Global Rates and FX Viewpoint

GBP in ’24: Shall We Get Carry(ied) Away?

15 January 2024

Rates and FX Research
Global

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A rogue no more

We have placed great store in sterling’s reintegration into to the G10 FX complex over the past year. This is important as it gives investors some degree of predictability on how GBP should trade through the course of a business cycle. Our base case scenario for a global soft landing, bull steepening of the US yield curve, yield compression and a weaker USD suggests a benign environment for volatility and risk. These factors should be cyclically supportive for GBP. But as ever, nothing is straightforward with the pound. There will be speedbumps (Spring Budget and General Election) and whilst GBP has traditionally struggled through a counter-cyclical cycle market expectations are sufficiently pessimistic, and the UK is no longer the outlier it once was. Slower growth may temper GBP upside so gains will be steady if unspectacular.

Can GBP Carry the day?

GBP based investors should consider raising hedges. With one of the highest policy rates in G10 and our expectation that the Bank of England will be the slowest to normalize policy, theory tells us that this should be fertile ground for FX outperformance particularly in a benign vol/risk environment. This is supported by a broad suite of our indicators which are signalling GBP upside from a carry/vol perspective. Funders such as JPY and CHF will likely continue to underperform whilst there are downside risks to our EUR/GBP profile this year. Historically, the BoE pricing has closely followed international curves and the policy rate spread between the BoE and Fed has rarely widened on a sustained basis. But the nuance here is as follows: the BoE will cut rates but by not as much as the market is currently pricing even after our BoE call change. This enhances sterling’s role as a carry trade long. Headline inflation will continue to fall on base effects but elevated service sector inflation and strong wage growth will remain a challenge for policy makers – cuts will be later rather than sooner.

Risks? There’s always something with the Pound.

A managed slowdown of the global economy – the absence of significant contagion and volatility – perhaps offers the best opportunity for GBP to weather these counter cyclical forces. According to our sentiment indicators, pessimism towards the UK economy and assets remains high. Weaker growth in the UK is therefore not a surprise and the UK is not the G10 outlier that it once was. However, there is an underlying fragility to this view which would be magnified if there is a sustained spike in global volatility/contagion risks exposing the UK’s Achilles Heel. This could trigger an unwind of carry trades. For those investors concerned about the medium-term structural underpinnings of the UK economy, we look to our FX Factor Signals for value trades. Here, GBP/NOK is the obvious candidate – Norway enjoys a robust internal and external backdrop with NOK significantly undervalued from current levels. Based on these parameters, our valuation signals point to a weaker GBP/NOK over the medium term for those looking to trade a medium-term view.

Refer to important disclosures on page 8 to 10.
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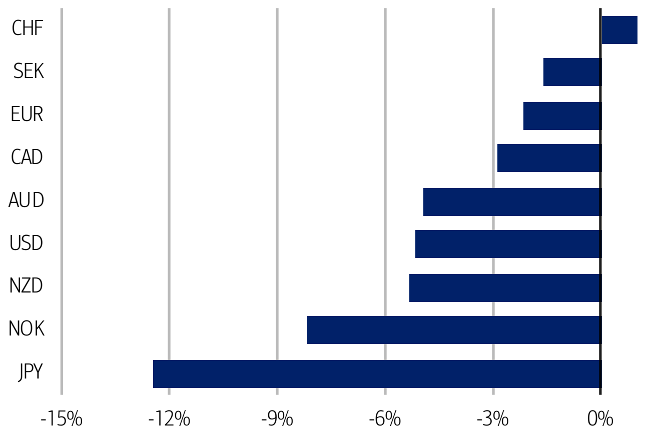
An Admiral Fight back

Sometimes boring can be nice and in the case of GBP, 2023 has been somewhat of a year of redemption. Few would have imagined Sterling would be the second-best performing currency in G10 in 2023 (Exhibit 1) with the nominal TWI trading at the top of the "reset range" (Exhibit 2) and whilst characterizing GBP as "boring" may sound somewhat facetious, there is a serious message behind this. We have placed great store in the view that a sense of normality has returned to GBP through the past year (see: Liquid Insight: GBP: Back to Basics 09 November 2023) after the dislocation following the September 2022 tumult. As we discuss in this note, we ask ourselves if there are any conditions in where GBP TWI can break through the reset ceiling on a sustained basis?

Exhibit 1: G10 FX performance vs GBP in 2023, %
GBP strength has only been outpaced by CHF



Source: BofA Global Research, Bloomberg

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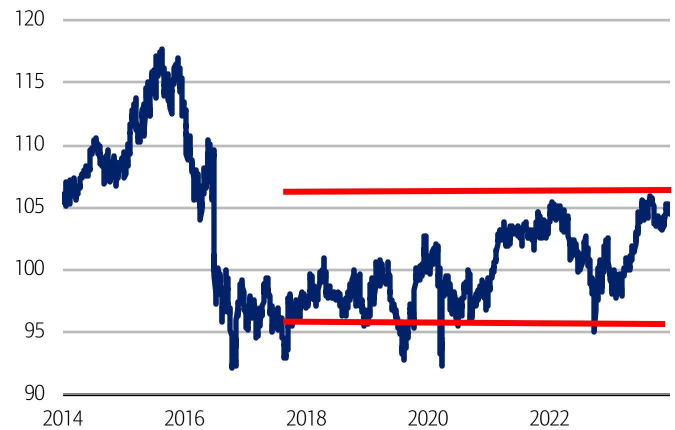
Exhibit 2: GBP Nominal TWI
TWI has hovered around the "reset range" highs.



Source: BofA Global Research, Bloomberg

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With GBP now free from the idiosyncratic anxieties that have plagued it in recent years, we can draw from the toolkit used to analyse other G10 currencies. What we know about the properties of GBP are the following:

- A procyclical currency – outperforms in through a global upswing, underperforms through a slowdown.
- A high beta (like AUD/NZD/Scandies) currency which is inversely correlated to market volatility – higher vol, lower GBP.
- High interest rate sensitivity both in absolute and relative terms.
- Current account vulnerability exacerbated by weak fiscal position. Vulnerable to spike in global risks and contagion.

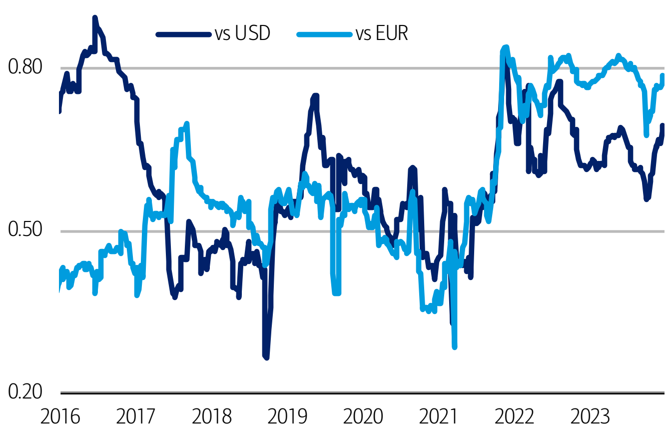
This framework will help us anchor our views on GBP through 2024 but as the bullets highlight, the global context is likely to be as important as the domestic one. With FX taking its lead from the fixed income markets in the early days of the year, the natural starting point is to look at how diverging paths on policy setting could impact GBP.

Could GBP carry the day?

One of the questions that we have been asked recently has been the following: with the Bank of England unlikely to cut rates as aggressively as the other G10 central banks (according to BofA economists' forecasts) surely this means that GBP will be attractive from a carry perspective given its historical interest rate sensitivity and widening rate differential? Unsurprisingly there is some conditionality on the answer and an obvious caveat. Historically, UK rates have moved in tandem with both US and EZ forward curves (Exhibit 3) which helps to explain why the UK rates curve is pricing in as many cuts as both the ECB and Fed. The key question is whether UK rates can decouple from the US on a sustained basis?

There have only been two occasion in the last 20-years where the UK base rate has been significantly above Fed Funds – 2004 and 2008. In both cases, this spread did not stay above +300bps for a sustained period (Exhibit 4). But here is where the conditionality kicks in. The backdrop to widening spreads in favour of the UK came under differing market dynamics. The backdrop in 2004 period is more consistent with our baseline scenario: rate cuts that potentially lead to spread widening within G10 will be achieved through a managed slowdown of the global economy and a low vol environment. This is important for GBP: if global central banks can cut rates and achieve a soft landing in the absence of a material pick-up in volatility (FX & Bond) then this could prove supportive for GBP.

Exhibit 3: 12mth rolling correlation GBP 1Y1Y OIS vs US and EZ
UK rate expectations usually track US and EUR curves



Source: BofA Global Research, Bloomberg

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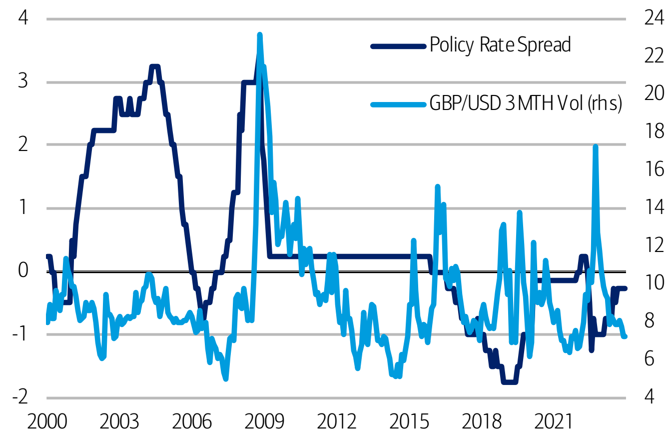
Exhibit 4: UK-US Policy rate spread vs GBP/USD Volatility
Policy spread can be GBP supportive if volatility is low



Source: BofA Global Research, Bloomberg

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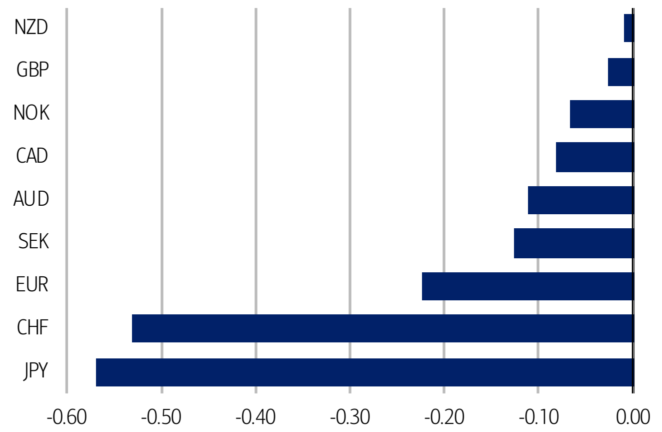
Exhibit 5 shows the 3mth carry/implied volatility ratio for G10 currencies versus USD. With the exception of NZD, GBP suffers the least carry attrition versus USD which makes it an attractive currency versus traditional funders such as CHF and JPY. It also helps to explain why EUR/GBP has underperformed since the start of the year which presents downside risks to our profile (see Exhibit 11). Whilst market pricing for the Fed/ECB cuts is still excessive relative to BofA rate calls, they are not as mispriced as BoE pricing. It appears to us that the rates market has been indiscriminate in pricing a one size fits all approach to the number and quantum of rate cuts for the three central banks. Exhibit 6, shows that the markets expects Base Rate to be 125bps below the current level by the end of the year. We think this is overly optimistic and poses asymmetric risks to GBP. Even if the BoE cuts rates earlier than we currently expect, we are unconvinced that they will cut by the amount that is currently priced in. A recalibration of the GBP curve towards our own view would lend support to GBP and enhance its status as a leading carry trade currency.

BoE officials have emphasized the need to keep policy rate higher for longer to the pace of service sector inflation and average wage growth. Though headline inflation is likely to continue to fall back towards target this year, concerns about elevated service sector inflation and wage growth is tangible. We are therefore inclined to think that market pricing remains overly ambitious on the scale of easing. With the National Minimum Wage set to increase in April and the potential for an expansionary Spring Budget on March 6th, the BoE will err on the side of caution to digest the full impacts of both. We are therefore inclined to fade the market consensus which is coalescing around a May rate cut.

Exhibit 5: 3mth carry/implied vol ratio vs USD
GBP offers relatively little carry drag vs USD.



Source: BofA Global Research, Bloomberg

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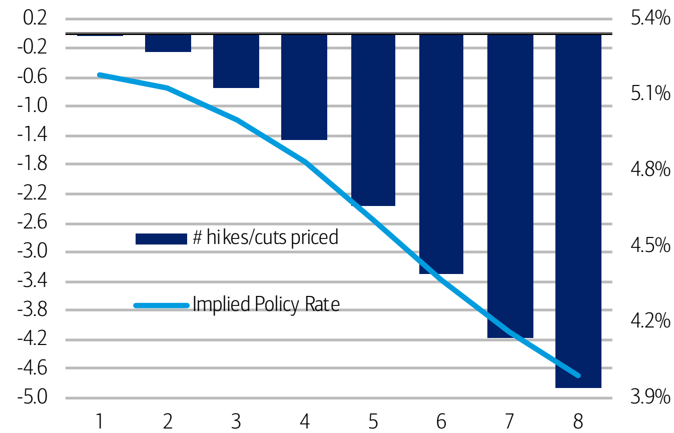
Exhibit 6: OIS Pricing for UK
Market is overambitious for rate cuts this year.



Source: BofA Global Research, Bloomberg

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GBP Factor Signals

Exhibit 7 presents a summary of our Factor Signal analysis for GBP. Our focus here is on the carry signal where the signal is positive for the bulk of G10 currencies. The signal is enhanced when we vol adjusted the carry signal. We think the current FX market sentiment is being driven by carry given the evolving expectations around interest rate cuts but at any one point in time, trend/value signals could dominate sentiment.

Exhibit 7: GBP Factor Signals
Factor analysis posting strong positive carry signals for GBP

	Spot (GBP/XXX)	Trend	Carry			Vol Adj Carry			Consensus			Value
			3m	6m	12m	3m	6m	12m	3m	6m	12m	
USD	1.27	↑↑↑	↔	↔	↔	↓	↔	↓	↓↓	↓	↓	↑↑↑
EUR	1.16	↑↑	↑	↑	↑	↑↑↑	↑↑↑	↑↑	↓↓↓	↓↓	↓	↓
JPY	183.42	↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↓↓↓	↓↓↓	↓↓	↓↓↓
AUD	1.90	↓↓	↑↑↑	↑↑↑	↑↑	↑↑↑	↑↑↑	↑↑	↓↓↓	↓↓↓	↓↓	↓
NZD	2.04	↓↓	↔	↔	↔	↔	↔	↓	↓↓↓	↓↓	↓↓	↑
CAD	1.70	↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↓↓	↓	↓	↑
CHF	1.08	↓↓	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑	↑↑↑
NOK	13.15	↓↓	↑↑↑	↑↑↑	↑↑	↑↑↑	↑↑↑	↑↑	↓↓↓	↓↓	↓↓	↓↓↓
SEK	13.05	↓↓	↑↑	↑↑	↑↑	↑↑↑	↑↑↑	↑↑↑	↓↓↓	↓↓	↓↓	↓↓↓

Note: Trend signal is given by the Moving Average Aggregation (MAA)signal, attenuated by the Up/Down volatility signal. MAA is rescaled between +100 and -100; MAA>20: uptrend; MAA>60 strong uptrend; MAA<-20: downtrend; MAA<-60: strong downtrend; if MAA>60 and U/D>80 -> high risk of reversal; if MAA<-60 and U/D<20 -> high risk of reversal; The strength of both carry and vol-adjusted carry signals is given by adding a z-score overlay to the pure carry signal. A positive carry signal would be strengthened by a positive z-score and weakened (though never reversed) by a negative z-score. A small - less than abs(0.5) – does not affect the carry signal. Consensus signals are measured relative to forwards, and the value signal, which is contrarian (overvalued currency leads to negative signal) is overlaid with the 5-year z-score in the same way as carry.
Factor heatmap first introduced in the report Factor Signals for FX Hedgers in February 2020
Source: BofA Global Research, Bloomberg

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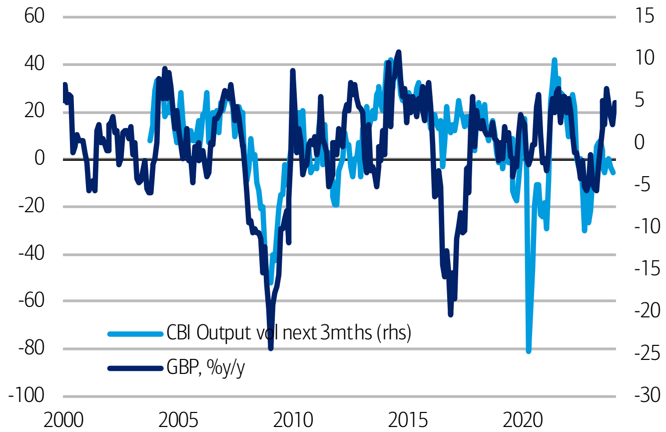
For GBP investors, the strength of the carry signal is already suggesting the need to increase hedges for GBP based investors, a decision that may be hastened further if the UK rates market comes around to our view and cuts by less than is priced in. Layering our forecasts for GBP/USD at 1.31 by year end and our fair value metrics that suggest GBP is undervalued, this adds further weight to the need to increase hedge ratios.

Swimming against the macro tide?

One of the major issues facing GBP through this cycle is that it is enjoying positive carry at a time when the global economy is entering a cyclical downturn. As our bullets noted above, the make-up of GBP – a procyclical currency which has historically run a current account deficit is a warning sign to those expecting a strong appreciation trend through 2024. Exhibit 8 plots the y/y change in GBP versus the CBI Output volumes in the next 3mths. The chart provides a clear illustration of the pro-cyclical properties of GBP through the course of a cycle. It is therefore evident slowing growth will provide a headwind to GBP through the course of the year.

Reiterating our base case scenario for a benign risk environment in 2024, rather than being a negative for GBP, weaker growth will be a limiting factor for GBP gains. Much has been made of UK growth underperformance versus its G10 peers. We continue to believe that trend growth is now structurally lower, but as Exhibit 9 flags, the UK has not been set adrift from the rest of the pack. Indeed, the UK is expected to grow at the same pace as Germany this year and next. We do not think slower growth this year will be a shock to markets. Indeed, our latest FXRSS suggests that pessimism towards GBP remains high. Weak data would not come as a surprise; stronger data would.

Exhibit 8: GBP TWI vs CBI Output Volume next 3mths
Slowing growth could be a headwind for GBP this year.



Source: BofA Global Research, Bloomberg

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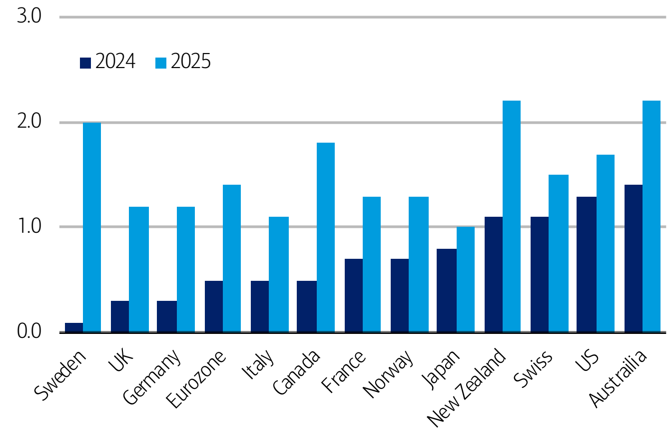
Exhibit 9: G10 Consensus forecasts 2024, 2025
UK growth weak in 2024 but not adrift of rest of G10



Source: BofA Global Research, Bloomberg

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Risks: They are tangible

As ever – a constructive GBP view does not come without its caveats and chief amongst these is the state of internal and external balances. For now, with a benign backdrop to risk and carry in the ascendancy, it is hard to make the case that markets will suddenly turn their attention to structural concerns. We have highlighted fiscal sustainability as a key risk to our base case scenario in the Global Macro Year Ahead. However, as we have stated previously, in the absence of global funding pressures, impediments to global cross border capital flows and higher volatility, we do not expect GBP to be unduly impacted for now.

However, the fragile state of the UK structural position is evident in Exhibit 10 which compares G10 structural indicators via a heat map. On most of the metrics in this table – fiscal position, trust in government and current account, the UK stands out. September 2022 provides a painful reminder how market discipline can impact a broad base of UK assets and while we would not expect such a re-run, investor focus is turning to the Spring Budget on 6th March. It is likely that the government will announce a fiscally stimulative budget ahead of a likely General Election this year. The question is whether the contours of that Budget will negatively impact the markets.

Exhibit 10: G10 Structural Indicators Comparison

The UK remains the standout as having structural issues (data using averages 2010-2022)

	AUD	CAD	EUR	JPY	NZD	NOK	SEK	CHF	GBP	USD
Current Account as % GDP	-1.8%	-2.4%	1.7%	2.7%	-3.5%	10.0%	4.6%	7.3%	-3.5%	-2.5%
Debt %GDP	65%	116%	90%	233%	52%	43%	59%	42%	114%	138%
Deficit %GDP	-3.7%	-2.3%	-3.1%	-5.4%	-1.8%	7.9%	-0.3%	0.1%	-6.0%	-8.1%
GDP Growth %	2.4%	1.9%	1.1%	0.8%	2.8%	1.5%	2.4%	1.9%	1.4%	2.1%
Government Trust	52	61		29	63	77	63	84	39	40

Source: BofA Global Research, Bloomberg

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At the time of writing, there is little information on the contours of the Budget, nor indeed the government's room for manoeuvre. However, with the Government trailing in the opinion polls and memories of September 2022 still fresh, there is growing interesting in hedging GBP exposure for this event. To be clear, we are not expecting a Gilt tantrum or marked GBP depreciation. We would, however, take the opportunity to pay some premium as a hedge to the event. The 6th March Budget will be a precursor to a General Election later in the year. In the absence of manifestos and the likelihood that that the election will not be held until after the summer, this is unlikely to cross the radar of investors yet. But upon announcement, we expect a vol premium to be placed on the election date with the contents of the respective manifestos scrutinised closely.

At some point through the cycle, market conditions will deteriorate sufficiently enough for the focus to return on budget and current account balances as carry trades succumb to the pressure of higher vol. For those whose focus is on the relative structural outlook, we would argue that there will be better levels to position for GBP shorts given the current supportive market setup for the pound. There are obvious short GBP/XXX in this scenario and one which standouts in Exhibit 10 is lower GBP/NOK. In conjunction with our GBP factor signals in Exhibit 7, the relative strength of Norway's structural position should be a factor which triggers an adjustment driven by relative valuation. We look for GBP/NOK to fall by nearly 6% over the course of 2024 towards the 12.50 level as shown in Exhibit 11.

Exhibit 11: GBP Forecasts vs G10

GBP expected to make broad based gains in 2024 vs funding currencies

		2024				2025			
	Spot	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GBP/USD	1.27	1.26	1.26	1.31	1.31	1.33	1.34	1.37	1.40
EUR/GBP	0.86	0.87	0.87	0.88	0.88	0.87	0.87	0.86	0.86
GBP/EUR	1.16	1.15	1.15	1.14	1.14	1.15	1.15	1.16	1.16
GBP/JPY	186	183	181	186	186	187	186	187	190
GBP/CHF	1.09	1.10	1.10	1.10	1.10	1.13	1.13	1.15	1.16
GBP/CAD	1.70	1.71	1.69	1.73	1.70	1.73	1.75	1.78	1.81
GBP/NOK	13.16	13.71	12.99	12.51	12.39	12.53	12.41	12.44	12.32
GBP/SEK	13.01	13.82	13.10	12.73	12.61	12.76	12.64	12.68	12.56
GBP/AUD	1.90	1.92	1.86	1.84	1.84	1.88	1.89	1.93	1.97
GBP/NZD	2.04	2.11	2.04	2.07	2.07	2.12	2.13	2.18	2.21

Source: BofA Global Research estimates

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Bank of England Meetings in 2024.

The Monetary Policy Committee (MPC) holds eight regularly scheduled meetings a year. Monetary Policy Reports are released on a quarterly basis.

Exhibit 12: BoE Monetary Policy Committee dates for 2024
8 BoE meetings. Reports in February, May, August, and November

Meeting date	Additional information
Thu, 01 Feb 2024	Monetary Policy Report
Thu, 21 Mar 2024	
Thu, 09 May 2024	Monetary Policy Report
Thu, 20 Jun 2024	
Thu, 01 Aug 2024	Monetary Policy Report
Thu, 19 Sep 2024	
Thu, 07 Nov 2024	Monetary Policy Report
Thu, 19 Dec 2024	

Source: Bank of England. See https://www.bankofengland.co.uk/monetary-policy/upcoming-mpc-dates

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