historically low GBPUSD rate, Dollar buyers were now more comfortable to extend their hedging further into 2024. As a result, they were able to improve their overall levels for the remainder of this year, by freeing themselves from less attractive trades, as they blended in additional cover.

On the other side of the market systematic Dollar sellers were happy to protect in the high 1.20s in return for participation down to the low 1.20s. However, discretionary sellers were mostly quiet, with the exception of those seeking to augment outperformance deals, that were in danger of running out of their profit targets.

Investec Fair Value Model

The recent sharp upward revision in US GDP growth forecasts contrasts with a smaller downward revision in the UK. US 2023 consensus growth has risen from 0.3% at the start of the year to 2% today. The recent robustness of US data has seen consensus forecasts rise beyond just 2023, to improve over the course of 2024, showing the improvement is expected to continue beyond the near term.

The relative strength in US activity indicators and growth expectations – compared to the UK and the rest of the world in fact – has kept the dollar in demand over the past few weeks, and should remain the primary driver of Dollar moves into year-end. Higher US inflation adjusted interest rates (currently the highest in the G10) will be expected to keep a floor under the Dollar, however, it is important to note that they also represent a meaningful tightening in US financial conditions which if it persists could eventually exert downward pressure on the economy and potentially the currency as well.



Source: Investec

Key events this month

13 September – US CPI

28 September – US GDP

20 September – UK CPI

21 September – Bank of England Rate Decision

29 September – UK GDP

29 September – FOMC Rate Decision

Investec