FX Watch

GBP: The message is getting through

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G10 FX Strategy
Global

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Key takeaways

- Better UK data & BoE pushback have seen recalibration in UK rate profile. This is supporting GBP TWI, trading at top of range
- Higher for longer rates helped by data bounce & critical for further GBP recovery. Dec seasonality small -ve in last 20 years
- GBP should trade at top of reset range, but structural headwinds should dominate in 2024. We remain short GBP/AUD via options

BoE message is getting through

The message finally appears to be resonating with markets. The Bank of England (BoE) has been at pains to stress to markets that UK rate pricing for cuts in 2024 is misplaced. The latest comments from Governor Bailey reinforce this narrative. In an interview for a local newspaper (Newcastle Chronicle) yesterday morning (27 November), Bailey stated: "We do have to get it (inflation) down to 2%, and that's why I have pushed back of late against assumptions that we're talking about cutting interest rates or we will be cutting interest in anything like the foreseeable future because it's too soon to have that discussion." These comments very much chime with the BofA Global Research house view that UK rates are likely to remain at elevated levels through much of 2024. It has taken some time for this to resonate with the UK rates market, but we are finally seeing signs that the message is being heard.

Exhibit 1 and Exhibit 2 show market expectations for UK rates for BoE meetings running up to November 2024. We have used the same scale for the right hand side (RHS) axis to show the comparison in the policy rate with 16 November pricing. As of 23 November, the UK rates market removed over 50bps of easing from the curve, and whilst most of that repricing has taken place for H2 2024, a cumulative 60bps has been removed from the March/May meetings. Our UK economics team believes that the BoE is likely to stay on hold for the majority of 2024, which clearly challenges even the current repricing of the curve. Indeed (and as we discuss below), part of the rationale behind our rate colleagues' short gilts trade in their Global Rates Year Ahead (see the report) is this mispricing and our ongoing structural concerns about the health of UK public sector finances and the external trade position.

Data is adding the kicker

The move in UK rates has not, however, been a force majeure. GBP has reacted, with the TWI trading towards the top end of the "reset range" as the pound returns to basics (see our 9 November 2023 Liquid Insights report), with UK rates a significant driver once more, as shown in Exhibit 3. The back-up in 1Y1Y SONIA has been driven by the improvement in UK data surprises. Whilst encouraging, we note that expectations around UK data have been weak, and whilst the recent flow has been encouraging, the macro outlook will likely remain poor in 2024. High inflation and anemic growth do not provide the basis for a strong currency, but for now, the rebound in data surprises has provided the catalyst for the back-up in UK yields (Exhibit 4).

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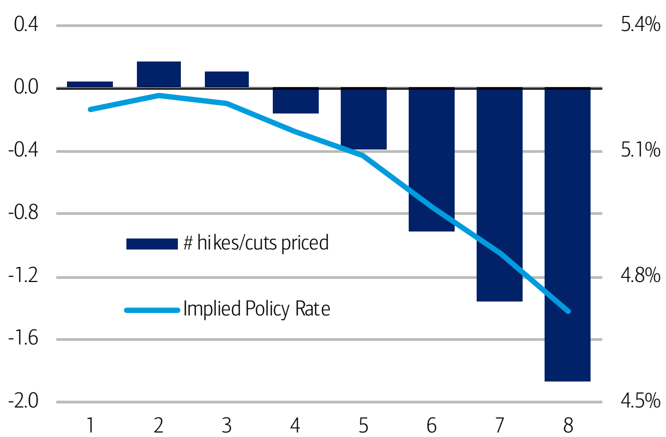
We suspect that this dynamic has also been driven by positioning. The latest CFTC data highlights the sharp reversal in GBP longs in recent weeks, pushing short-term positioning back to a net short. This may be enough for a modest extension of the rally, but we do not think that positioning or momentum is extreme enough to warrant a sustained break above the reset highs. Furthermore, options skew has not materially shifted in favour of GBP to suggest that this move can be sustained. Pricing out rate cuts may have some further marginal benefits for GBP, but the real "game changer" would be if data continues to improve, forcing the rates market to price in more rate hikes.

Tactical versus structural views on GBP

The bulk of November's GBP gains have come against USD, with GBP/USD +3.7% at the time of writing as we head into month-end flows. US bull steepening creates fertile ground for high-beta FX outperformance, and whilst GBP has been a beneficiary, other currencies within G10, such as the Scandinavian and Antipodean currencies, have fared better. This highlights the inherent conflict in market attitudes towards the pound: reconciling the recalibration of the UK rates curve versus long-held structural concerns over the UK macro outlook. Whilst we think that there is some justification to hold a tactical long in GBP (noting that EUR/GBP has been a popular short through month-end), we ultimately view this as an opportunity to re-establish shorts in GBP.

The structural reasons, however, warranting caution into 2024 have been outlined on numerous occasions: the BoE is holding rates higher for longer for the wrong reasons, in our view, inflation (especially core and services) remains uncomfortably high and the breakdown of UK surprises indicates that the personal/labour market components are less positive than they have been through much of this year. The ability of the UK economy, therefore, to continue to surprise to the upside is limited. We are comfortable with our view that recent events present some tactically bullish trades (versus lower yielders) but that the structural outlook remains bearish, and we hold a lower GBP/AUD conviction via options as part of our year ahead trades (see the 19 November Global Macro Year Ahead report).

Exhibit 1: UK BoE pricing 23 November
Rates market has priced out some easing following MPC and data



Source: BofA Global Research, Bloomberg

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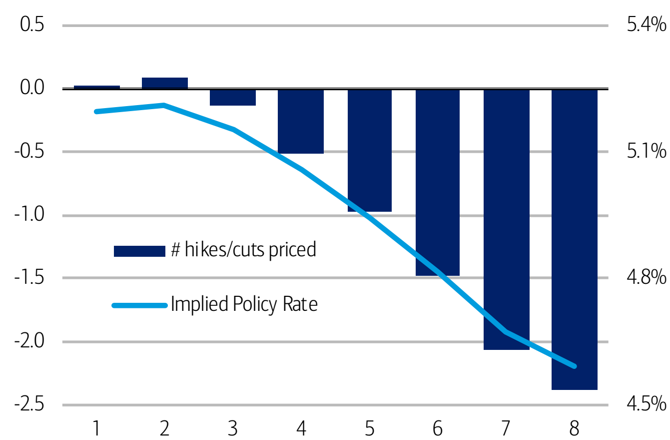
Exhibit 2: UK BoE pricing 16 November
As markets were looking for rate cuts as soon as Q2 2024



Source: BofA Global Research, Bloomberg

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Exhibit 3: GBP TWI versus 1Y1Y SONIA

GBP TWI has once more become a rates story.

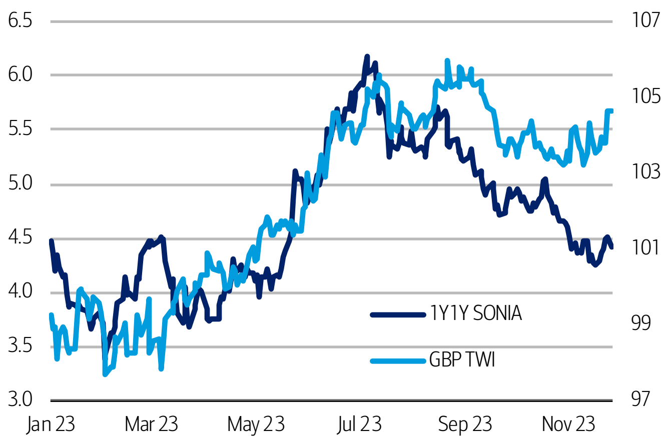

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Exhibit 4: 1Y1Y SONIA versus UK Data Surprises

UK data has improved and helped rally in UK yields.

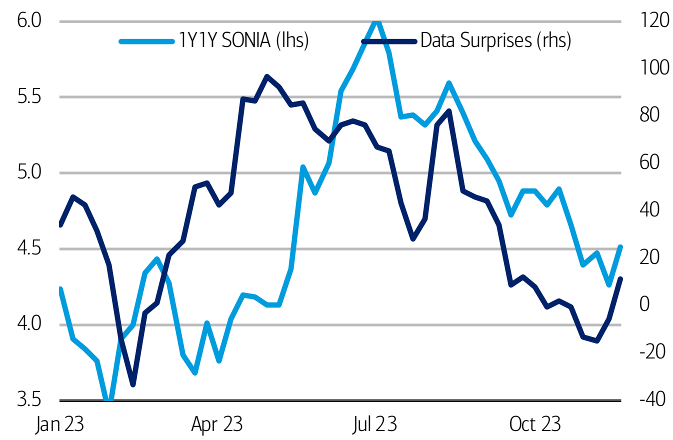

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Exhibit 5: GBP IMM Positioning vs GBP/USD

IMM is short but not at extremes to suggest a major bounce in GBP

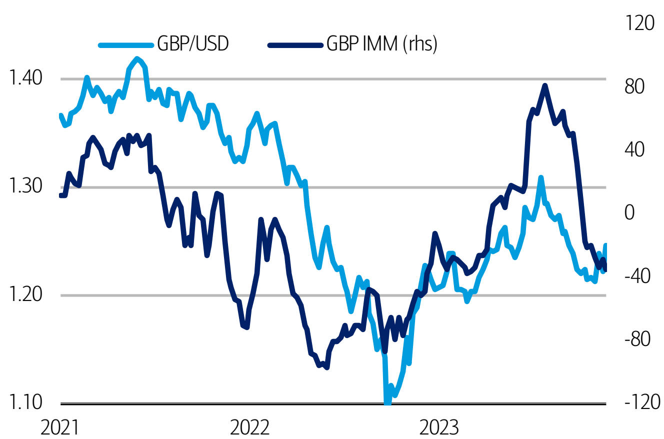

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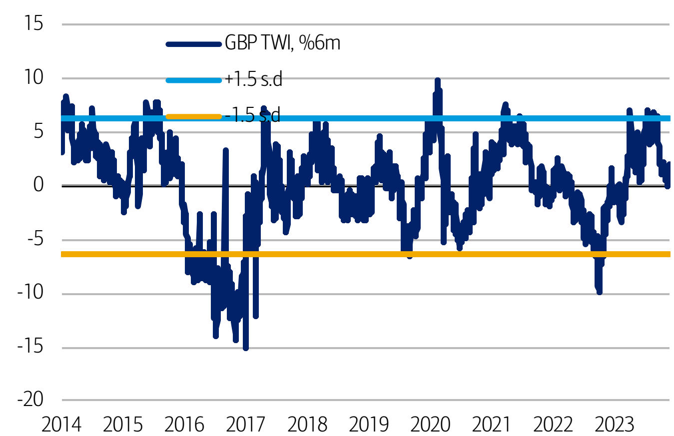
Exhibit 6: GBP TWI 6mth % annualized change

Momentum also suggests that market is not stretched to lift GBP materially.



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A quick word on GBP seasonality

Turning to seasonality, we note that December has traditionally been the weakest month for GBP versus the majors. But we can identify two pairs where selective GBP strength may be justified. Table 1 shows December performance of GBP versus the major G10 currencies along with the 15-year average. Both GBP/USD and GBP/CAD have performed well in recent years, and for choice, GBP/USD has the better optics: Fed expected to remain on hold, further steepening of the US yield curve and a better backdrop to global risk. For GBP, a further reiteration of the high for longer to further recalibrate the UK rates curve in December should also prove supportive as long as data continues its current wave of positivity. Furthermore, consistent with our reset range, GBP/USD has potential upside towards $1.30 under this "perfect storm" scenario.

Table 1: GBP December performance versus major G10

Outperformance versus USD and CAD is a key takeaway.

	USD	EUR	JPY	CHF	CAD	AUD	NZD	SEK	NOK	Yearly Average
15yr AVG	-0.1%	-1.3%	-0.1%	-1.9%	-0.3%	-0.9%	-1.6%	-1.4%	-0.7%	
2008	-5.1%	-15.7%	-9.8%	-16.4%	-6.5%	-11.4%	-9.9%	-8.1%	-5.7%	-9.8%
2009	-1.6%	2.8%	5.9%	1.3%	-1.9%	0.5%	-2.6%	0.9%	0.3%	0.6%
2010	0.3%	-2.8%	-2.7%	-6.5%	-2.5%	-6.0%	-4.5%	-4.2%	-5.9%	-3.9%
2011	-1.0%	2.7%	-1.9%	1.7%	-0.6%	-0.3%	-0.6%	0.8%	2.5%	0.4%
2012	1.5%	-0.1%	6.7%	0.1%	1.3%	1.8%	0.5%	-0.9%	-0.5%	1.2%
2013	1.2%	0.0%	4.0%	-0.4%	1.2%	3.3%	0.1%	-0.6%	0.2%	1.0%
2014	-0.4%	2.4%	0.5%	2.6%	1.4%	3.7%	0.2%	4.3%	5.5%	2.2%
2015	-2.1%	-5.0%	-4.4%	-5.0%	1.4%	-2.9%	-5.7%	-5.3%	-0.4%	-3.3%
2016	-1.3%	-0.8%	0.9%	-1.1%	-1.4%	1.1%	0.9%	-2.3%	-0.2%	-0.5%
2017	-0.1%	-0.9%	0.0%	-1.0%	-2.6%	-3.2%	-3.8%	-2.5%	-1.6%	-1.7%
2018	0.0%	-1.3%	-3.4%	-1.6%	2.7%	3.7%	2.3%	-2.7%	0.5%	0.0%
2019	2.6%	0.7%	1.8%	-0.8%	0.3%	-1.1%	-2.2%	0.3%	-2.4%	-0.1%
2020	2.6%	0.2%	1.6%	-0.1%	0.6%	-2.1%	0.2%	-1.6%	-2.2%	-0.1%
2021	1.8%	1.3%	3.5%	0.9%	0.7%	-0.1%	1.6%	2.0%	-0.8%	1.2%
2022	0.2%	-2.6%	-4.8%	-1.9%	1.4%	-0.2%	-0.6%	-0.4%	-0.1%	-1.0%

Source: BofA Global Research, Bloomberg

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