European Rates Viewpoint

Charting UK Rates and FX – May 2023

08 May 2023

Rates Research
Europe

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Rates: Last 25 in May(be)

Heading into this week's Monetary Policy Committee (MPC) meeting, the market prices the Bank of England (BoE) to hike 65bp cumulatively by September 2023. Our own base case expectation is for one more 25bp hike. Risks remain skewed towards additional hikes, and more importantly much delayed cuts given the UK's underlying inflation bias. We continue to like being positioned for higher real yields as a result.

As the BoE's last hike nears, a historical check on the Bank shifting to an on-hold stance implies similar conclusions to the ones in the US. One important difference is that timing the last hike matters in the UK – and remains highly uncertain. In both cases, bearing in mind idiosyncrasies of the current cycle against the past ones is important.

FX: A classic position squeeze

In the run up to the BoE, GBP price action has been a response to broader theme of position reduction in G10 FX. GBP has been a popular short versus EUR and momentum in the run-up to the current crisis was overstretched. GBP price action against the backdrop of rising volatility is at odds with the long-standing relationship between the pound and market risk.

We view the current phase as an adjustment process as we cannot see a situation where sterling can remain resilient against the backdrop of deterioration in global cross-border capital flows. The end of the BoE cycle and a renewed downturn in data should all combine to drive GBP weaker into the year-end.

Sentiment: Approaching neutral

The latest FX and Rates Sentiment Survey published on 17 April showed GBP sentiment moving sharply higher. While some GBP shorts were covered, the disconnect between view and exposure remains large. There was little change in Gilt sentiment, with both positioning and sentiment continuing to drift towards neutral.

European Rates Research
MLI (UK)

Kamal Sharma
FX Strategist
MLI (UK)
ksharma32@bofa.com

Agne Stengeryte
Rates Strategist
MLI (UK)
agne.stengeryte@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
mark.capleton@bofa.com

See Team Page for List of Analysts

Abbreviations:

BoE: Bank of England
DMO: Debt Management Office
MPC: Monetary Policy Committee
NS&I: National Savings and Investment
ASW: Asset Swap Spread
QE: Quantitative Easing
TPR: The Pension Regulator
IMM: International Monetary Market
M&A: Mergers and Acquisitions

Timestamp: 08 May 2023 01:00AM EDT

Rates and FX forecasts

We adjusted our Gilt and Sonia yield forecasts recently to (1) reflect updated BoE Bank rate call and (2) bring longer-dated yield forecasts back above the forwards (Exhibit 1, Exhibit 2, Exhibit 3 and Exhibit 4). We expect significant cheapening in short-dated Gilts relative to Sonia amid pickup in issuance from April. We pencil-in some flattening of 10s30s Gilt curve while 30y ASW remains stable (see: UK rates section of The inflation fight in a slowdown, 26 April 2023).

Exhibit 1: UK government bond yield forecasts, %
As of 5 May 2023

Gilts					
	Now	Q2 2023	Q3 2023	Q4 2023	Q1 2024
Bank rate	4.25	4.50	4.50	4.50	4.25
2y	4.04	3.75	3.90	4.05	4.00
5y	3.71	3.75	4.00	4.00	4.00
10y	3.76	4.00	4.00	4.00	4.00
30y	4.03	4.00	4.00	4.00	4.00

Source: Bloomberg, BofA Global Research

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Exhibit 2: UK swap yield forecasts, %
As of 5 May 2023

Sonia					
	Now	Q2 2023	Q3 2023	Q4 2023	Q1 2024
3m Sonia	4.48	4.50	4.50	4.25	4.00
2y	4.52	4.25	4.15	4.05	4.00
5y	4.00	4.00	4.00	4.00	4.00
10y	3.70	3.75	3.75	3.75	3.75
30y	3.51	3.50	3.50	3.50	3.50

Source: Bloomberg, BofA Global Research

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Exhibit 3: Our bond and swap forecasts vs. market forwards, bp
As of 5 May 2023

Gilts	Q2 2023	Q3 2023	Q4 2023	Q1 2024
2y	-19	6	31	35
10y	23	23	23	23
Sonia	**Q2 2023**	**Q3 2023**	**Q4 2023**	**Q1 2024**
2y	-17	-14	-10	-2
10y	2	5	9	13

Source: Bloomberg, BofA Global Research

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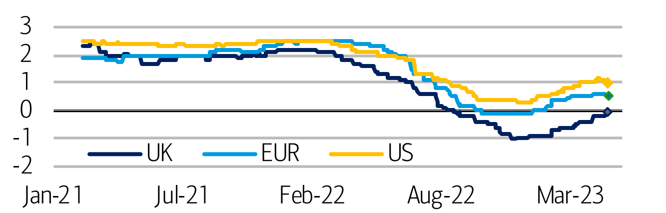
Exhibit 4: BofA 2023 growth forecast vs. Bloomberg consensus, %
All pretty close to consensus



Source: Bloomberg, BofA Global Research

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In FX, April seasonality has once again played out (see: FX Watch: GBP: It's April 03 April 2023), lifting GBP across the board. Of more interest, however, was the inability of the pound to react positively in a week where both inflation and wages printed above expectations. Despite our call for a further rate hike in May, we do not think this will materially benefit GBP as the pound has long ceased to be a rate sensitive currency and as markets remain uneasy about the growth/inflation mix this year. Much of the tail risks have been priced out, positioning is no longer stretched but this may be as good as it gets for GBP (GBP – As good as it gets?, 19 April 2023 and Exhibit 5).

Exhibit 5: GBP forecasts versus G10
As of 3 May 2023

			2023				2024	
	Spot	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GBP/USD	1.25	1.18	1.19	1.21	1.21	1.21	1.26	1.26
EUR/GBP	0.88	0.89	0.90	0.91	0.91	0.91	0.91	0.91
GBP/JPY	170	163	170	169	163	160	158	158
GBP/CHF	1.11	1.10	1.09	1.08	1.09	1.09	1.10	1.10
GBP/CAD	1.70	1.58	1.55	1.55	1.51	1.51	1.58	1.58
GBP/NOK	13.46	12.59	12.11	11.65	11.42	11.42	11.21	10.99
GBP/SEK	12.85	12.81	12.78	12.09	11.76	11.65	11.54	11.32
GBP/AUD	1.88	1.73	1.65	1.63	1.59	1.59	1.66	1.66
GBP/NZD	2.01	1.61	1.56	1.52	1.49	1.49	1.49	1.49

Source: BofA Global Research, Bloomberg

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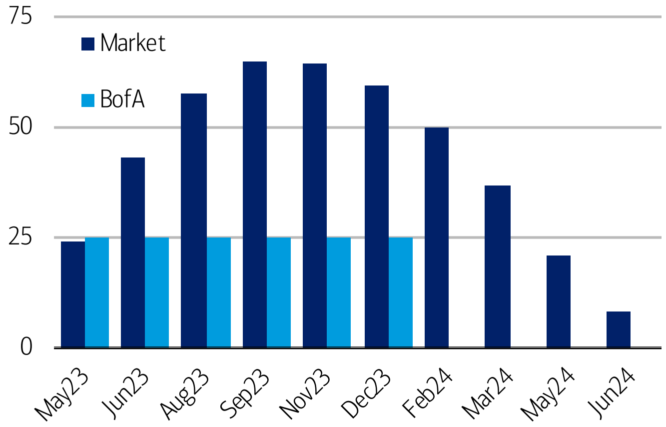
Rates: Last 25 in May(be)

Exhibit 6: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp

More than two 25bp Bank rate hikes ahead priced in by the market



Source: Bloomberg, BofA Global Research

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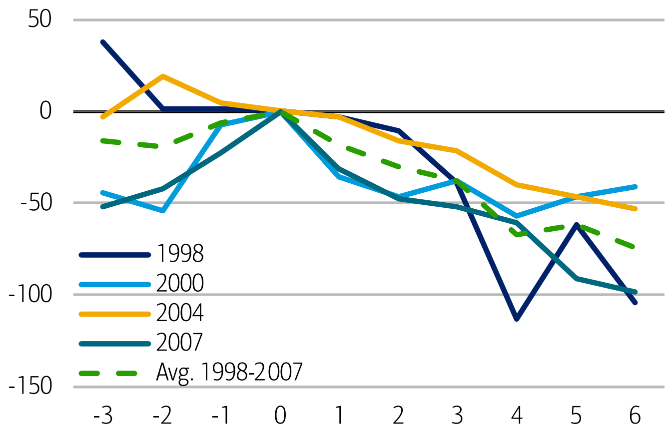
Exhibit 7: 10y Gilt dynamics around the last BoE hike, cumulative bp

Around 75bp of rally in 4 months post last hike



Source: Bank of England, BofA Global Research. X-axis = months before and after last BoE hike

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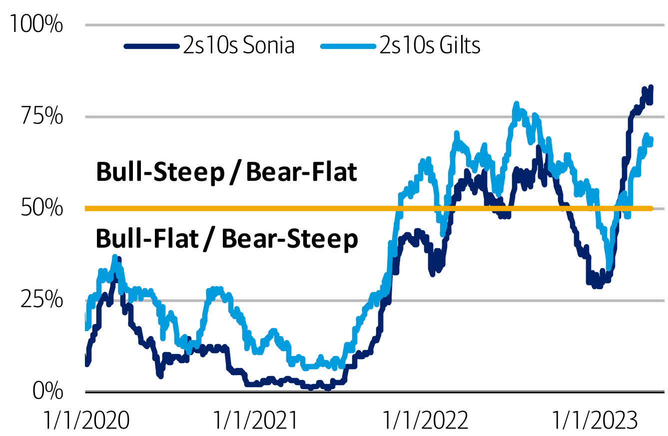
Exhibit 8: Frequency of 2s10s bull-steepening moves, %

Shifting progressively towards bull-steepening/bear-flattening dynamic



Source: Bloomberg, BofA Global Research

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25bp in May, risks to the upside

Heading into this week's Monetary Policy Committee (MPC) meeting, the market prices the Bank of England (BoE) to hike 65bp cumulatively by September 2023. The market is also pricing a subsequent 25bp cut by March 2024 (Exhibit 6).

Our own base case expectation is for one more 25bp hike, with risks skewed to more hikes. We expect fewer rate cuts than the market in 2024 (see the report BoE preview: 25bp and risks of more hikes, 4 May 2023).

As the BoE's last hike nears, a historical check on the Bank shifting to an on-hold stance implies similar conclusions to the ones in the US. One important difference is that timing the last hike matters in the UK. In both cases, bearing in mind idiosyncrasies of the current cycle against the past ones is important.

Roadmap for a BoE on hold

2y and 5y Gilts performed well following the last BoE rate hike in 1998, 2000, 2004 and 2007, rallying some 100bp on average in the first six months after. Rally in 10y appeared to be more short-lived, amounting 75bp on average (Exhibit 7). Timing the last hike was important: investors were typically slightly penalised for being 2-3 months early, with the rally 2-3m after exceeding the prior selloff by 15-25bp on average.

Assuming May MPC to be the last hike would imply that the current market forwards price in less than 10bp rally in 10y Sonia and even less in Gilts 6m ahead. High possibility of further hike(s) beyond May and the relative importance of timing the last hike might help explain market's reluctance to price in significantly more than that.

Some bull-steepening already priced in

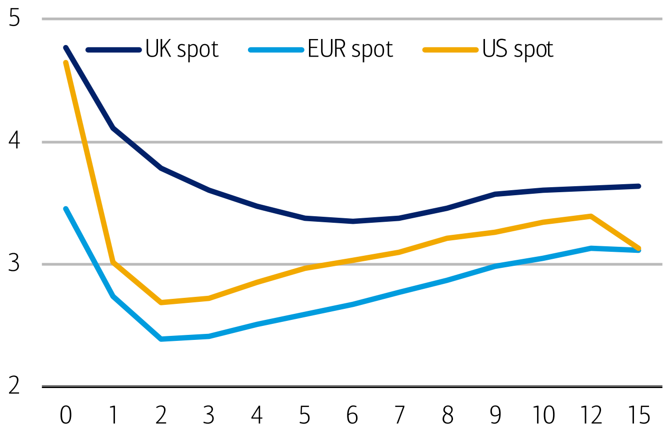
On the curve, the current 2s10s has been trading increasingly in bull-steepening/bear-flattening dynamic (Exhibit 8). Market forwards also appear to be pricing around 20-25bp of bull steepening in the 6 months ahead in Sonia and Gilts.

From historical perspective, 2s10s Gilt curve tending to bull steepen at the end of the hiking cycle is explained by the approaching rate cuts to contain a slowdown.

In the cycles analysed, on average the first cut occurred 8 months after last hike. The curve should then bear steepen if the Bank keeps rates credibly on hold while the longer end of the curve starts to price in the early expansion phase.

Exhibit 9: Market implied path of 1y Sonia, SOFR and €STR gaps, %

We agree with slower approach to trough but not its level relative to the US



Source: Bloomberg, BofA Global Research

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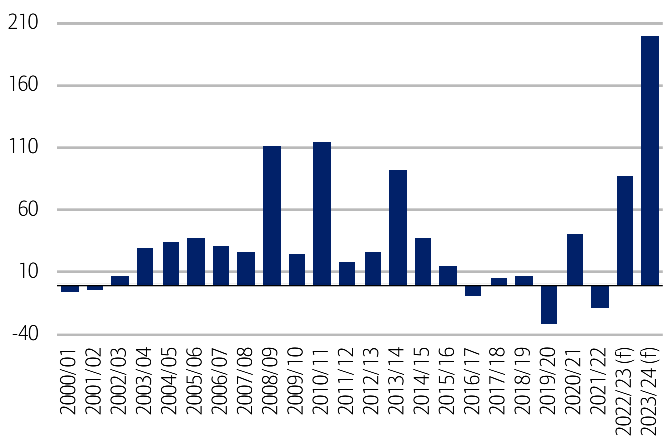
Exhibit 10: Gilt net supply to private investors, £bn

More than double the amount to be sold in 2022/23



Source: DMO, BoE, BofA Global Research

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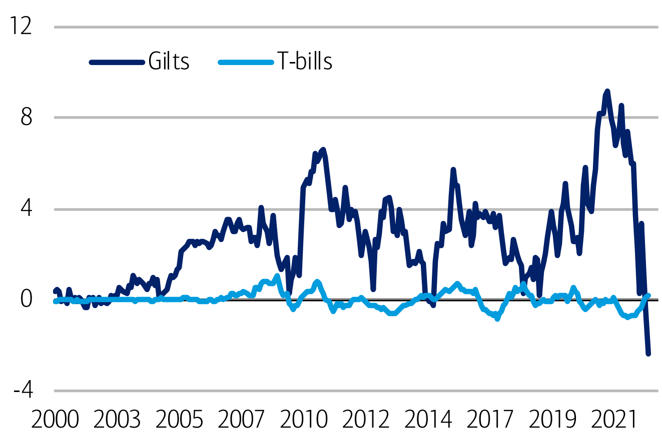
Exhibit 11: Non-residents' net buying of Gilts and T-bills (12m MA), £bn

Huge in recent years, in decline lately



Source: BoE, BofA Global Research

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Yet still not easy to trade last hike

Overall, comparison of current market pricing to historical precedent suggests duration to be clearer expression to play approaching last hike than the curve.

But uncertainty about the number of hikes ahead coupled with importance of timing makes it tricky still.

Looking at market implied paths of 1y Sonia and SOFR, we agree with the more gradual tightening in the UK than elsewhere.

In the past, we didn't quite agree with the longer term path implying trough at broadly same levels as in the US. Current differential looks more correct to us (Exhibit 9).

Small reduction in 2023/24 Remit

The DMO's financing Remit for 2023/24 has been revised following the release, with the Net Financing Requirement (NFR) now forecast to be £242.8bn, £3.3bn lower compared to the Spring Budget projection.

The £3.3bn reduction in the NFR will be managed via £2.1bn reduction in sales of short conventional Gilts via auctions and a reduction of £1.2bn in sales of long conventional Gilt auctions.

The small -0.4% and -0.2% changes to short and long Gilt sales relative to Spring Statement does not change the big picture that short Gilt sales will comprise the largest proportion of supply by the DMO – 35.6% - versus long Gilt sales comprising 20.9%. Gilt supply to private investors from the DMO and Bank of England (BoE) combined will remain historical record high (Exhibit 10).

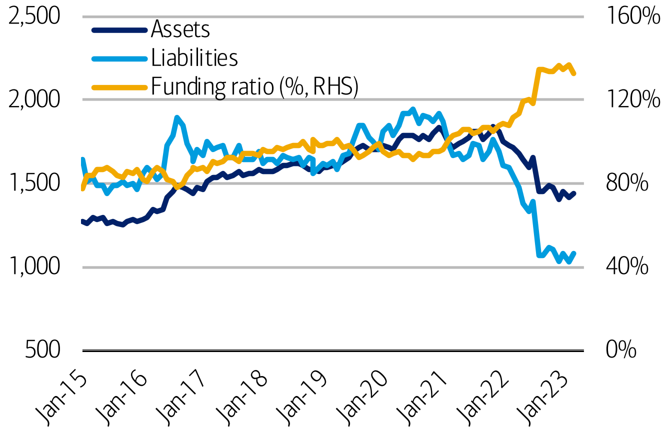
Foreign bid continues to fade

March Gilt purchase data in last week's BoE Bankstats report revealed that non-residents sold £6.3bn, having sold £29.7bn in the first two months of 2023 (Exhibit 11).

Next to Gilt selling, foreign investors bought £0.3bn of T-bills. They also withdrew £11.2bn cash from deposits with UK Monetary Financial Institutions (MFI).

Domestic non-bank investors continued to be the main buyers of Gilts in March, acquiring £25.3bn, having accumulated £38.0bn in January and February.

Exhibit 12: PPF 7800 assets and liabilities to end-March, £bn
Pension scheme solvency remains strong



Source: PPF, BofA Global Research

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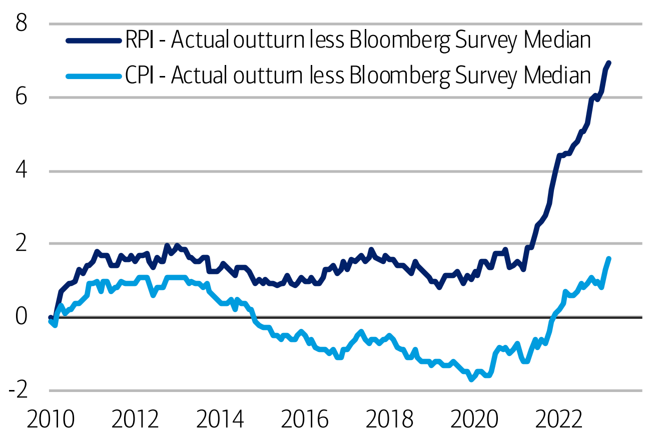
Exhibit 13: "Economiss" indices – Cumulative forecast errors
Consensus forecast errors for each month's print, sum since 2010, %



Source: BofA Global Research, Bloomberg

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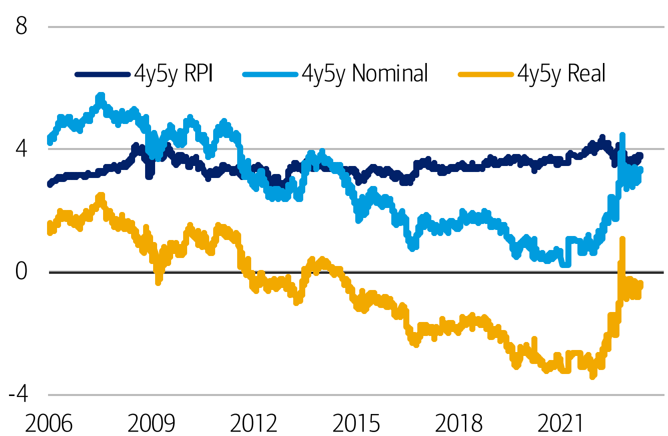
Exhibit 14: 4y5y nominal, inflation and real swap rates, %
Before GFC, 4y5y inf. was lower than now, but 4y5y RY much higher



Source: Bloomberg, BofA Global Research

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LDI spring clean

TPR's guidance on use of leverage within LDI was in line with prior guidance from the BoE in late March. The regulator stated that the market stress buffer – a buffer set to allow an LDI fund to operate with "business as usual" in the event of sharp market movements – should be 250bp at minimum.

Importantly, this min level will need to assume that the fund will be able to provide additional cash or assets to replenish the buffer within a short period (we would say) of five days.

As expected, the guidance was complex and time limit short. We suspect many LDI accounts will choose to position conservatively with higher-than minimum market stress buffers.

But the Gilt supply picture should still be supportive of 2s20s Gilt ASW curve steepeners, in our view (Exhibit 12).

Acute inflation uncertainty

That the UK has an inflation persistence problem is no longer a minority view. The cumulative consensus forecast misses through the pandemic are large for CPI and huge for RPI.

Remember these are the sums of errors of forecasts for the month ahead, not, say, year-ahead forecast errors (Exhibit 13).

And the dispersion of Core CPI component inflation rates is telling, with only 10% of the core basket recording sub-2% rates and 30% recording rates of over 10%

High inflation priced, but not the real rates needed to deal with it

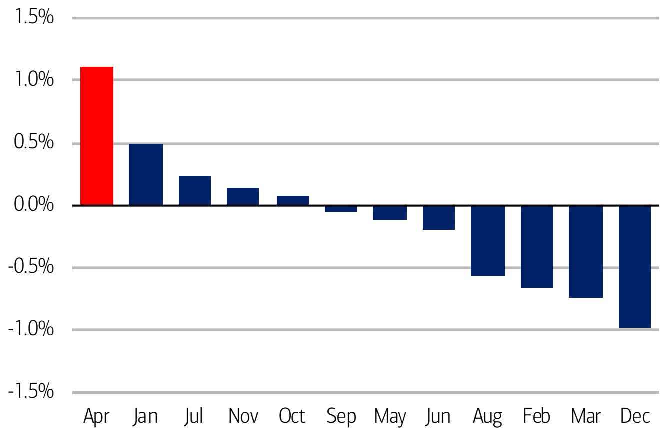
We would contend that the market will need to adapt to the likelihood that the UK will need meaningfully positive real policy rates to keep inflation in check (Exhibit 14).

This was the case before the global financial crisis, and if the disinflationary benefits of globalization have indeed ebbed, then it will likely be the case again. We are, after all bearish Gilts outright and relative to other markets.

Higher real rates will also probably be required to attract and retain foreign capital to finance the UK's persistent current account deficit (and to encourage the domestic saving needed to shrink it).

GBP: Now comes the hard part

Exhibit 15: GBP TWI Monthly Performance Over Past 15yrs
April seasonality is strongest +ve for GBP through the year



Source: BofA Global Research, Bloomberg

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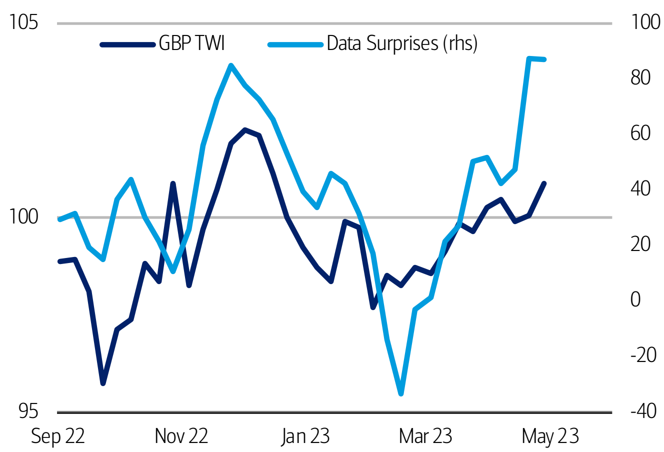
Exhibit 16: Data has been supportive
UK data surprises have priced out worst case since September



Source: BofA Global Research, Bloomberg

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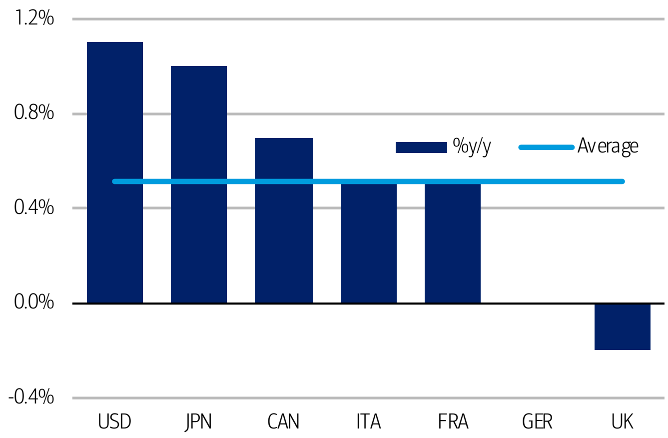
What now after April sun?

It has been another strong April for GBP which made gains across the board (except for CHF) and particularly JPY and NOK (Exhibit 15). This should be about as good as it gets for GBP as many of the seasonal negative months are ahead of us starting with May. We have made constant reference to the changing characteristics of GBP from a rate sensitive currency to a global risk proxy largely due to the increasingly challenging domestic macro backdrop. If “sell in May, go away” holds and risk assets come under pressure, we think GBP could be at the forefront of this market correction.

It has not been as bad as feared

UK data surprised have continued to improve and a currently at recent cyclical highs. The breakdown reveals that the labour market remains the strongest sector of the UK economy and responsible for the positive data surprises. Cyclical indicators remain weak but as Exhibit 16 shows, GBP has been supported by the improvement in data. This may be about as good as it gets as cyclically positive surprises may be harder to achieve given the move that we have seen in recent months.

Exhibit 17: 2023 GDP Consensus forecasts (%y/y)
Not as bad but not great for UK growth this year.



Source: BofA Global Research, Bloomberg

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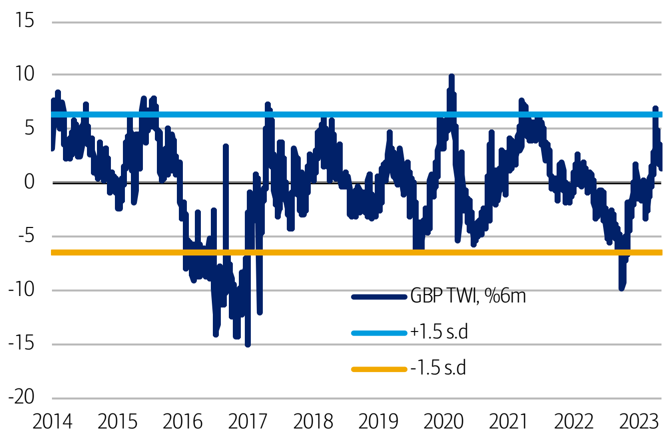
The growth conundrum

As much as UK data has surprised to the upside, consensus forecasts continue to project that the UK will be the growth laggard in G10 (Exhibit 17). Direction of travel is important but so is quantum and with inflation likely to remain stubbornly high for the foreseeable future, we find it hard to make the case for a further rally in GBP based on fundamentals alone.

Exhibit 18: GBP TWI Momentum using 6mth changes
GBP is looking overstretched



Source: BofA Global Research, Bloomberg

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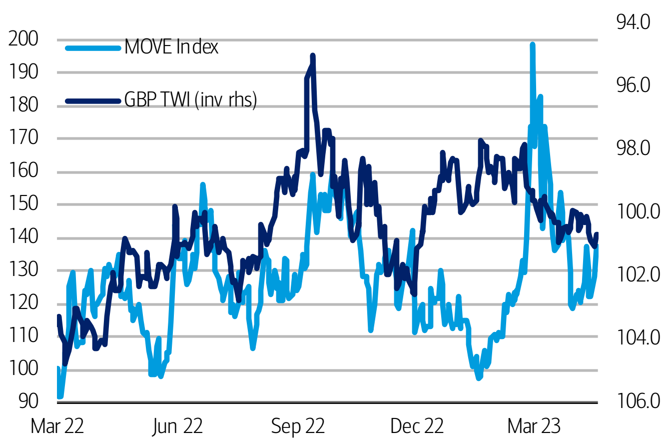
Momentum is stalling

GBP TWI has corrected from significant oversold territory but is now looking exhaustive (Exhibit 18). Whilst it has been a good start to the year for GBP, the underlying message remains the same: there is a ceiling above which GBP will struggle to appreciate. In TWI terms, the ranges appear well defined and most importantly for us, GBP remains confined to the post referendum ranges.

Exhibit 19: GBP TWI vs MOVE Index
Higher volatility has not recently impacted GBP.



Source: BofA Global Research, Bloomberg

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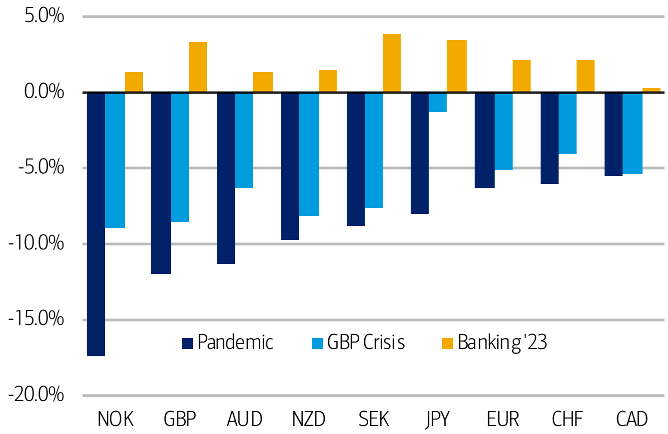
The volatility/GBP disconnect

One of the key features of recent price action has been the durability of high beta G10 FX to the concerns about regional banking (Exhibit 19). We have stated that if there was "perfect crisis" for markets then it would be in banking given the vast tool kit accumulated since the GFC. As a result, the market could read how the playbook evolved. This is important for G10 FX because whilst measures such as bond volatility rose, other measures which we think are important for FX have remained sanguine.

Solvency matters for GBP

In a recent note (see: [FX Viewpoint: Financial Conditions & FX. Be Careful what you wish for 03 May 2023](#)) we argued that FX markets are better equipped to handle traditional crises such as the one we saw in March. Exhibit 20 illustrates this point for G10 more broadly: the March banking tumult challenged the way in which markets though G10 FX price action would evolve. This is largely because the response evolved how one would have thought. The pandemic and the GBP crisis were black box events and suggest anything similar will see GBP coming under traditional risk off pressure is solvency and liquidity are compromised.

Exhibit 20: G10 FX Performance vs USD through recent "crises"
2023 was more plain vanilla than the previous black box events...



Source: BofA Global Research, Bloomberg

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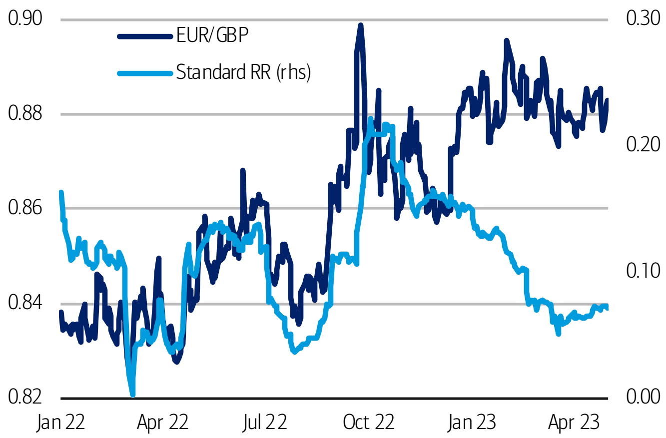
EUR/GBP option skew has stabilised

EUR/GBP is broadly changed on the year but remains elevated relative to its long-run history There have been bouts of pressure whilst standardised risk reversals continued to drift lower from the October extremes (Exhibit 21). This disconnect is interesting has it once again validates our view that positioning and pricing out of tail risks have been the dominant driver for GBP. In no way does performance year-to-date reflect a vote of confidence in the currency, particularly set against the backdrop of a lack of foreign participation.

Exhibit 21: EUR/GBP vs 3mth standardized risk reversal
EUR/GBP has been resilient to move in skew up until now



Source: BofA Global Research, Bloomberg

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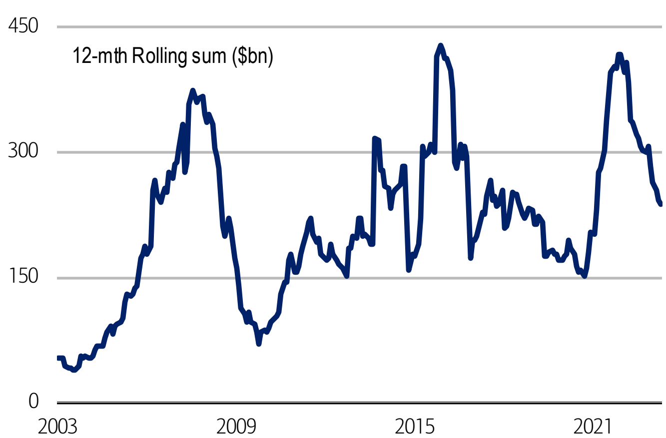
Focus on Investor Appetite for UK Plc

Our key focus over the coming year is on cross-border capital flows. This is not only important in the context of financing the current account deficit but an important sign on investor confidence on UK Plc. So far, the omens are not good. Exhibit 22 shows how foreign demand for UK M&A has slowed following strong interest following the signing of the Brexit deal. That interest has waned and has focused investors on the UK current account deficit.

Exhibit 22: Cross-border M&A where UK is target
No sign of an improvement in demand for UK plc



Source: BofA Global Research, Bloomberg

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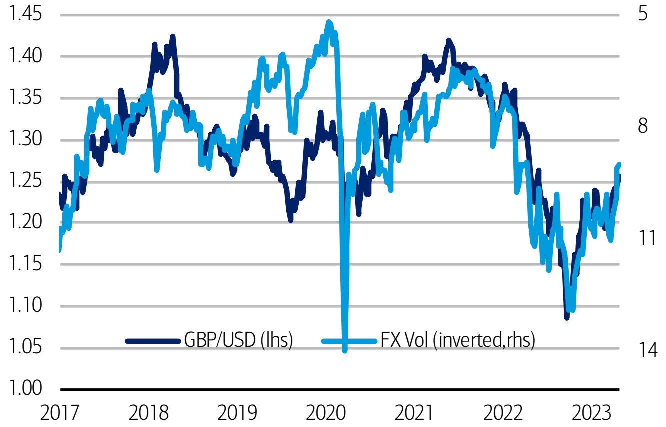
Exhibit 23: FX volatility versus GBP/USD
Benign environment for FX vol is good for GBP



Source: BofA Global Research, Bloomberg

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FX vol sees little trouble ahead

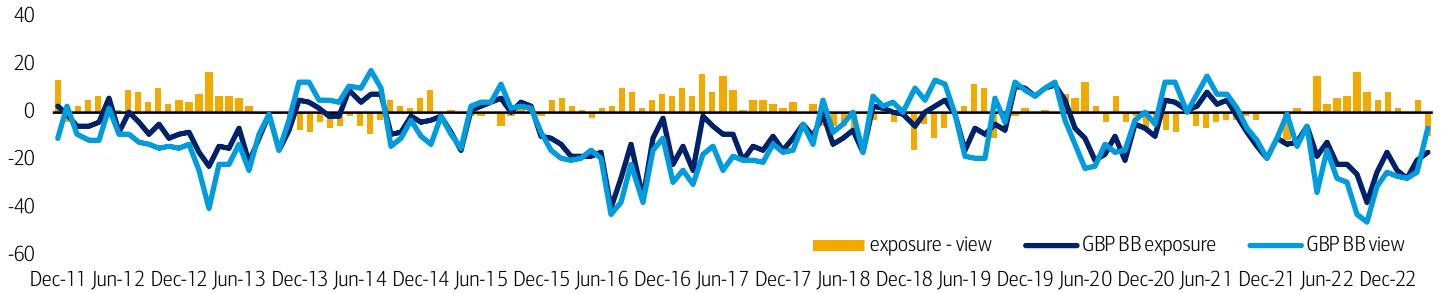
Whilst solvency concerns remain paramount in our minds as a more significant driver of G10 FX, the FX volatility market appears to be equally benign at present (Exhibit 23). GBP is now the consummate risk FX play which in many ways makes it more predictable to trade than on macro fundamentals. As a team, we are concerned about the prospect for higher volatility, which could be a factor in GBP underperformance through May.

FX and Rates Sentiment Survey

This is an excerpt from [FX and Rates Sentiment Survey – Shaken, not stirred] published on 17 April 2023.

GBP sentiment has moved sharply higher, and while some GBP shorts were covered, the disconnect here is large (Exhibit 24). Little change in Gilts where positioning and sentiment continue to drift towards neutral (Exhibit 25, Exhibit 26 and Exhibit 27).

Exhibit 24: FX exposure and view: GBP
GBP shorts continue to moderate though sentiment has moved significantly further, now close to neutra



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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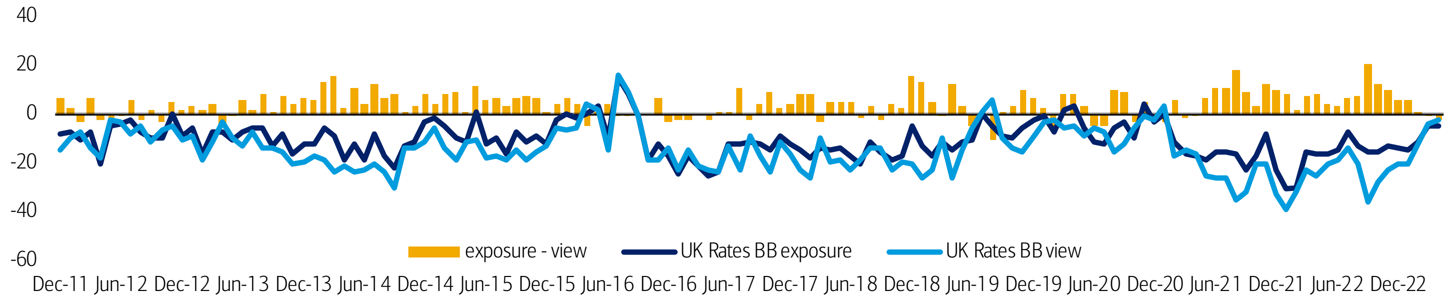
Exhibit 25: Duration exposure and view: UK
Little change in either positioning or sentiment this month; both continue to drift towards neutral



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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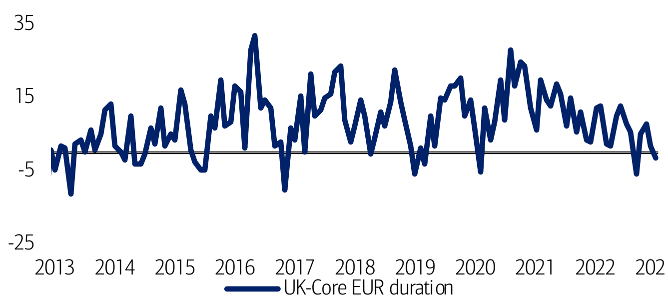
Exhibit 26: UK-Core Europe Duration Exposure
UK vs Core EUR Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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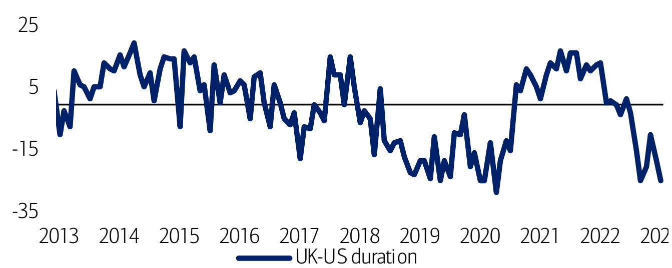
Exhibit 27: UK-US Duration Exposure
UK vs US Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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Research Analysts

European Rates Research

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
ralf.preusser@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
sphia.salim@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
mark.capleton@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
erjon.satko@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
ronald.man@bofa.com

Agne Stengeryte
Rates Strategist
MLI (UK)
agne.stengeryte@bofa.com

FX Rates & Commodities Research

Athanasios Vamvakidis
FX Strategist
MLI (UK)
athanasios.vamvakidis@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
ksharma32@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
michalis.rousakis@bofa.com