European Rates Viewpoint

Charting UK Rates and FX – December 2023

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Rates: Left behind

We expect UK rates to continue to underperform cross-market. Our economists see the BoE cutting later than either the Fed or the ECB. The inflation problem in the UK is more structural. The UK also has unique macro vulnerabilities: the current account deficit, weak public sector balance sheet and large external liabilities. Despite slightly better than expected Gilt demand dynamics, supply will remain elevated in 2024. All this points to more persistent risk premia being priced in the UK even as the BoE eventually starts cutting. We are short Gilts vs. ACGBs, short Gilts on real yields vs EUR and short the GBP front-end vs EUR. In the following pages, we outline our forecasts (page 2), near-term views ahead of this Thursday's Bank of England (BoE) meeting (page 3), thoughts on Gilt supply-demand (page 4) and some of our key trade ideas (page 5).

FX: Waning Momentum

GBP has benefited from the improvement in the global risk outlook, a pricing out of front-end rate cuts and positive data surprises. However, this is one of the least anticipated BoE meetings this year and whilst the BoE has been successful in recalibrating UK rate expectations, this is unlikely to be enough to carry GBP into a strong position in 2024. Higher rates may imply attractive carry but when compared to the impending data flow, it is a double-edged sword. Higher for longer is not the panacea for GBP as rates remain at lofty levels for all the wrong reasons. BoE communication may become increasingly challenging in the coming months as it tries to square the circle versus stubbornly high inflation.

Sentiment: Less bearish GBP sentiment

Modestly less bearish GBP sentiment but still bearish, with positioning roughly in line. The Gilt short covering is largely complete, with exposure and views aligned and relatively unchanged from last month.

Rates and FX forecasts

Rates: more persistent risk premia even as the BoE eventually starts cutting

Our UK rate forecasts imply underperformance relative to forwards and on a cross-market basis. Our economists see the Bank of England (BoE) cutting later than either the Fed or the ECB. We think the inflation problem is more structural than elsewhere and think that monetary policy transmission has clearly slowed. These, along with macroeconomic fragilities, the supply-demand outlook and political risks, inform our view of more persistent risk premia being priced in the UK even as the BoE embarks on the cutting cycle (Exhibit 1 and Exhibit 2).

Exhibit 1: BofA Gilt yield forecasts, %

We expect short-dated Gilts to cheapen relative to Sonia in 2024

	Gilts				
	1Q24	2Q24	3Q24	4Q24	4Q25
Bank rate	5.25	5.25	5.25	5.25	4.25
2y	4.50	4.75	4.75	4.75	4.25
5y	4.25	4.50	4.50	4.50	4.50
10y	4.50	4.50	4.50	4.50	4.50
30y	4.50	4.50	4.50	4.50	4.50

Source: Bloomberg, BofA Global Research

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Exhibit 2: BofA Sonia yield forecasts, %

We expect 10y Sonia at above-forward 4.25% throughout 2024-2025

	Sonia				
	1Q24	2Q24	3Q24	4Q24	4Q25
3m Sonia	5.25	5.25	5.25	5.00	4.00
2y	4.75	4.75	4.50	4.50	4.00
5y	4.25	4.25	4.25	4.25	4.25
10y	4.25	4.25	4.25	4.25	4.25
30y	4.00	4.00	4.00	4.00	4.00

Source: Bloomberg, BofA Global Research

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FX: Limited Scope for GBP rallies

Our GBP profile versus major G10 expects only a modest rally versus G10 and in some cases depreciation particularly versus the Scandies and Antipodeans (Exhibit 3). Whilst higher rates may enhance carry considerations, we are sceptical that the mix of high rates and a slowing economy will prove attractive. GBP/USD rallies will be a function of our broader views on USD. With an election year in the offing, this is likely to be a factor for investors.

Exhibit 3: GBP/XXX forecasts

We expect modest GBP strength versus USD in 2024

		2023	2024			
	Spot	Q4	Q1	Q2	Q3	Q4
GBP/USD	1.26	1.21	1.26	1.26	1.31	1.31
EUR/GBP	0.86	0.87	0.87	0.87	0.88	0.88
GBP/JPY	184	185	196	190	191	186
GBP/CHF	1.10	1.10	1.10	1.10	1.10	1.10
GBP/CAD	1.70	1.64	1.71	1.69	1.73	1.70
GBP/NOK	13.76	13.44	13.71	12.99	12.51	12.39
GBP/SEK	13.18	13.22	13.82	13.10	12.73	12.61
GBP/AUD	1.91	1.89	1.92	1.86	1.84	1.84
GBP/NZD	2.05	1.69	1.67	1.61	1.59	1.59

Source: BofA Global Research estimates

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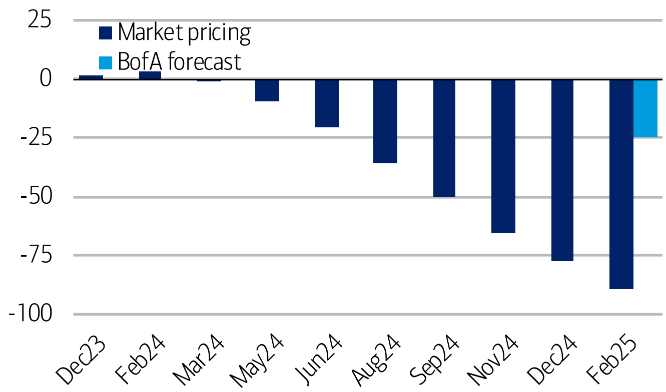
Rates: Left behind

Exhibit 4: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp
Market pricing of first 25bp Bank rate cut between June and August 2024



Source: Bloomberg, BofA Global Research

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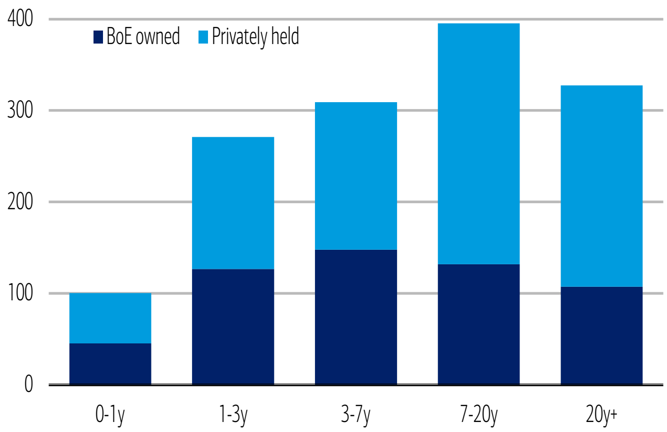
Exhibit 5: BoE Gilt ownership by value, £bn
BoE now owns more 1-3y Gilts than 20y+Gilts by value



Source: BofA Global Research, Bank of England, Debt management Office, Bloomberg

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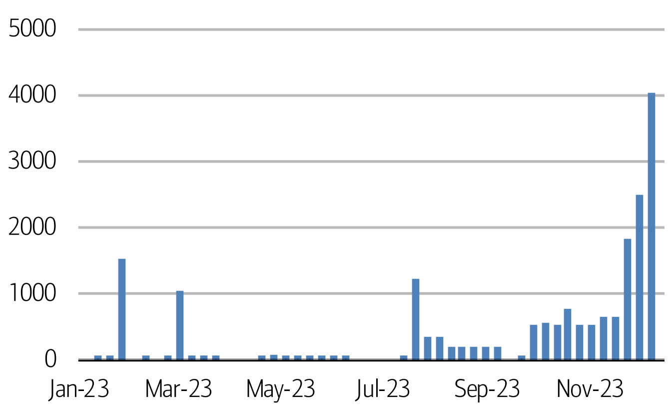
Exhibit 6: BoE STR facility usage, £mn
Higher usage lately



Source: Bank of England, BofA Global Research

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BoE: show rather than tell

We expect the Bank of England (BoE) to keep Bank Rate and guidance unchanged at this week's policy meeting. We expect a 6-3 vote in favour (Cuts are next, but not immediate, 8 Dec). The risk of a first cut earlier than we currently expect has increased, but while there have been a couple of encouraging data prints, we see persistent inflation problems.

The BoE had made policy sufficiently restrictive but 5-year swap rates have fallen over 50bp since October, likely prompting the recent house price resilience. The BoE could strengthen guidance to encourage the market to price a 'table mountain' path of rates again. But we suspect it will be reticent to give strong guidance. The BoE will have to show rather than tell we suspect, holding rates at 5.25% well beyond current market expectations of the timing of the first cut (Exhibit 4).

QT: Okay isn't necessarily optimal

We've long argued that the BoE should alter the maturity buckets used for its Gilt sales, saying that with the passage of time and the market sell-off having collapsed the WAM of the Quantitative Easing (QE) portfolio, it would be appropriate for the Bank to tilt its Quantitative Tightening (QT) sales shorter. Despite the enticing addition of line in a Market Notice that hinted at change, subsequent comments from the Deputy Governor suggest that nothing is likely to be imminent.

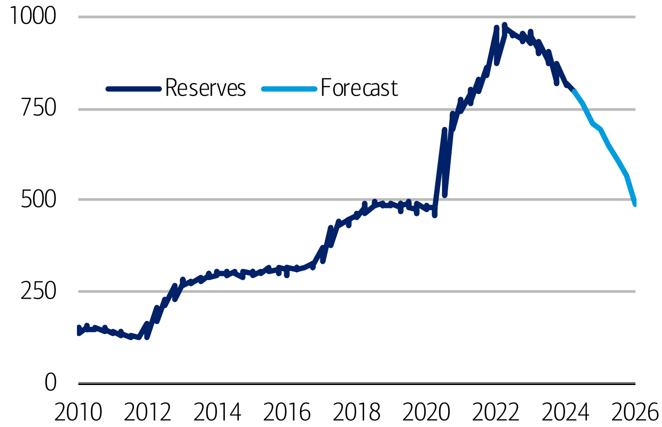
We broaden out the debate. We think Ramsden is right to say that P&L considerations shouldn't affect Bank decisions, up to a point, but if there is a large term premium that can be saved by selling fewer longs and more shorts, then perhaps that could be considered? More importantly, there are broader macro benefits from such a change, concerning money supply, the adjustment away from superabundant liquidity and the portfolio effect (Room for improvement. BoE active QT might be going okay but could be better, 5 Dec) and Exhibit 5.

BoE's Standing Repo Facility in focus

Last week's BoE Standing Repo Facility (STR) saw the largest yet £4.0bn uptake, on a coupon payment day (Exhibit 6). The uptake likely reflects the arbitrage opportunity between repo rate (trading around Bank + 3bp) and STR (fixed at Bank rate) being used, and perhaps an increase in usage if more internal approvals to use STR have been obtained.

More generally, pick up in STR operations as repo cheapened indicates dissipating cash/collateral imbalance. Under current framework, funding pressures may have more limited impact in the UK vs. Europe given more attractive pricing, we think (BoE reserves: Preferred minimum closer than you think, 7 Dec).

Exhibit 7: BoE reserves incl. BofA forecast, £bn
TFSME roll-off to accelerate reserves drop in 2025



Source: Bank of England, BofA Global Research

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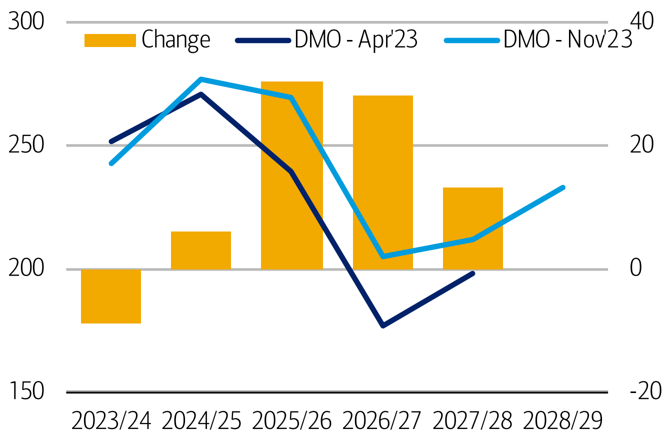
Exhibit 8: DMO's illustrative gross financing requirement, £bn
+£78bn in 2024/25 to 2027/28



Source: Debt Management Office, BofA Global Research

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Exhibit 9: Net buying of Gilts per investor type, £bn
Domestic non-banks the main buyer of Gilts so far in 2023

	MFI ex. CB	Non-residents	CB (incl. reinv.)	Non-MFI
2015	2.6	60.5	27.5	-2.7
2016	5.3	44.4	68.5	-34.0
2017	-15.4	22.7	32.6	31.9
2018	-10.8	22.0	21.2	24.8
2019	-10	46.4	40	-22
2020	-18.1	51.2	317.9	38.8
2021	-5.7	81.9	190.0	-58.7
2022	-1.7	40.1	-3.8	24.5
2023 year-to-Oct	28.3	17.8	-29.7	107.5

Source: Bank of England, BofA Global Research

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PMRR on the horizon

We forecast the BoE balance sheet to drop by slightly over £100bn in 2024 and £200bn in 2025 (Exhibit 7). On the asset side, we assume BoE's QT will amount to £100bn per year. The roll-off of the Term Funding Scheme with additional incentives for SMEs (TFSME) will have an increasingly meaningful role into 2025. We do not assume early TFSME repayments. Risks therefore skew to earlier balance sheet drop. On the liability side, the decline will be reflected in the fall in Bank reserves.

BoE's latest estimate of aggregate Preferred Minimum Range of Reserves (PMRR) is £335-495bn (Hauser, 3 November), not far from where we estimate reserves will be by late 2025. To test where the true PMRR might be, the Bank has already introduced a weekly STR facility which offers unlimited amounts of reserves against Gilt collateral at Bank Rate. More will likely need to be done to ensure alternative liquidity sources as reserves decline in the UK over the course of 2024.

Supply is not going away

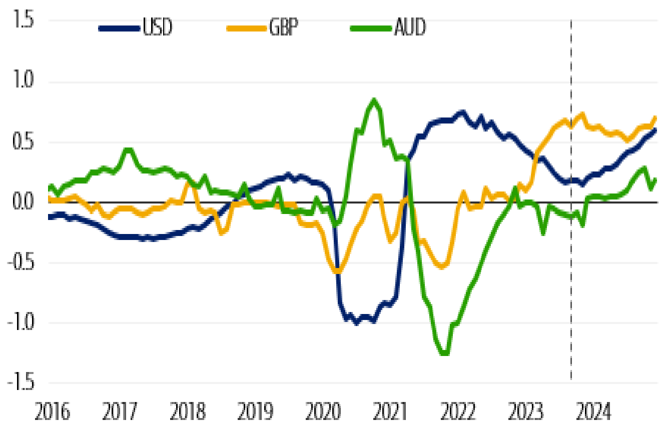
The Debt Management Office (DMO) kept Gilt sales broadly unchanged following the Autumn Statement (-£0.5bn relative to its April update), opting to reflect £10.5bn reduction in Net Financing Requirement (NFR) via £10bn reduction in net T-bill sales. Emphasis on T-bill reduction was in line with our thinking (Autumn Statement preview: limited room, 14 November).

Large upward revisions to Illustrative Gross Financing Requirement (IGFR) projections for 2024-2028 - +£6bn in 2024/25; +30.5bn in 2025/26; +£28.1bn in 2026/27 (Exhibit 8) – reinforced our bearish 2024 outlook – we expect more persistent risk premia being priced even as the BoE eventually starts cutting (2024: Cloudy with a chance of landing, 19 November).

2023 - the year of the domestics

Gilt supply from the BoE and the DMO will remain substantial in future fiscal years. But there are some reasons for cautious optimism on demand side: Gilt supply at the front-end and limited buying by foreigners at the start of the year could lead to enough short-dated Gilt cheapening for domestic banks to step up their buying even further (Gilt buying in October: 2023 - the year of the domestics?, 29 Nov and Exhibit 9). We believe that banks have the potential to buy a lot of Gilts. But at the right price. Thereafter, demand would be relatively elastic, we think. Concerns about future demand are well-warranted still however: dependency on overseas demand for Gilts has reduced but remains a macroeconomic fragility. And outlook for LDI demand is highly uncertain.

Exhibit 10: 12-mth z-scores of net monthly supply
AU supply to remain more subdued than UK



Source: BofA Global Research, Bloomberg

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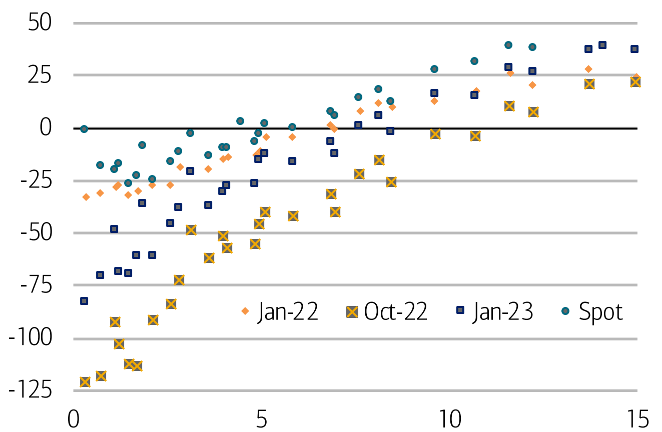
Exhibit 11: Gilt z-spreads to Sonia versus years to maturity, bp
Back to January 2022 ASW levels



Source: Bloomberg, BofA Global Research

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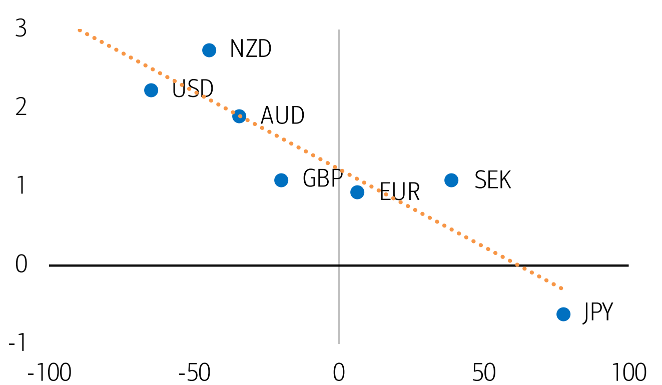
Exhibit 12: 10y real yields vs. Net IIP/GDP ratio, %
UKTi (wedge-adjusted) expensive on this metric (EUR represented by OATei).



Source: BofA Global Research, Refinitiv

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Short Gilts vs. ACGBs

The case for UK rate underperformance has weakened versus US. Instead, we prefer selling Gilts vs. ACGBs given the divergent bond supply outlook between Australia and the UK (Exhibit 10). In financial year 2022/23, the Australian Government delivered an unanticipated fiscal surplus, and we expect another surplus in financial year 2023/24, which concludes at the end of the second calendar quarter in 2024. Legislated tax cuts and pre-election fiscal outlays likely means the budget will return to deficit in 2024/25 but we only expect a modest increase in pre-election spending of AUD 20bn.

Given the WAM of the AOFM's funding program has typically settled around 10 years, lower supply should be a tailwind for Australian duration. The unique steepness of the Australian yield curve also means bonds are likely to continue to attract demand.

ASWs: short-end Gilts to cheapen still

We expect short-dated Gilts to cheapen still over the course of 2024 (Exhibit 11). The supply-demand balance should drive short-dated Gilts cheaper still in 1H 2024, despite BoE QT skew now seems somewhat less likely. We expect the impact from supply to be amplified by lacklustre demand: overseas investors who favour that part of the curve tend to be flat/net sellers in Q1 turning long in Q2. The balance should lead to cheapening of short-dated Gilts, which we would expect to be capped by domestic banks when Gilts reach flat to 25bp over Sonia levels.

For the long-end, outlook is less clear: soaring pension fund solvency might accelerate de-risking, but only for the shrinking portion of the pensions universe as yet unhedged; and with the desired end-game often a full buyout, the insurer preference for credit instruments over Gilts is a concern. But improved funding may cause schemes to re-assess their target endstates, potentially going for longer-term self-sufficiency, superfunds or capital-backed journey plans.

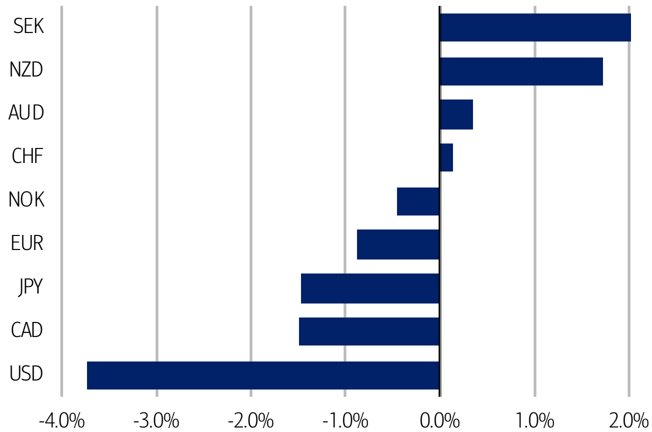
A cleaner cross-market bear trade

The UK's heavy dependency on external finance should require higher real yields relative to other markets, we would argue, especially now that pension demand for linkers is well into the endgame. And we can project a future deterioration in the UK's International Investment Position (IIP) relative to the EA's on the basis of persistent large current account deficits that are unlikely to correct for some years (Exhibit 12). We are bearish UK real yields vs EUR partly. We also believe that the UK will need materially tighter monetary policy (i.e., higher real policy rates) than elsewhere to keep inflation in check.

We expect two linker redemptions next year to prompt reinvestment into other short-dated issues and expect iota compression in 2026 and 2027 issues.

FX: Trading GBP Ahead of the BoE

Exhibit 13: G10 FX Performance vs GBP over past month, %
GBP performance has only been bettered by other high beta G10 FX



Source: BofA Global Research, Bloomberg
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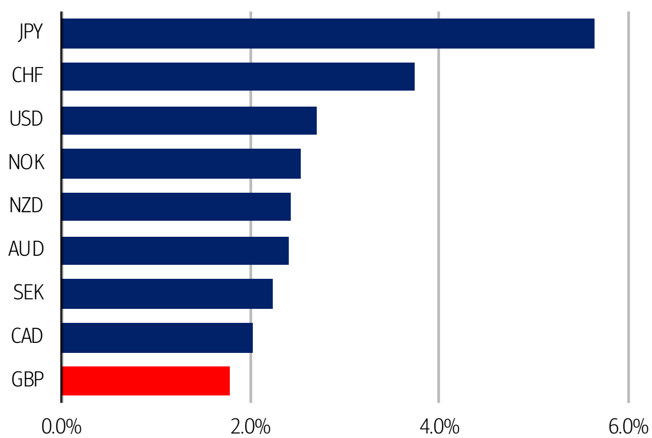
GBP's Moment in the Sun

GBP has performed well over the past month (Exhibit 13) surpassed only by the other high beta currencies in G10. The bulk of the gains have come against the broader USD sell-off. As we discuss below, there have been several factors which have contributed to the rebound in GBP, but which all lead back to the same conclusion: GBP has regained its place in the G10 FX fold (Liquid Insight: GBP: Back to Basics 09 November 2023). November price action is consistent with some of sterling's long-term anchors: rate differentials; data; perception of risk.

Exhibit 14: 1mth change in 1wk implied vol vs EUR
Market does not see BoE as a major event risk



Source: BofA Global Research, Bloomberg
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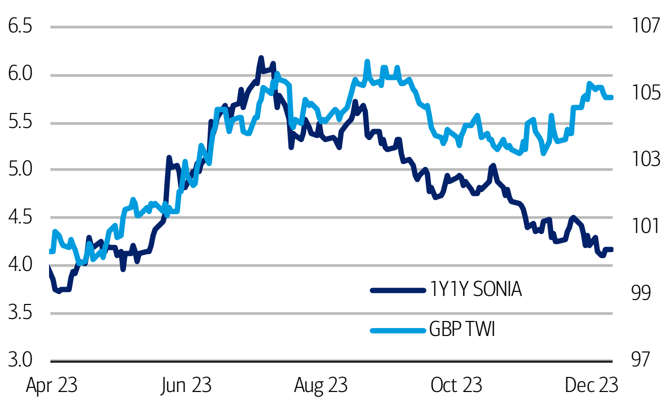
The BoE is a non-event for markets

Ahead of this week's decision, Exhibit 14 shows the 1mth change in 1wk implied volatility versus USD. GBP/USD 1wk implied vol change over the past month sits at the bottom of this chart which suggests that the market is attaching little risk to this as an event. This makes sense to us given Thursday is a non-QIR meeting and as described above, though inflation indicators are moving towards the BoE, Thursday should be a holding statement and a further reiteration that the market is wrong to price in early rate cuts.

Exhibit 15: GBP TWI versus 1Y1Y SONIA
GBP TWI looks rich compared to move in SONIA



Source: BofA Global Research, Bloomberg
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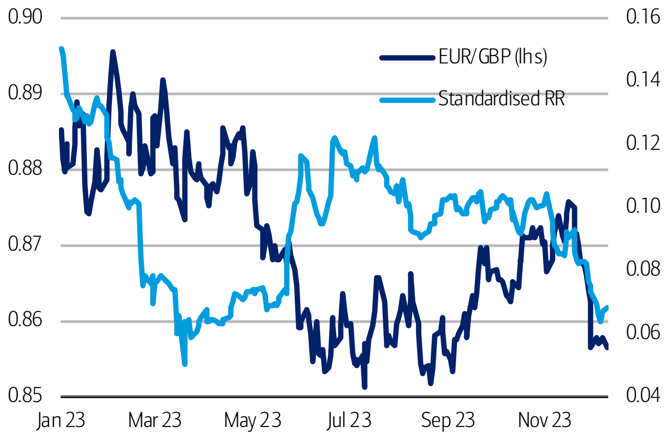
Rates have helped but that is half the story

Our analysis suggests that the rally in GBP has been excessive relative to the move in SONIA as shown in Exhibit 15. The benign global risk backdrop, declining vol and US curve steepening have all played their part in sterling's recovery. The combination of positive data surprises and the pricing out of near-term rate cuts has been supportive as GBP has once again reverted to its traditional drivers. We think the combination of better data and unwinding of rate cuts has been an important dynamic in helping GBP.

Exhibit 16: EUR/GBP vs 3mth standardized risk reversal
Relative move in rates is feeding into skew



Source: BofA Global Research, Bloomberg
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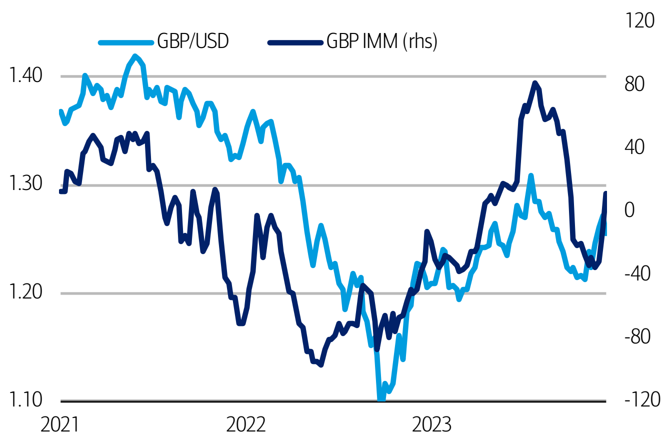
GBP skew moving by default

A key question is whether the bounce in GBP has been accompanied by expectations for further gains. We have looked at options skew and Exhibit 16 shows that standardized 3mth EUR/GBP risk reversals have been increasingly moving in favour of a stronger GBP. This is most likely explained by the move in EUR rates on increased expectations that the ECB will deliver earlier than anticipated rate cuts. We think this is more of a EUR than a GBP story: GBP/USD risk reversals have not move concomitantly.

Exhibit 17: GBP/USD IMM vs GBP/USD
Liquidation of shorts has helped GBP



Source: BofA Global Research, Bloomberg
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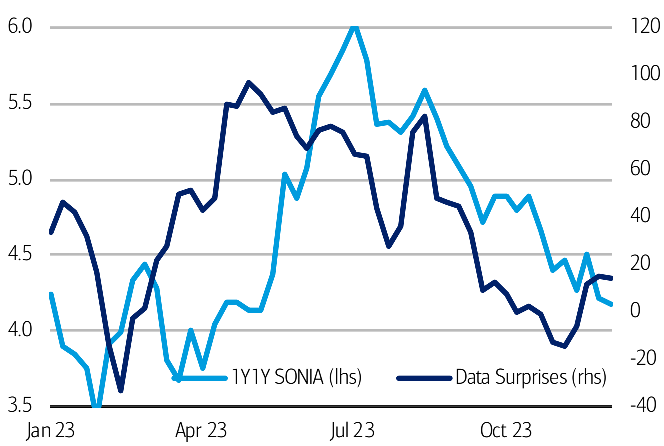
Liquidation not enthusiasm

IMM data for GBP/USD supports our view that the recent bounce does not suggest the start of a more protracted period of GBP gains. Exhibit 17 highlights that GBP shorts have been liquidated with positioning close to neutral. There is no renewed appetite to be bullish GBP; only appetite to be less bearish. This has been a key tenet of views towards GBP this year – the market has been content to price out bad news but has been reluctant to price in good news. We continue to believe that UK rates are being held higher for longer for bad reasons (structural supply side) than good – this should limit the extent of GBP gains.

Exhibit 18: 1Y1Y SONIA vs UK Data surprises
UK rate expectations have tracked improvement in data



Source: BofA Global Research, Bloomberg
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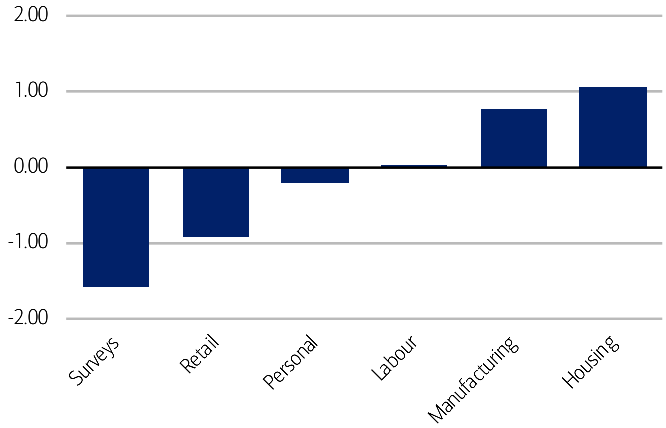
Data surprises and rates = strong combo

As we discuss above, the combination of improving data and receded rate cut expectations has been a powerful driver for the liquidation of GBP shorts. The BoE has been given added ammunition in its argument that it is too early to be discussing rate cuts. Exhibit 18, however suggests that we are past the peak in good news – positive data surprises are now receding, and UK rates curve is following.

Exhibit 19: Breakdown of UK data surprises.
Survey indicators suggest activity set to slow.



Source: BofA Global Research, Bloomberg
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The macro-headwinds are mounting

The breakdown of UK data surprises in Exhibit 19 shows some worrying trends. This BoE may argue that rates are unlikely to fall anytime soon, but they are facing worsening economic conditions in 2024. This may well come to a tipping point where macro deterioration may overtake the narrative on elevated inflation. From an FX perspective, we find it hard to believe that these would be conditions conducive for a sustained GBP rally.

Exhibit 20: GBP TWI
GBP unlikely to break reset ranges

Source: BofA Global Research, Bloomberg
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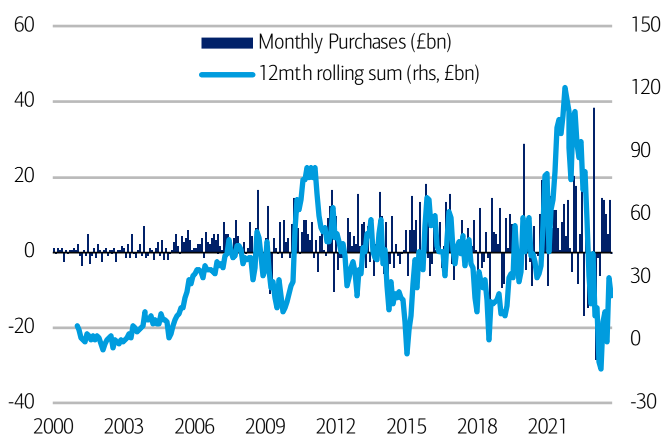
Reset ranges remain intact

As a consequence, we doubt that GBP on a TWI basis can sustain a break above the reset ranges that we have been discussing for some time (Exhibit 20). We continue to focus on the structural headwinds that are likely to challenge the BoE insistence that rates will need to remain elevated due to inflationary pressures. In a world where the majority of central banks are likely to cut rates into H2 2024, we find it difficult to see from a risk-reward perspective how the BoE can buck the trend.

Exhibit 21: Gilt buying by Foreign Investors
Foreign demand for UK Gilts has been weak



Source: BofA Global Research, Bloomberg
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A final word on overseas demand

We save one of our favourite charts to the end - Exhibit 21 shows foreign demand for gilts. As the chart highlights, demand has been weak since the GBP crisis last year. This remains a key issue for the pound in the context of financing the current account deficit. It matters because unless there are definitive signs of renewed foreign interest in UK Plc, higher rates may not be enough to support GBP over the medium term.

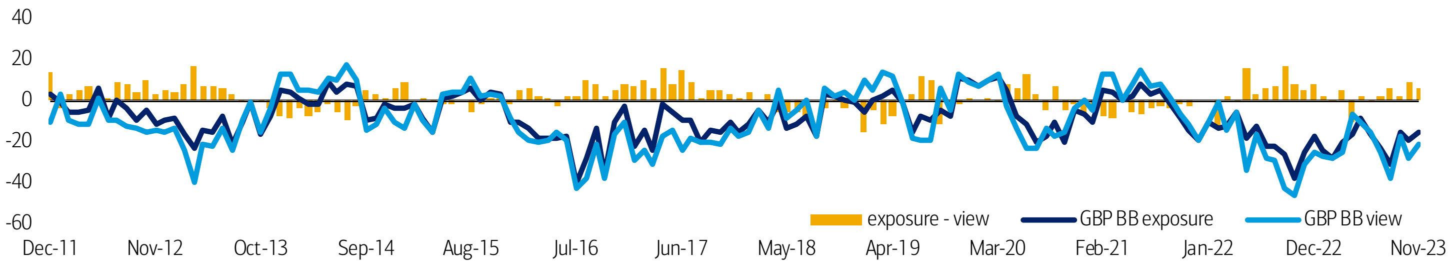
FX and Rates Sentiment Survey

This is an excerpt from FX and Rates Sentiment Survey - USD positioning unwind has begun published on 10 November 2023.

Modestly less bearish GBP sentiment but still bearish, with positioning roughly in line (Exhibit 22). The Gilt short covering is largely complete, with exposure and views aligned and relatively unchanged from last month (Exhibit 23, Exhibit 24and Exhibit 25).

Exhibit 22: FX exposure and view: GBP

Modestly less bearish GBP sentiment but still bearish, with positioning roughly in line



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 appendix for formulas.

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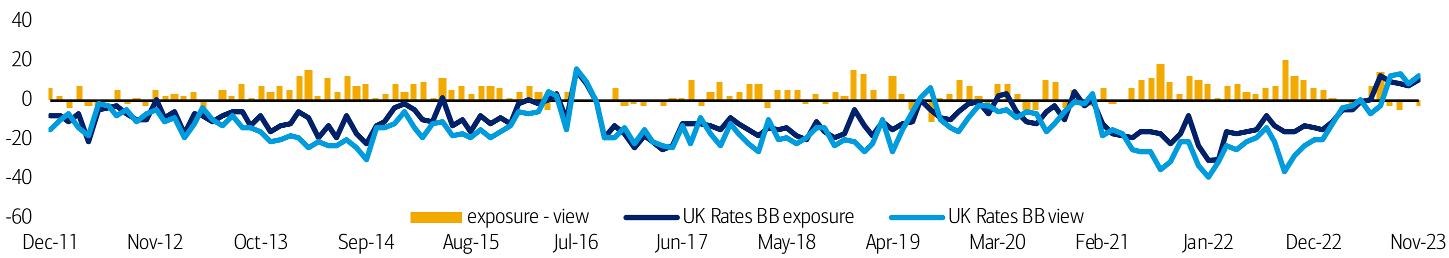
Exhibit 23: Duration exposure and view: UK

Gilt short covering is largely complete, with exposure and views aligned and relatively unchanged from last month



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 appendix for formulas.

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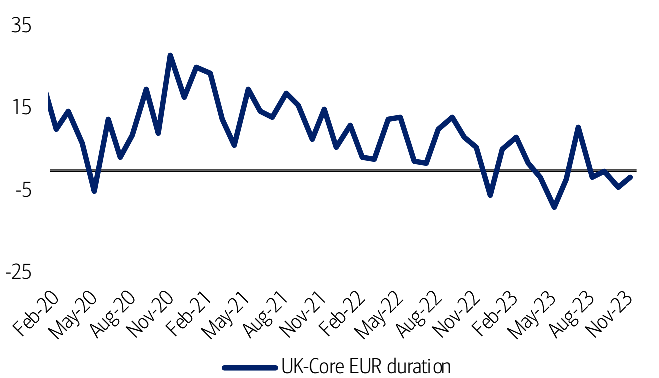
Exhibit 24: UK-Core Europe Duration Exposure

UK vs Core EUR Bull-Bear rates exposure spread neutral



Source: BofA Global Research FX and Rates Sentiment Survey

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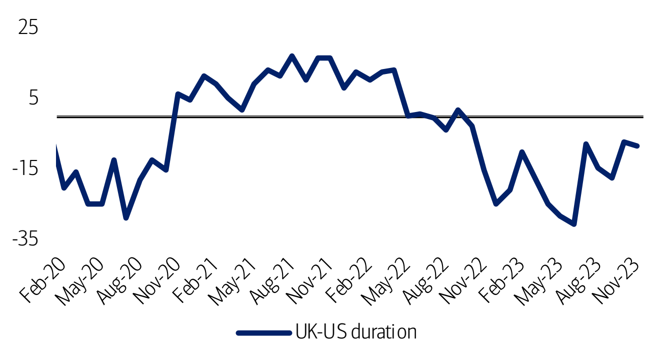
Exhibit 25: UK-US Duration Exposure

UK vs US Bull-Bear rates exposure spread slightly wider



Source: BofA Global Research FX and Rates Sentiment Survey

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Disclosures

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