GBPEUR Update

May 2022

Economist commentary

Despite the looming threat of further disruption to energy supplies and the negative effect this is having on business confidence a Eurozone recession is not our central expectation. We forecast quarterly growth of 0.2% in Q1, whilst our full year 2022 and 2023 GDP forecasts stand at 3.2% and 3.0%, broadly unchanged from a month ago. It is Germany, the largest member of the Eurozone economy and formerly the engine of growth, that we expect to be one of the drags on economic output and where we feel recession risks are more elevated. The German government is hoping to shield the economy by delaying a Russian energy embargo. The problem is that because businesses are forward-looking and anticipate an embargo will come eventually, the business climate is already deteriorating rapidly.

Recession warnings are also burning brighter in the UK, given the historic squeeze in disposable incomes facing households over the coming quarters, including the combination of fiscal and monetary policy tightening. We expect Q2 GDP to contract by 0.2% on a quarterly basis, driven by a drop in government health spending, higher taxes, the big jump in prices and the extra June bank holiday. However, we think a negative Q2, will likely be followed by a modest rebound in Q3 of around 0.3%. We then see a flat or slightly negative Q4, weighed by another bout of inflationary pressures. Ultimately, we think strong household balance sheets and consumers tapping into their savings should help avoid an outright drop in household spending or recession. Household balance sheets are the strongest they have been since before the global financial crisis – at least in aggregate. Also, the job market is historically tight, so any potential slowdown in demand will likely result in a more muted impact on unemployment.

Trading commentary

The UK consumer is more gloomy on their personal finances than their continental counterparts, partly because of differences in government support to cushion households from the cost of living crisis. The rise in National Insurance and the limited support for rising energy bills both underpin fears that the economy may be headed for a downturn. On the business front, in general firms' confidence has been holding up much better than that of consumers, but we think that this divergence is unlikely to persist.

The EU's high inflation and robust growth are not harmonious with negative rates and the ECB's €9 trillion balance sheet. We would be very confident in this being unwound were it not for uncertainty over threat of disruption to energy supplies. The UK led the way into the rate-hiking cycle and the UK economy is the most vulnerable to stagflation. The market is pricing in twice as big a rise in rates over the rest of this year from the MPC compared to the ECB. This is a major handicap. With the economic outlook deteriorating fast, rate increases that are well discounted will do little to help the pound and still believe it will trade lower versus the Euro.

Market Forecasts

	As of	Q2 22	Q3 22	Q4 22	Q1 23	2023	2024	2025	2026
Median		1.19	1.19	1.18	1.18	1.18	1.15	1.15	--
Mean		1.19	1.19	1.18	1.18	1.18	1.16	1.18	--
High		1.22	1.25	1.28	1.28	1.28	1.30	1.30	--
Low		1.16	1.11	1.09	1.08	1.04	1.14	1.12	--
Forward		1.19	1.18	1.18	1.16	1.15	1.15	1.14	1.14
Investec	27/04/2022	1.21	1.20	1.20	1.20	1.19	--	--	--
JPMorgan Chase	02/05/2022	1.20	1.20	1.20	1.19	--	--	--	--
Morgan Stanley	26/04/2022	1.20	1.19	1.18	1.16	1.12	--	--	--
Citigroup	13/04/2022	1.19	1.18	1.18	1.18	1.18	--	--	--
BNP Paribas	31/03/2022	1.16	1.16	1.16	1.16	1.16	--	--	--
Barclays	30/03/2022	1.20	1.20	1.20	1.20	1.22	1.20	1.19	1.18

Source: Bloomberg. Correct as of 02/05/2022

FX Strategist commentary

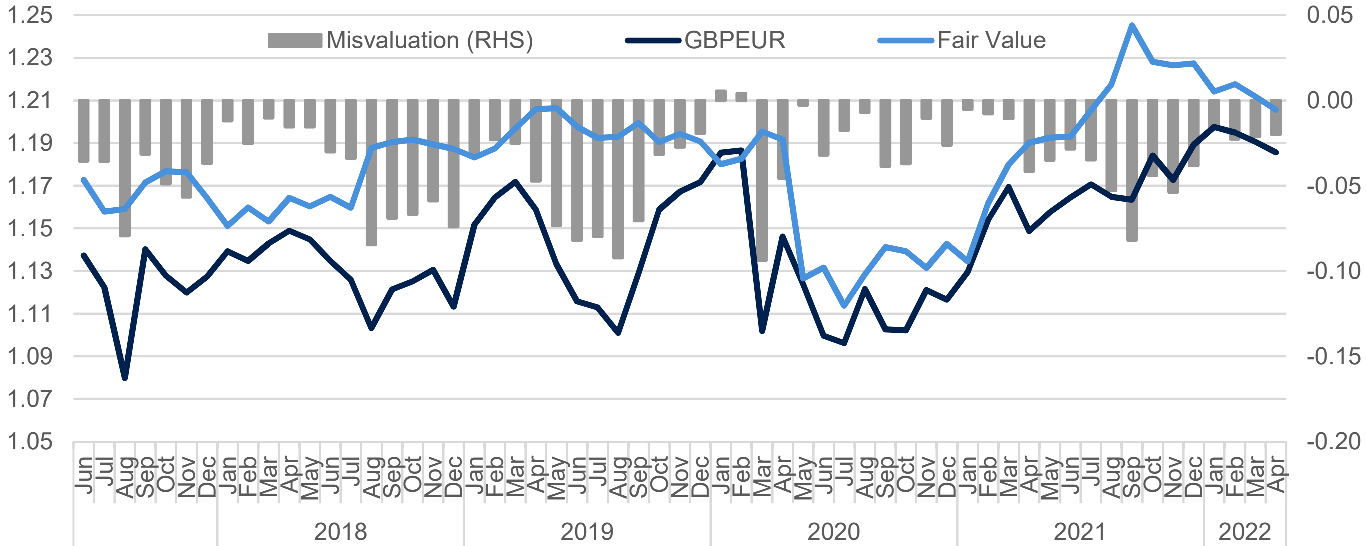
Last month was in many ways a repeat of the previous one in terms of the opportunities that it offered clients with Euro exposures. After rallying to close to 1.21 in the first half, GBPEUR then saw a sharp fall back to almost 1.18, giving both buyers and sellers the chance to improve their averages. The general trend higher in GBPEUR over the past six months has made it easier for Euro buyers to achieve their target hedge rates and hedge ratios, whilst Euro sellers have found this more difficult. As a result while buyers are relatively relaxed about rises in GBPEUR, whenever there is a sharp fall, we see a notable pick up in Euro selling activity and this was the case again.

The majority of Euro sellers looked for guaranteed protection rather than outperformance, however the rise in expected volatility meant that many clients chose to employ leverage in order to improve their levels, meaning that the hedge rates achieved were close to 1.16. Among Euro buyers it was predominantly systematic clients who added to their cover. Discretionary buyers were generally either comfortable with their levels of cover or felt they could afford to wait for more favourable levels to bring up their averages.

Investec Fair Value model

The latest PMIs show a continued rise in factory input costs, but a fall in output prices in the UK. This is the first time such a combination has been seen since late 2019 in the UK, but it has yet to happen in the Euro Area since the inflationary wave began last year. Such a combination marks a fall in the relative competitiveness of the UK economy and as this measure is a direct input into the GBPEUR Fair Value model this has continued its recent gradual decline for another month and now lies at around 1.20.

European bond yields have also staged a small comeback to those of UK gilts, which also weighs on the Fair Value. The explanatory power of interest rates is diminished in the case of the Euro and Sterling because the central banks are hiking for 'bad' reasons such as the increase in production costs and wages. While ordinarily higher rate differentials would be supportive of a currency, in the case of the frail UK and Eurozone economies there are doubts over whether they can sustain higher rates without tipping into recession.



Source: Investec

Key events this month

5 May – UK Bank of England Rate

12 May – UK GDP

18 May – UK CPI

17 May – Eurozone GDP

18 May – Eurozone CPI

24 May – Eurozone Manufacturing PMI