Liquid Insight

GBP: Back to Basics

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Rates and Currencies Research
Global

Global Rates & Currencies Research
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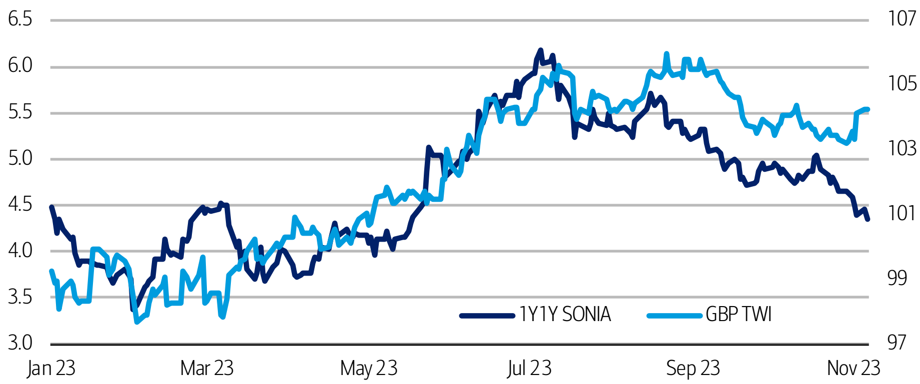
Key takeaways

- GBP back into the G10 fold after a year where idiosyncratic risk premium has been priced out. Sense of normality has returned
- Reduced GBP risk premium has helped outperformance & seen recalibration to traditional drivers: rates & risk = lower GBP/AUD
- Pricing out of '24 UK rate cuts should be +ve GBP whilst risk-on also +ve. GBP lows in place but structural headwinds matter

By Kamal Sharma

Chart of the day: GBP TWI vs 1Y1Y SONIA
Rates are back as a significant driver for GBP since the start of the year



Source: BofA Global Research, Bloomberg

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A semblance of normality

A key part of our GBP narrative in 2023 has been that the pricing out of idiosyncratic risks meant that the lows in GBP were in place. However, pricing out bad news rather than pricing in much good news would also suggest that GBP rallies would be limited. Though GBP has performed well versus G10 peers, this has not been enough to challenge the post Brexit ranges. 2023 has therefore provided the clearest manifestation of the "GBP Reset": our theory that the structural headwinds to the UK economy would keep GBP confined to a lower trading range established since 2020. The removal of UK-specific risk premium has consequently seen GBP re-establish itself to some of its traditional anchors. Global risk sensitivity is once again a key driver for GBP. Of more significance is the return of rate sensitivity as a key variable.

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The good, the bad & GBP

In many ways, GBP has traditionally been a relatively straightforward currency to analyse. Sterling has historically been guided by the global rates cycle but also the global risk cycle. Recent events have, however, been anything but predictable as GBP has been buffeted by several idiosyncratic factors which saw GBP decouple from its traditional anchors. However, it has become increasingly evident that these drivers have once again returned as important drivers for sterling. This is important as it has implications for market participations. The lifeblood for any currency is predictability and having certainty around key variables. This was severely impacted in September 2023 when the GBP FX became increasingly dislocated. But since then, a semblance of normality has returned. From consistency in bid-offer spreads and improved liquidity to a normalisation in FX volatility versus G10 peers, GBP is no longer the outlier it has been in recent years.

Table 1: Heatmap of UK Assets Following September 2022 Tumult

UK assets have normalized over the past year

	GBP Vol Sprd vs G10	UK 10yr Yield	Policy Uncertainty	UK 2yr Rate Spread	UK-Germany CDS Spread
GBP Crisis (Sept '22)	5.32	3.79	6.48	4.96	5.86
1Y	0.81	2.29	0.01	0.88	0.18
3M	-0.93	1.47	0.32	1.49	1.63
1M	-0.36	1.41	-0.69	0.34	0.46
1W	-0.31	1.33	2.11	0.17	0.62
Current	-0.36	1.16	-0.11	0.08	0.89

Source: BofA Global Research, Bloomberg

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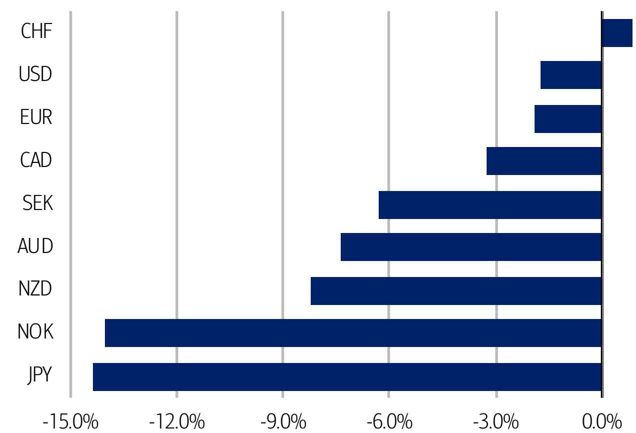
Exhibit 1: GBP Performance vs G10 YTD, %

Pricing out of risk premium has led GBP recovery in 2023



Source: BofA Global Research, Bloomberg

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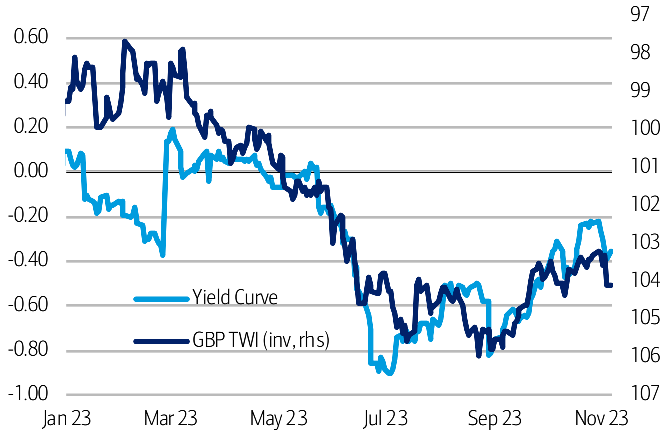
This year's price action has been dominated by the continued pricing out of risk premium following the September 2022 tumult. As Table 1 highlights, September 2022 marked the high point in market stress in UK assets. Normalisation has continued through much of the year. This is an important backdrop in understanding GBP price action through 2023. In our view, the bulk of the heavy lifting which accounts for sterling outperformance through this year has been driven by the pricing out of idiosyncratic risk premium (the "bad news") rather than a fundamental improvement in the outlook for the UK economy (the "good news"). GBP has consequently performed strongly since the start of the year (Exhibit 1) as risk premium has normalized and extreme bearish sentiment/positioning has been liquidated according to our suite of indicators (please see Liquidi Cross Border Flows: USD sell-off can extend & FX and Rates Sentiment Survey – I have a dollar). However, as we discuss below, the GBP correction has come against the backdrop of an increasingly challenging structural macro outlook, which we think will be the limiting factor for sterling rallies in 2024.

The return of some familiar friends

Recent signs have been encouraging, suggesting that GBP has reintegrated back into the G10 pack following the risk premium unwind. Our Chart of the Day encapsulates the most significant improvement in the fortunes of GBP. Sterling's rate sensitivity has been well known. It is the consummate play on the rates cycle, more so than any other in G10. Both on an outright (UK), spreads (UK versus weighted G10) and yield curve basis, GBP has shown a consistent correlation. Exhibit 2 shows the relationship between GBP TWI (inverted) and the UK yield curve (2s10s). An interesting feature of this chart is the inverse relationship: GBP tends to weaken as the curve steepens. To us this suggests that the path of front-end rates is more important for the pound than back-end rates. Part of the explanation may lie in our analysis of risk premium above: a bull flattening of the curve as buyers re-entered the market after the September 2022 sell-off. Recent steepening of the curve has once again begun to weigh on GBP.

Exhibit 2: GBP versus UK yield curve (2s10s)
GBP TWI rallies on curve flattening of the UK yield curve.



Source: BofA Global Research, Bloomberg

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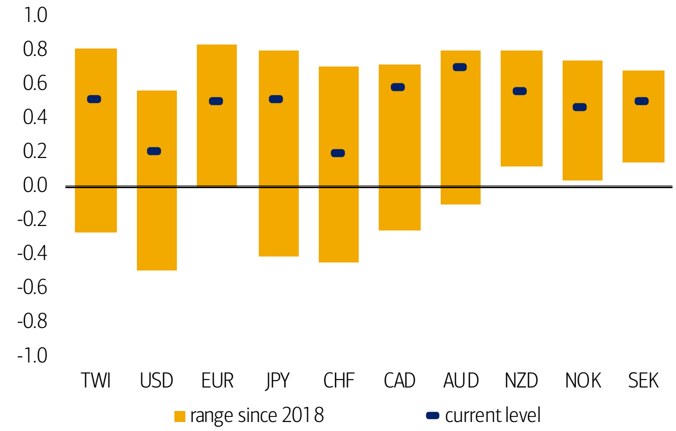
Exhibit 3: GBP/XXX correlation versus rate spreads*
Correlation has improved between GBP/XXX and rate spreads.



Source: BofA Global Research, Bloomberg. *6mth rolling correlations between GBP/XXX & relative rate spreads.

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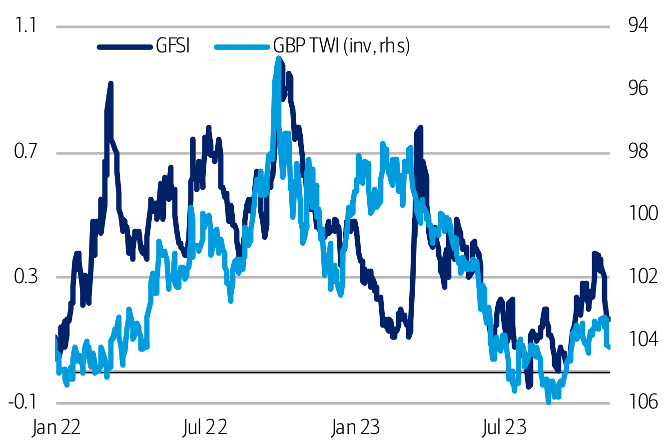
Exhibit 3 looks at the re-emergence of UK rate differentials as a potent driver for GBP on a TWI and relative basis. Widening front end spreads has been a function of improving UK data and the pricing out of downside macro risks and the comcomitant rise in rate hike expectations. Unsurprisngly to us, GBP/AUD has the strongest correlation to relative rate spreads and perhaps offers the best opportunity for those looking to play divergent central bank policies. Taking the three charts together, it is clear to see that rates are now back in favour as the key driver for GBP. On this metric alone, we continue to believe that market pricing for UK rate cuts into next year seems inconsistent with rhetoric from the BoE. We believe that the profile ressembles more of a table top rather than a downward sloping curve. Pricing out those rate cuts provides support for GBP, in our view.

Exhibit 4: GBP TWI vs BofA GFSI
Risk is also back as a driver for GBP TWI



Source: BofA Global Research, Bloomberg

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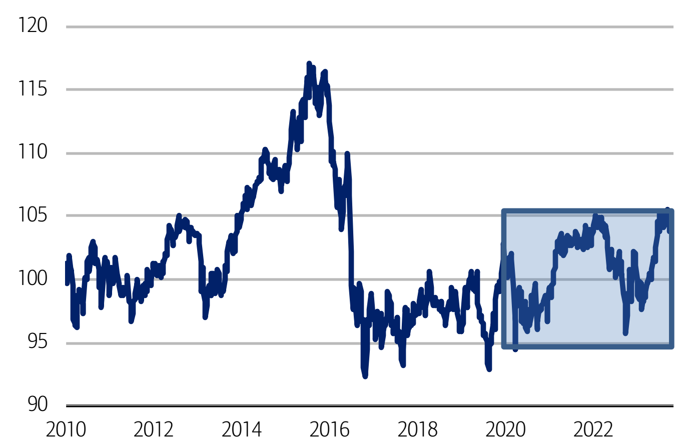
Exhibit 5: GBP TWI since 2010
GBP recoveries continue to stall at top of "reset" range



Source: BofA Global Research, Bloomberg

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The correlation between GBP and the global risk outlook has also been an important driver over business cycles and as Exhibit 4 flags, the BofA GFSI index is back as an important driver GBP. The reasoning is obvious and has been discussed many times before – risk-on enhances the role of cross-border capital flows which alleviates market concerns about relative current account positions.

But rates & risk can't do all of the heavy lifting

Whilst the conditions appear to be in place for further GBP gains – a potential Fed pivot which supports risk, BoE still challenging rate cuts priced into the curve in 2024 – we doubt that the recalibration to both rates and the risk cycle is enough for GBP to seriously challenge the post 2020 ranges. The UK finds itself in a unique situation where it faces specific structural challenges. This implies that the BoE may have to keep rates higher for longer at a time when other central banks may be cutting rates to boost the economy.

As per our UK Economics team, this has an inevitable knock-on impact on growth which is why the UK is likely to grow slower than its peers next year. The challenge we think, is that this makes the case for potentially more aggressive easing into 2025. On that basis, whilst the GBP rally this year has been encouraging, it has not been fostered by a sense of genuine improvement in UK macro prospects – quite the opposite: higher rates are needed to curb structurally higher inflation, but will in turn impact the economy more so than any other in G10. This probably suggests that GBP upside is likely to rely more on the improvement in the risk outlook than on the rate outlook. Even then, we find it hard to see how GBP will be able to break free from this range as the "reset" theory (Exhibit 5) continues to play out this year.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The only game changer**, Global FX Weekly**, 3 Nov 2023
- Yellen the dove, **Global Rates Weekly**, 3 Nov 2023
- Officials still against USD strength, **Liquid Cross Border Flows**, 30 Oct 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: The only game changer 03 November 2023

Global Rates Weekly: Yellen the dove 03 November 2023

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