European Rates Viewpoint

Charting UK Rates and FX – August 2023

Rates: Time to rethink cuts that might follow

Gilt yields have rallied substantially in response to last week's June inflation downside surprise, outperforming US Treasuries and Bunds. We expect the BoE to hike Bank Rate by 25bp at next week's policy meeting. We see risks skewed to a more hawkish vote. A shift in the Committee's focus towards the average setting of policy, with the implicit intention of reducing the peak in rates but extending its duration, could draw the market's attention to the latter. The market taking out/postponing Bank Rate cuts could be the next catalyst for front-end curve steepening.

Weekly Gilt supply will slow into August. But we expect a pickup again from September. Our first go at updating Gilt supply numbers from the BoE and the DMO for the remainder of the fiscal year suggests tentative risks of an additional £20bn from the DMO (largely via increased debt servicing costs) and an additional £7bn from the BoE (assuming £10bn extra QT) in original cost terms over the six months from September). We explore in more detail who might buy all these Gilts in the charts below.

FX: Bearish risks around the BoE meeting

With markets pricing a good chance of a 50bp hike next week and a higher terminal than in our base case, we see downside GBP risks around the upcoming BoE meeting, also given the long GBP positioning, particularly of hedge funds. Both around the BoE and in the next months, we see bearish GBP risks vs. mainly USD, a reflection of positioning and our bullish USD call, in turn owing to the strong US data, our hawkish Fed call, and cautious view on risk—we expect cable at 1.24 by year-end. But, at current levels, we find EURGBP risks more symmetric than last month, also given carry and the weak Eurozone data. Still, positioning is on balance an upside EURGBP risk.

Going forward, how painful disinflation proves is key. The UK rates may have moved lower after the downside surprises in the US and UK June CPI prints but remain near potentially overly restrictive levels. In this vein, our economists highlight the risks with the UK public finances, esp. ahead of the UK election. As a result, we do not view upside inflation surprises as GBP-positive (and vice versa). We did find the June CPI data as encouraging, but it is still early. We were also encouraged by some signs of labour-market easing (incl. higher participation), but wage growth remains high, and our economists do not expect much more help from labour supply onwards. For GBP to push meaningfully higher from current levels given positioning, we would need to see meaningful progress on these fronts in the coming months.

Sentiment: Mixed signals

The latest FX and Rates Sentiment Survey showed GBP selling (again) as investors continued to take a negative view of the implication of sticky core inflation for the currency. Gilt short covering continued despite sentiment remaining weak.

28 July 2023

Rates Research
Europe

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Abbreviations:

BoE: Bank of England
DMO: Debt Management Office
MPC: Monetary Policy Committee
APF: Asset Purchase Facility
NS&I: National Savings and Investment
QE: Quantitative Easing
QT: Quantitative Tightening
OBR: Office for Budget Responsibility
ONS: Office for National Statistics
FXRS: FX and Rates

Timestamp: 28 July 2023 12:00AM EDT

Rates and FX forecasts

Our latest UK rates forecasts reflect small tweaks made when we last fine-tuned our BoE call. Our current base case is for two 25bp Bank Rate hikes in August and September and rates on hold over the course of 2024. We see risks skewed to a more hawkish vote in August. We continue to pencil in 10y Sonia at 4.5% and 10y Gilt at 4.75% throughout (see Exhibit 1, Exhibit 2, Exhibit 3 and Exhibit 4).

Exhibit 1: UK government bond yield forecasts, %
We continue to pencil in 10y Gilt at 4.75% throughout

	Gilts						
	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
Bank	5..50	5.50	5.50	5.50	5.50	5.50	4.50
2y	5.00	5.00	4.75	5.00	4.75	4.50	3.5
5y	4.50	4.75	4.50	4.50	4.25	4.25	3.75
10y	4.75	4.75	4.75	4.75	4.75	4.75	4.75
30y	4.50	4.50	4.50	4.50	4.50	4.50	4.50

Source: Bloomberg, BofA Global Research

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Exhibit 2: UK swap yield forecasts, %
We continue to pencil in 10y Sonia at 4.5% throughout

	Sonia						
	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
3m Sonia	5.50	5.50	5.50	5.50	5.50	5.25	4.25
2y	5.50	5.25	5.00	5.00	4.75	4.50	3.50
5y	4.75	4.75	4.50	4.50	4.25	4.25	3.75
10y	4.50	4.50	4.50	4.50	4.50	4.50	4.50
30y	4.00	4.00	4.00	4.00	4.00	4.00	4.00

Source: Bloomberg, BofA Global Research

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Exhibit 3: Our bond and swap forecasts vs. market forwards, bp
Slightly above the Sonia forwards in 10y, below in 2y

Gilts	Q3 2023	Q4 2023	Q1 2024	Q2'24	Q3'24	Q4'24
2y	3	12	-3	31	21	7
10y	49	51	53	55	56	58
Sonia	**Q3 2023**	**Q4 2023**	**Q1 2024**	**Q2'24**	**Q3'24**	**Q4'24**
2y	-8	-19	-27	-11	-11	-17
10y	28	34	41	47	55	61

Source: Bloomberg, BofA Global Research

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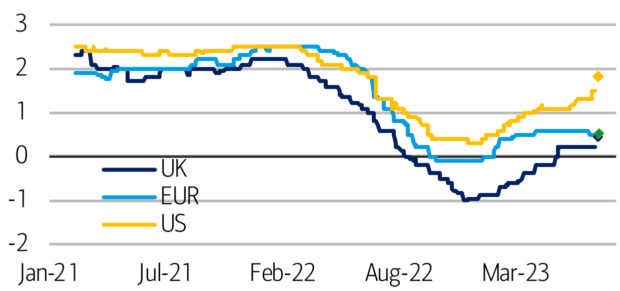
Exhibit 4: BofA 2023 growth forecast vs. Bloomberg consensus, %
Pretty close to consensus in Europe and the UK



Source: Bloomberg, BofA Global Research

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In FX, with markets pricing a decent probability of a 50bp hike next week and a higher terminal vs. our base case, we see downside GBP risks around the upcoming BoE meeting, also given the long GBP positioning. Further out, we remain concerned about UK hard-landing risks, although recent data offer some hope. We continue to expect cable lower by year-end, but now find risks to EURGBP more symmetric than last month.

Exhibit 5: GBP forecasts versus G10 FX
Downside risks for cable this year, more balanced for EURGBP

	Spot	Sep-23	YE 2023	Mar-24	Jun-24	Sep-24	YE 2024
GBP/USD	1.29	1.24	1.24	1.26	1.29	1.35	1.35
EUR/GBP	0.86	0.85	0.85	0.85	0.85	0.85	0.85
GBP/JPY	181	182	180	176	174	176	169
GBP/CHF	1.11	1.15	1.15	1.17	1.16	1.17	1.17
GBP/CAD	1.70	1.64	1.61	1.64	1.66	1.73	1.70
GBP/NOK	13.06	12.87	12.52	12.25	12.19	11.97	11.75
GBP/SEK	13.47	13.58	13.00	12.60	12.44	12.33	12.10
GBP/AUD	1.90	1.85	1.80	1.75	1.77	1.82	1.80
GBP/NZD	2.07	2.03	2.00	1.97	1.98	2.05	2.01

Source: BofA Global Research, Bloomberg. Spot and forecasts as of July 27.

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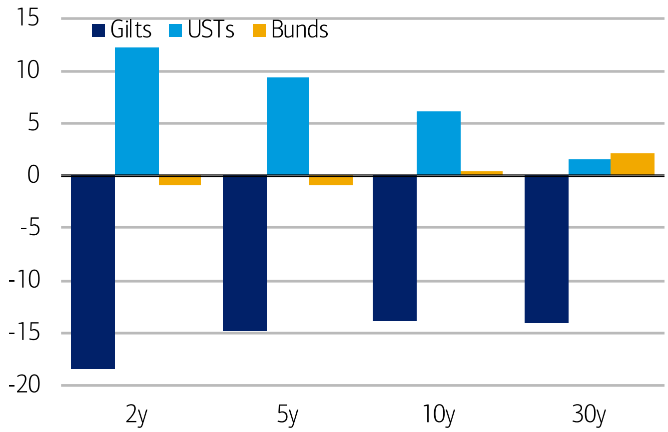
Rates: Time to rethink cuts

Exhibit 6: Yield changes since 17 July, bp
UK outperformed Europe and the US



Source: Bloomberg, BofA Global Research
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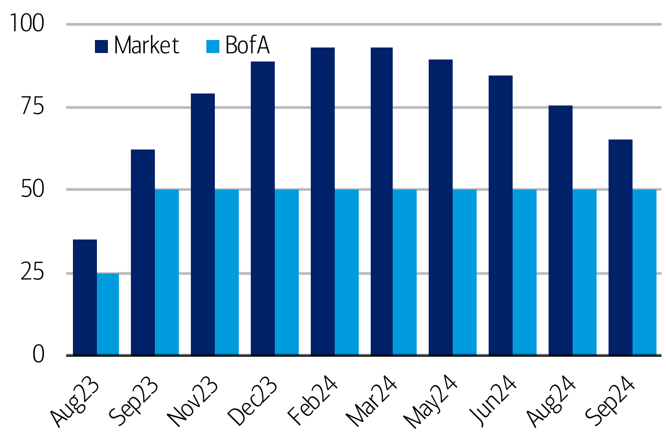
Exhibit 7: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp
Market pricing in near 100bp of hikes to peak



Source: Bloomberg, BofA Global Research
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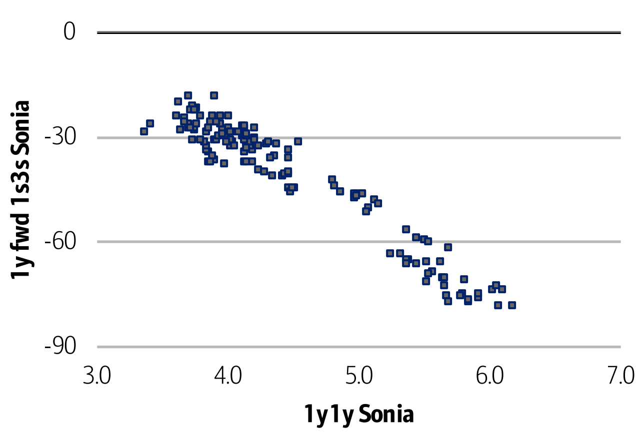
Exhibit 8: 1y fwd 1s3s vs. 1y1y Sonia, bp and %
1y fwd 1s3s Sonia steepener = low beta duration expression



Source: Bloomberg, BofA Global Research
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Sharp repricing post inflation data

Gilt yields rallied substantially in response to last week's June inflation downside surprise, outperforming US Treasuries and Bunds (Exhibit 6).

Not all data have surprised in the same direction, however, making August Bank Rate hike judgement more meaningful. Judgement of the precise surprise is also complicated by the BoE adjusting its expectations at the June meeting without publishing precise numbers.

At the least we can argue the key data over the past month have been more mixed relative to BoE expectations than before the June meeting.

25bp hike

We expect the BoE to hike Bank Rate by 25bp at next week's policy meeting. We look for a three-way split vote, 1-7-1, with Dhingra preferring no change in rates and Mann a 50bp hike. We see risks skewed to a more hawkish vote.

Market pricing of terminal Bank Rate has shifted lower since inflation data. The near-term outlook for rate hikes remains uncertain: not all data surprises have been to the downside, so we cannot rule out another 50bp rate hike in August.

But it seems less likely than it was in June. Market pricing of 37bp is reflection of these two possibilities (Exhibit 7).

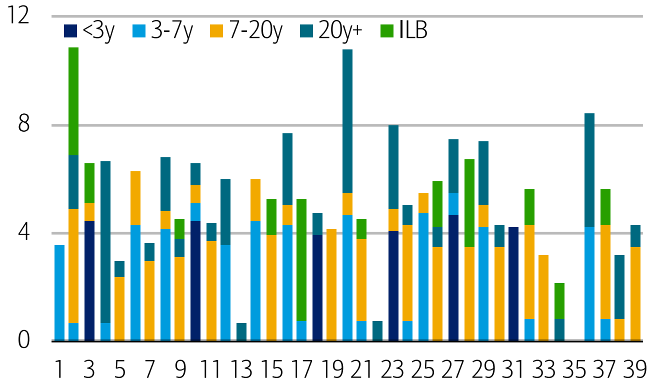
Time to rethink cuts that might follow

Steepening of 1y forward 1s3s Sonia after last Wednesday's inflation number suggested to us that markets' interpretation of the inflation release was more about the level of peak rates and the path to it, but not so much about cuts that might follow.

A shift in the Committee's focus towards the average setting of policy, with the implicit intention of reducing the peak in rates but extending its duration, could draw the market's attention to the latter.

The market taking out/postponing Bank Rate cuts could be the next catalyst for front-end curve steepening (Exhibit 8).

Exhibit 9: Weekly Gilt supply by the DMO and BoE, £bn
Supply is now drying up ahead of August



Source: DMO, BoE, Bloomberg, BofA Global Research

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Exhibit 10: APF stock reduction in Oct'22 - Sep'23 and Oct'23 - Sep'24
Ramsden's speech suggested APF stock reduction could be kept at £100bn

Oct'22 - Sep'23		
Total APF stock reduction: £100bn	APF - Gilts: £80bn stock reduction	Passive QT: £35bn Active QT: £45bn
	APF - Corp bonds: £20bn stock reduction	
Oct'23 - Sep'24		
Total APF stock reduction: £100bn	APF - Gilts: £100bn stock reduction	Passive QT: £50bn Active QT: £50bn
Total APF stock reduction: £80bn	APF - Gilts: £80bn stock reduction	Passive QT: £50bn Active QT: £30bn

Source: BofA Global Research

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Gilt supply (BoE & DMO) to fade into Aug

With the UKTi 2045 syndication and this week's heavy Gilt supply out of the way, weekly Gilt supply will slow into August (Exhibit 9). But we expect a pickup again from September.

Our first go at updating Gilt supply numbers from the BoE and the DMO for the remainder of the fiscal year suggests tentative risks of an additional £20bn from the DMO (largely via increased debt servicing costs) and an additional £7bn from the BoE (assuming £10bn extra QT) in original cost terms over the six months from September).

Ramsden's QT hints

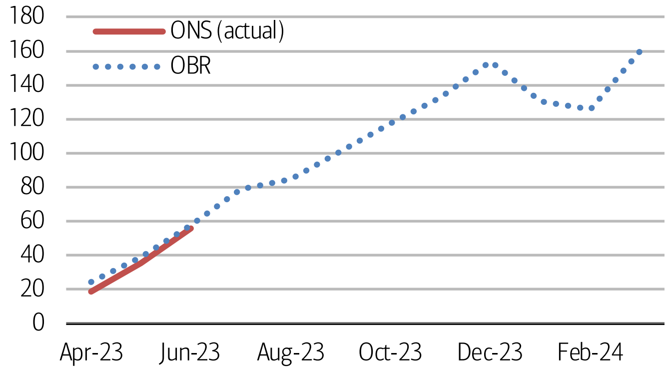
Dave Ramsden's 19 July speech was the first BoE signal of what might be expected when the new year of QT starts in October. He discussed accelerating the pace of Gilt APF reduction to £100bn over the year from September (relative to this year's £80bn reduction of the Gilt stock).

However, allowing for the fact that this year also included the £20bn disposal of all corporate bond holdings, the aggregate pace of QT would be unchanged (Exhibit 10). This would mean £50bn of active Gilt sales over the period (in original cost terms). Total QT of £100bn would be £20bn more than our working assumption that Gilt QT would be kept unch at £80bn.

For active Gilt sales, the increase would be only marginal at £5bn versus active sales this year in original cost terms. An assumption of additional £10bn of active QT for October 2023 - March 2024 would result in £25bn total (£17bn in market value (MV) terms, we would estimate).

Exhibit 11: CGNCR ex. B&B, NRAM, NR and CCFF (GBPbn, cumulative)

Broadly in line with projection



Source: OBR, ONS, BofA Global Research

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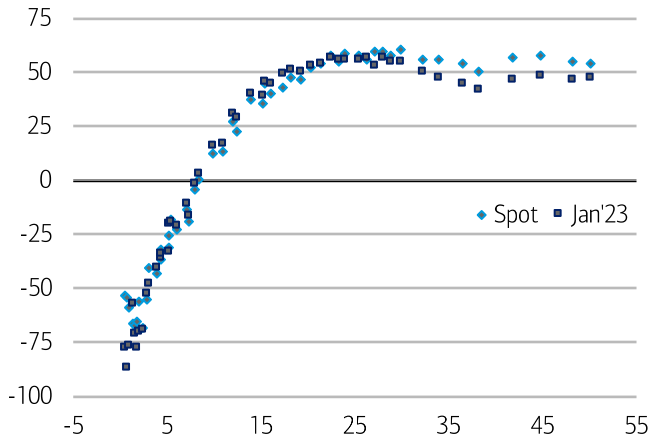
Public sector finance data: going to plan

So far, the Remit is going to plan. UK public sector finance data for June suggested that the DMO's Remit was going to plan in the first three months of the fiscal year 2023/24. The CGNCR (central government net cash requirement) came in at £20.1bn in June, slightly above the OBR's projection of £18.4bn (Exhibit 11). Cumulatively, CGNCR stands at £55.9bn after the first three months of the fiscal year, broadly in line with OBR's projection of £57.5bn.

The NS&I monthly flow was a negative £0.3bn in June, once again less than in the month prior (it was a positive £0.9bn in May). After the first NS&I interest rate increases in December 2022, monthly inflows increased to £3.95bn in March, but have been dropping since. While still very early into the new fiscal year, such a quarterly pace would be in line with the DMO's £7.5bn NS&I fiscal year projection.

Exhibit 12: Gilt z-spreads to Sonia versus years to maturity, bp

Still trading as much as 50bp through Sonia at the front end



Source: Bloomberg, BofA Global Research

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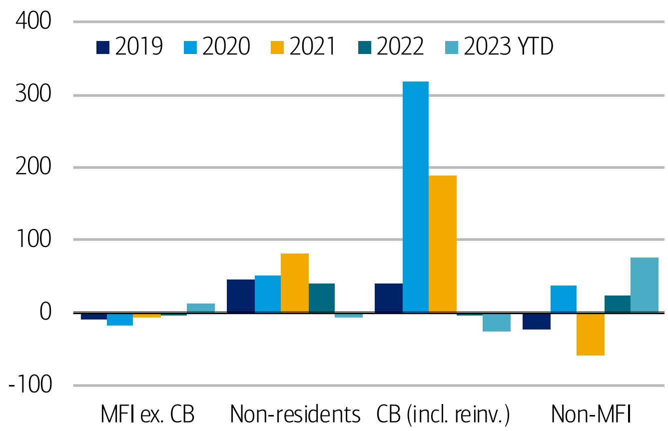
Exhibit 13: Net buying of Gilts per investor type, £bn

Overseas investors remain net sellers of Gilts in 2023 YTD



Source: BoE, BofA Global Research

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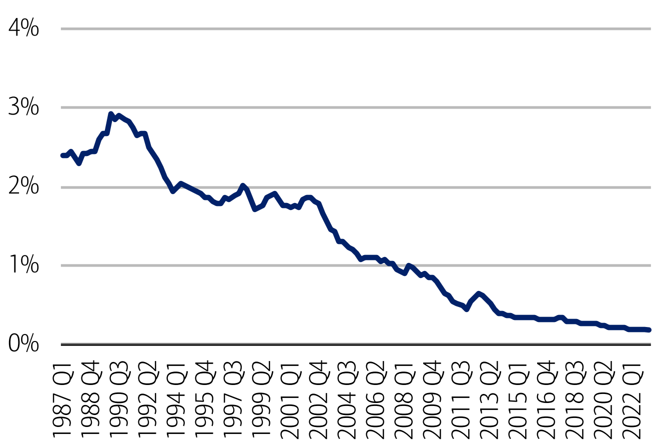
Exhibit 14: Share of Gilt holdings owned by households, %

Households hold a very small proportion of the Gilt market currently



Source: ONS, BofA Global Research

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Will the banks buy the Gilts?

Banks have never owned fewer Gilts than today – perhaps a natural response to the collapse in yields, although we highlight no recovery since the upward move in yields. This, in part, reflects that Gilt yields are below those on swaps (Exhibit 12). This will in any event drive banks to prefer a swap to a Gilt.

It may be that Gilt yields need to be higher still than just closing the gap to swaps. Given the leverage capital ratio, they need to yield more to be appealing. That's a further 80bp yield pickup required from here, according to our Banks' analysts.

O'seas investors – net sellers of Gilts YTD

The latest data on Gilt buying suggested buying by overseas investors, but YTD they remain net sellers (Exhibit 13).

The data for May in BoE's Bankstats report revealed that non-residents bought £13.7bn of Gilts in the month, having bought £14.6bn in April and sold £36.0bn in the first three months of 2023. In addition, foreign investors bought £0.98bn of T-bills and withdrew £21.0bn cash with UK MFIs (monetary financial institutions).

Domestic non-bank investors continued buying Gilts in May, acquiring £4.3bn, having purchased £70.9bn in the first four months of the year. Domestic banks were marginal buyers also, buying £5.0bn, having bought £8.6bn in January-April 2023.

The attractiveness of low coupon Gilts for private direct investors

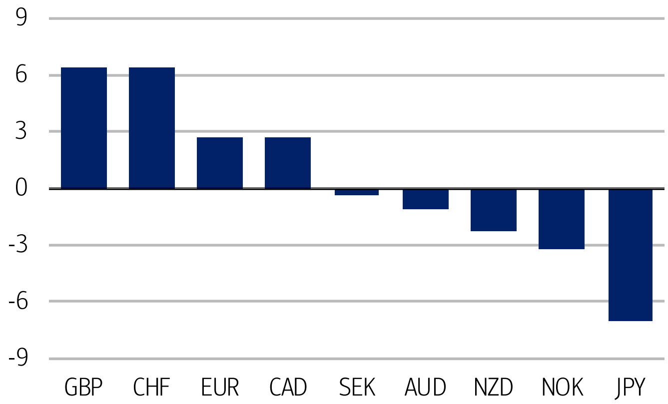
Our understanding of income tax rules suggests that low coupon Gilts are very tax efficient for retail investors, who so far hold a very small proportion of the Gilt market (Exhibit 14).

We do not give tax advice and we do not give any investment advice for retail investors, and nothing in this note should be construed as such; we are simply noting that the tax efficiency of low coupon Gilts could likely attract retail, driving an RV wedge between the neighboring Gilts with different coupons.

This is accentuated in a post-QE environment of superabundant liquidity, where banks do not feel compelled to compete violently for retail term deposits.

GBP: Downside risks around BoE meeting

Exhibit 15: G10 FX vs. USD year-to-date
GBP leading G10 FX this year



Source: Bloomberg. Data through July 27.

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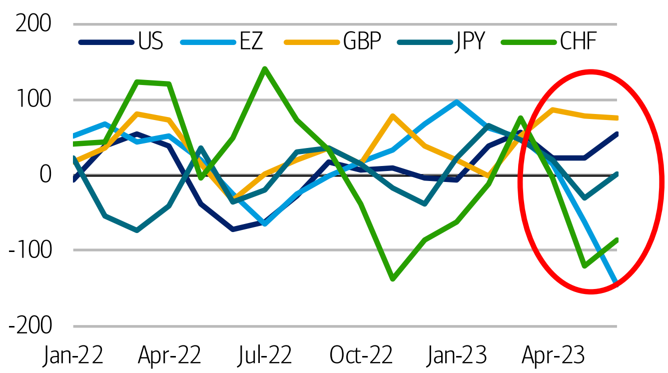
Still at the top…

So far in Q3, GBP performance hasn't stood out, likely amid UK harder landing risks and the long GBP positioning.

But this follows an impressive run earlier in the year, with GBP leading G10 FX in both Q1 and Q2 (Exhibit 15).

Exhibit 16: Data surprises (Citi index)
UK data have proven way more resilient than expected particularly vs EZ data



Source: Bloomberg. Monthly data through June 2023.

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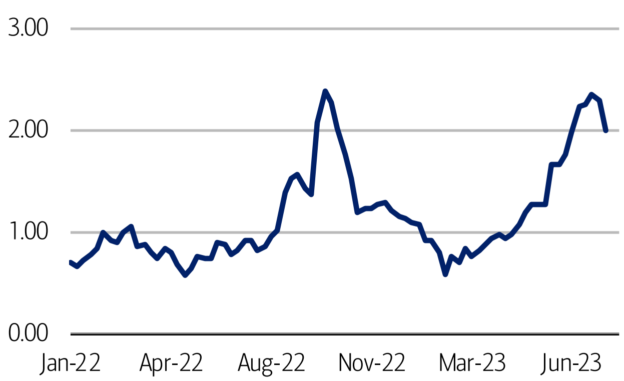
…with UK data much better than expected

The UK data has been much better than expected (Exhibit 16), which the GBP strength this year likely reflects.

With the bar for GBP now higher, our focus is on the UK supply side and, relatedly, how sticky core inflation may prove.

Exhibit 17: UK 2-year swap spreads, trade-weighted, percent
High UK rates to continue supporting GBP, but too high may not



Source: BofA Global Research, Bloomberg. We use a narrower version of the narrow sterling index, including and resizing weights for Eurozone, US, China, Switzerland, and Japan. Data through July 21.

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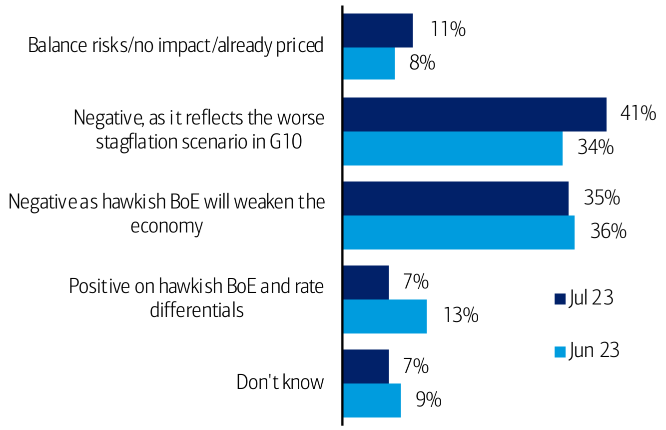
Harder landing risks lower but not zero…

UK rates fell after the downside surprises in the US and UK June CPI prints (Exhibit 17) but remain near potentially overly restrictive levels. In this vein, we have highlighted the risks with the UK public finances, esp. ahead of the UK election (see UK Macro and Financials: Government rather than consumer stress, although maybe consumer stress too 11 July 23).

As a result, we do not view upside inflation surprises as positive for GBP (and vice versa) at the current UK rate levels. We did find the June UK CPI data encouraging, but it is still very early. We have been encouraged by some signs of easing in the labour market (incl. higher labour force participation), but wage growth remains too high, and our economists do not expect meaningfully more help from labour supply near term.

Exhibit 18: The impact of the renewed surge in UK core inflation on GBP is:
Stagflation is bad for GBP



Source: BofA Global Research FX and Rates Sentiment Survey, July 2023

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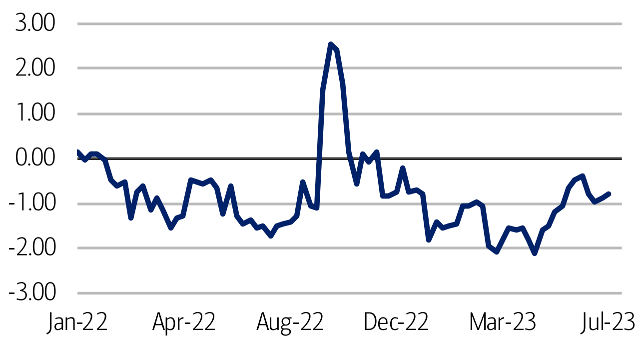
…with most seeing stagflation as bad for GBP

Ahead of the June UK CPI print stagflation concerns rose further (see also [FX and Rates Sentiment Survey: Getting a long isn't easy 14 July 23]), which suggests downside risks for GBP should the downside inflation surprise in June prove one-off.

Exhibit 19: Idiosyncratic 3-month implied volatility GBP spread
GBP vol well-behaved (and way off Sep-22 highs)



Source: BofA Global Research, Bloomberg. Note: We define the idiosyncratic GBP implied volatility spread as that between the equally weighted average of the 3-mth EUR/GBP and GBP/USD implied volatilities and the equally weighted average of the 3-mth EUR/USD, USD/JPY, EUR/JPY and EUR/CHF implied volatilities. Data weekly through June 16.

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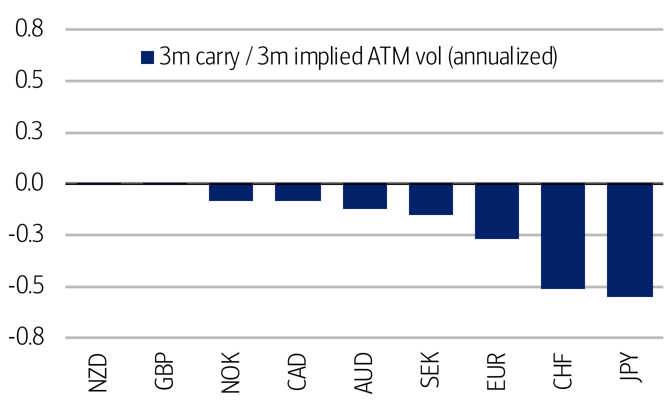
GBP vol remains well-behaved

GBP vol has behaved well overall this year, remaining way off the Sep-22 highs (Exhibit 19).

Going forward, we remain worried the markets' "goldilocks" base case could be tested, and for more UK-centred risks we would look at the UK fiscal side, esp. into the next election.

Exhibit 20: 3-month vol-adjusted carry vs USD (annualized)
Carry supports GBP vs most of G10 FX



Source: BofA Global Research, Bloomberg. Data as of July 27.

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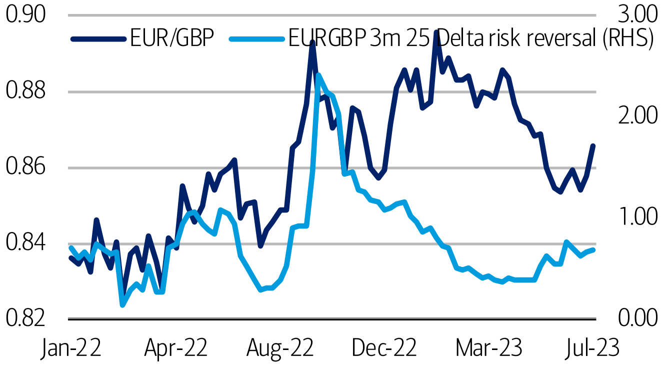
GBP carry a plus by the G10 FX standards

BoE higher for longer and lower vol mean attractive vol-adjusted carry vs. most G10 FX incl. EUR (Exhibit 20).

Exhibit 21: EUR/GBP vs 3mth 25 Delta risk reversal
Option skew stabilized but some scepticism remains



Source: BofA Global Research, Bloomberg. Weekly data through July 21.
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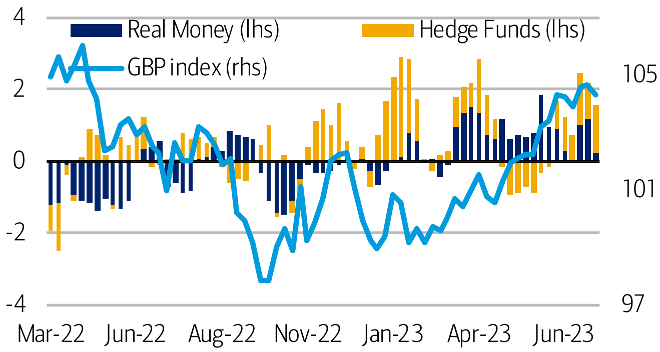
EUR/GBP option skew has stabilised

EUR/GBP risk reversals are well-behaved by their past 5-year standards and way off their Sep-22 levels (Exhibit 21).

But they suggest slightly more scepticism towards GBP in recent weeks, likely on higher concerns about inflation stickiness.

Exhibit 22: BofA investor 4-week GBP flows (z-score) and GBP TWI
GBP has seen very strong and persistent investor demand this year



Source: BofA Securities, Bloomberg. We show the 2-year z-score of rolling 4-week flows. Data through July 21
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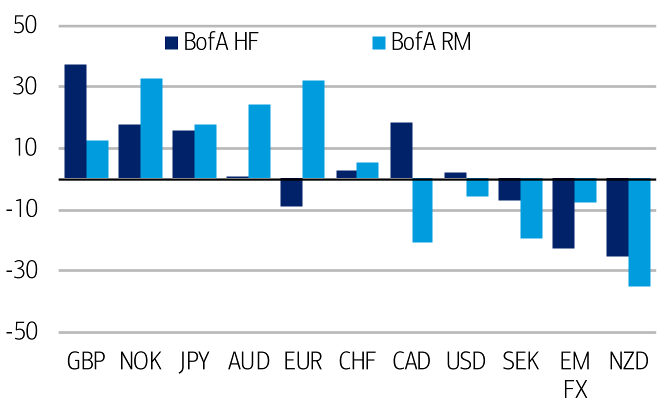
GBP an investor favourite this year...

GBP has seen persistent investor demand this year (Exhibit 22), and the strongest in G10 FX by some distance, according to our proprietary flows (please see Liquid Cross Border Flows).

Exhibit 23: Latest BofA investor positioning
We see GBP longs, esp. vs USD, could be at risk around the BoE meeting



Source: BofA Securities. +50 (-50) represents a max long (short) positioning relative to history. Currencies ranked on the equally-weighted average for Hedge Funds (HF) and Real Money (RM). Data though July 21
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...but risks to GBP longs around the BoE

We are concerned about GBP investor positioning, which we now find to be the longest in G10, especially for hedge funds.

Positioning suggests greater downside risks for cable than upside risks for EURGBP (see also Liquid Cross Border Flows).

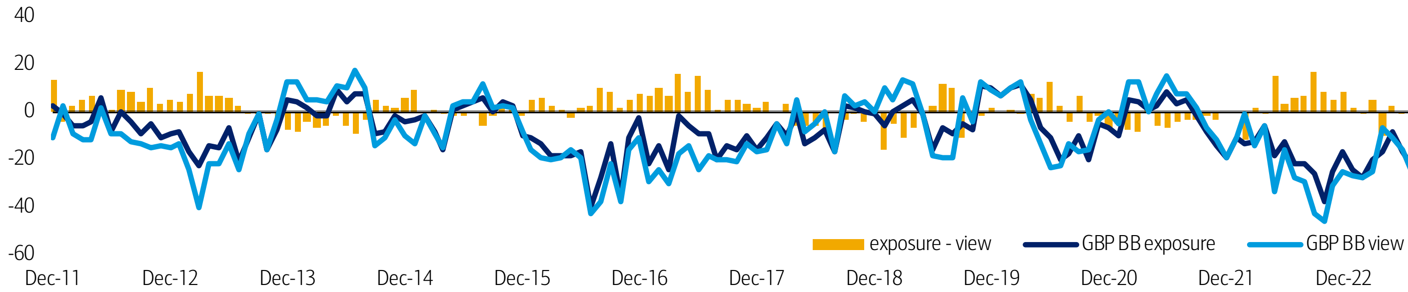
FX and Rates Sentiment Survey

This is an excerpt from FX and Rates Sentiment Survey - Getting a long isn't easy published on 14 July 2023.

GBP was again sold as investors continued to take a negative view of the implication of sticky core inflation for the GBP (Exhibit 24). Gilt short covering continued, with sentiment still weak, making direction call tricky (Exhibit 25, Exhibit 26, Exhibit 27).

Exhibit 24: FX exposure and view: GBP

GBP exposures continue to decline



Source: BofA Global Research FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See publication for formulas.

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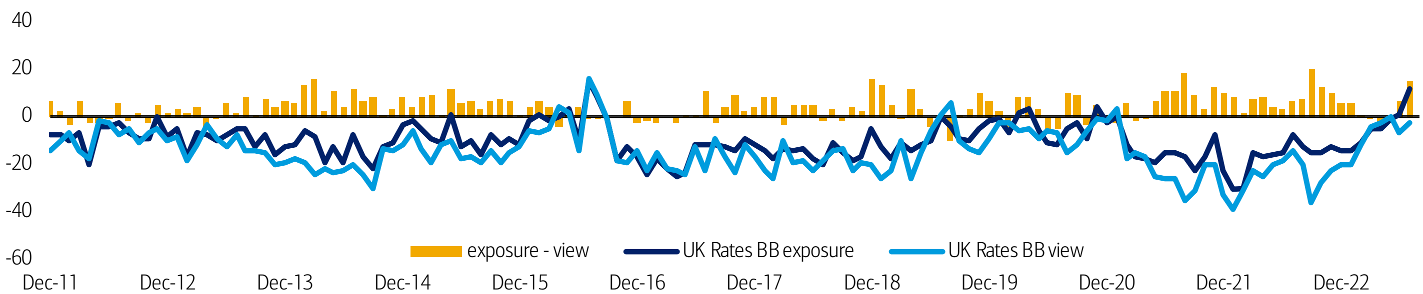
Exhibit 25: Duration exposure and view: UK

Gilt short covering continues, even as sentiment is weaker



Source: BofA Global Research FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See publication for formulas.

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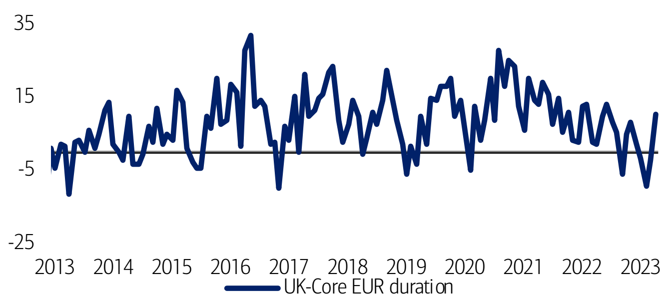
Exhibit 26: UK-Core Europe Duration Exposure

UK vs Core EUR Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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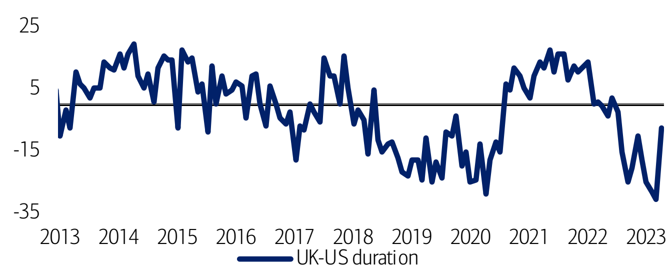
Exhibit 27: UK-US Duration Exposure

UK vs US Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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