Global Rates Viewpoint

Charting UK Rates and FX – June 2023

19 June 2023

Rates Research
Global

Rates: Maintaining a bearish bias

We made small adjustments to our yield forecasts recently, but key message remains the same that despite investors being short the UK cross market and BoE pricing more hawkish than our forecasts we remain worried about Gilt underperformance.

Supply will remain an issue in Q3, macro vulnerabilities will remain pronounced, and scope for BoE cuts appears to be more limited than elsewhere, even towards the end of the forecast horizon. Our 10y Sonia forecasts for 4.5% by Q4'23 and 4.25% for Q4'24 are 20-30bp above the forwards, implying a small underperformance vs our expectations in the US.

The difficulty with expressing an inflation persistence view is that so much is already priced in the RPI swap curve and the breakeven curve. We therefore think that the way to express concern is in the real curve. In our view, a degree of inflation persistence is priced, but not a sufficiently tight profile of real policy rates to tackle the problem.

FX: Risks more symmetric from here

We revised up our GBP forecasts meaningfully, seeing more balanced risks ahead. GBP has had an impressive run this year, leading G10 FX both in Q1 and so far in Q2:

(1) Expectations for the UK were very low: the UK activity data has not stood out vs elsewhere despite a lower base but has proven much better than expected.

(2) Markets have repriced the BoE much higher. Given the UK supply constraints, the stronger activity data has meant an even tighter labour market, stronger-than-expected inflation (with core inflation yet to peak), and perhaps modestly deanchored inflation expectations (UK Viewpoint: Growing too much to fix entrenched inflation 30 May 2023). Our economists expect three more 25bp rate hikes with upside risks from the BoE, but markets are currently pricing another five hikes from here.

(3) We now have more clarity of the post-Brexit regime, better relations with the EU, and significant reduction of related tail risks.

Going forward, we see balanced risks vs EUR. A lot, we think, depends on how and when inflation comes down in both. Certainly, our UK outlook for this year and next has a strong stagflationary flavour, with the lowest growth and the highest inflation in G6. But, to us, the key question is: which central bank is prepared to bring inflation to target? UK over-tightening risks still look non-existent to us (BoE preview: lots to do 15 June 23).

Sentiment: GBP sold, Gilt short covering continued

The latest FX and Rates Sentiment Survey published on 9 June showed GBP again sold, in line with last month's deterioration in sentiment, as investors took a negative view of the implication of sticky core inflation for the currency. Gilt short covering continued, even as sentiment deteriorated slightly after inflation surprise in late May.

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Abbreviations

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

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Rates and FX forecasts

We made small adjustments to our yield forecasts recently, but key message remains the same that despite investors being short the UK cross market and BoE pricing more hawkish than our forecasts we remain worried about Gilt underperformance (Exhibit 1, Exhibit 2, Exhibit 3 and Exhibit 4). Supply will remain an issue in Q3, macro vulnerabilities will remain pronounced, and scope for BoE cuts appears to be more limited than elsewhere, even towards the end of the forecast horizon. Our 10y Sonia forecasts for 4.5% by Q4 2023 and 4.25% for Q4 2024 are 20-30bp above the forwards and imply a small underperformance versus our expectations in the US (Global rates mid-year: sufficiently resilient, 15 June).

Exhibit 1: UK government bond yield forecasts, %
As of 19 June 2023

Gilts	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
Bank rate	5.25	5.25	5.25	5.25	5.00	5.00	4.00
2y	4.75	4.75	4.50	4.50	4.25	4.00	3.00
5y	4.25	4.25	4.00	3.75	3.75	3.75	3.25
10y	4.75	4.75	4.75	4.75	4.50	4.50	4.50
30y	4.75	4.75	5.00	5.00	5.00	5.00	5.00

Source: Bloomberg, BofA Global Research

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Exhibit 2: UK swap yield forecasts, %
As of 19 June 2023

Sonia	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
3m Sonia	5.25	5.25	5.25	5.00	5.00	4.75	3.75
2y	5.25	5.00	4.75	4.50	4.25	4.00	3.00
5y	4.50	4.25	4.00	3.75	3.75	3.75	3.25
10y	4.50	4.50	4.50	4.50	4.25	4.25	4.25
30y	4.25	4.25	4.50	4.50	4.50	4.50	4.50

Source: Bloomberg, BofA Global Research

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Exhibit 3: Our bond and swap forecasts vs market forwards, bp
As of 19 June 2023

Gilts	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024
2y	-35	-30	-49	-43	-57	-71
10y	30	32	33	35	12	13
Sonia	**Q3 2023**	**Q4 2023**	**Q1 2024**	**Q2 2024**	**Q3 2024**	**Q4 2024**
2y	-37	-54	-67	-79	-86	-94
10y	15	20	26	32	13	19

Source: Bloomberg, BofA Global Research

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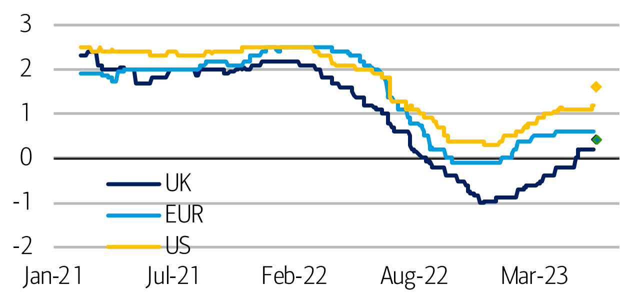
Exhibit 4: BofA 2023 growth forecast vs Bloomberg consensus, %
As of 19 June 2023



Source: Bloomberg, BofA Global Research

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In FX, we now see EURGBP at 0.85 through our forecast horizon (Exhibit 5). Combined with our EURUSD revisions (see G10 FX mid-year forecasts update: USD strong(er) until landing 15 June 23), this still leaves us with a higher cable forecast vs our previous outlook. Pre-election fiscal stimulus presents two-sided risks to GBP. Our analysis suggests investors are long cable and short EURGBP, although no position is stretched.

Exhibit 5: GBP forecasts versus G10
We now see more symmetric GBP risks from here, with upside for cable by end-2024

	Spot	Sep-23	YE 2023	Mar-24	Jun-24	Sep-24	YE 2024
GBP/USD	1.28	1.24	1.24	1.26	1.29	1.35	1.35
EUR/GBP	0.85	0.85	0.85	0.85	0.85	0.85	0.85
GBP/JPY	182	177	174	170	170	169	169
GBP/CHF	1.15	1.15	1.15	1.17	1.16	1.17	1.17
GBP/CAD	1.69	1.64	1.61	1.64	1.66	1.73	1.70
GBP/NOK	13.64	12.87	12.52	12.25	12.19	11.97	11.75
GBP/SEK	13.72	13.58	13.00	12.60	12.44	12.33	12.10
GBP/AUD	1.87	1.85	1.80	1.75	1.77	1.82	1.78
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 Monday June 19.

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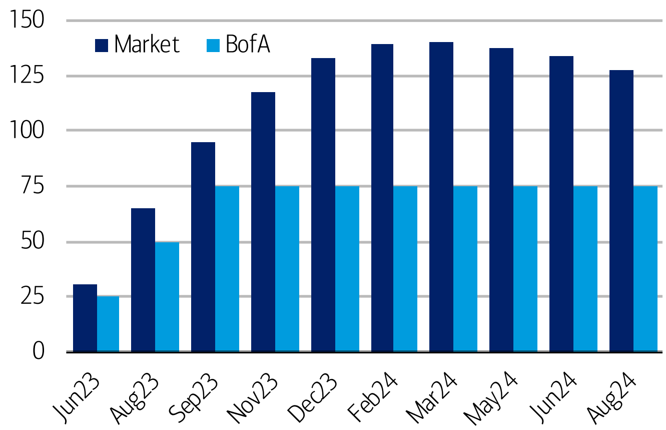
Rates: Maintaining a bearish bias

Exhibit 6: MPC-dated Sonia Bank Rate hike exp. vs BofA f'casts, bp
Market expecting over 125bp of additional Bank rate hikes from the BoE



Source: Bloomberg, BofA Global Research

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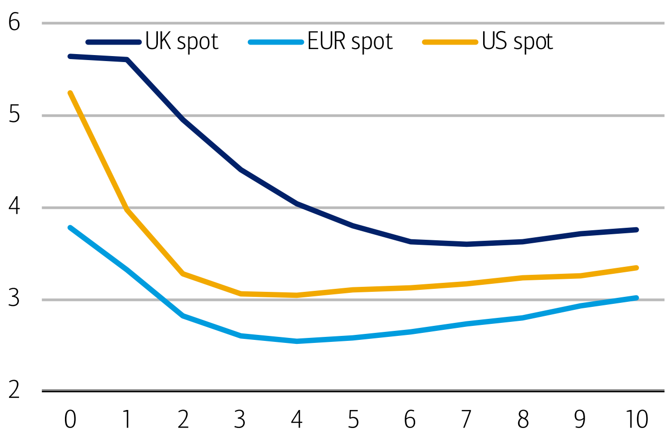
June MPC: expect 25bp hike, 2-6-1 split

All indicators of persistent inflation pressure that the Bank of England (BoE) said it would monitor closely have surprised on the upside since May's MPC meeting.

Our Chief UK Economist Rob Wood expects the BoE to hike Bank Rate by 25bp at its meeting later this week and continue to signal its data dependence (Exhibit 6).

Given very strong wage and price momentum, he sees risks that the more hawkish members of the Committee vote for a 50bp hike and that one of the doves votes to hike 25bp. We assume a 2-6-1 vote (hold, 25bp, 50bp, respectively), but risks to that call are wide (Bank of England preview: lots to do, 16 June).

Exhibit 7: Market implied path of 1y Sonia, SOFR and €STR gaps, %
Rates high for much longer in the UK than elsewhere



Source: Bloomberg, BofA Global Research

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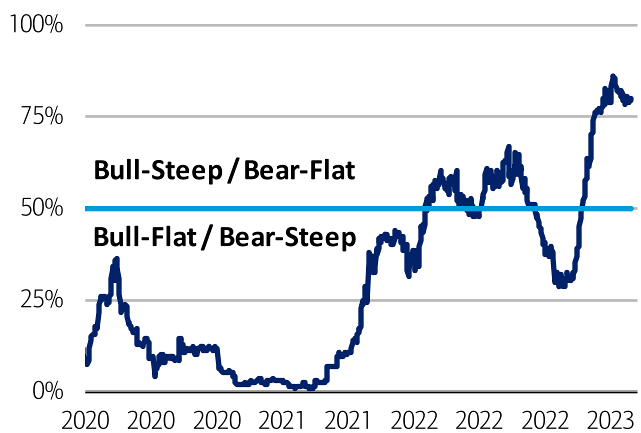
Easier policy, better growth in 2025

With inflation falling and unemployment above the inflation neutral level in second half 2024 we think the BoE can begin easing rates. We look for one rate cut in 2024, in August, then one per quarter in 2025 taking Bank Rate to 4.0% at end-2025. Growth improves as pressure on mortgage holders drops taking 2025 growth at 0.6%.

Looking at market implied paths of 1y Sonia and SOFR, the market has adjusted towards a much more gradual tightening in the UK than elsewhere (Exhibit 7). In the past, we didn't quite agree with the longer-term path implying trough at broadly same levels as in the US.

Exhibit 8: Frequency of 2s10s Sonia bull-steepening moves, %
Sharp shift to bull-steepening/bear-flattening dynamic moderating recently



Source: Bloomberg, BofA Global Research

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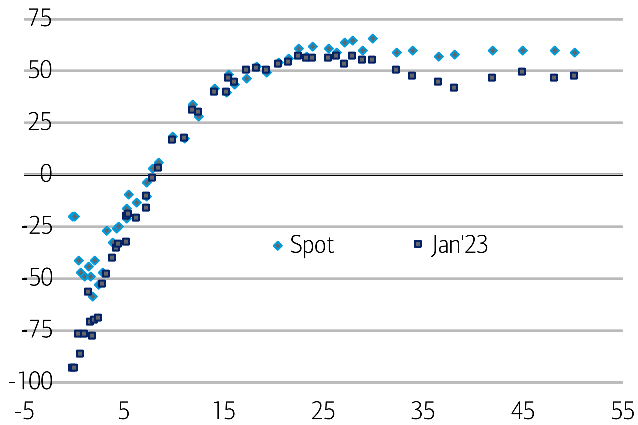
Front-end Sonia to stay flat for a while

We have been advocating 1y forward 1s3s Sonia flattener as a way to fade rate front-loaded cut expectations and potentially still crowded front-end longs in the UK, cross market since mid-May. We closed the trade recently as the curve flattened to target (1y forward 1s3s Sonia flattener reaches target, 13 June). Our forecasts imply flat front-end Sonia for a while still.

Further out on the curve, Sonia 2s10s have been trading increasingly in bull-steepening/bear-flattening dynamic, but that has moderated slightly as of late (Exhibit 8). Gilt 2s10s exhibit a similar picture. 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. But that narrative is now delayed for a while longer.

Exhibit 9: Gilt z-spreads to Sonia versus years to maturity, bp
Some short-dated Gilts trading 50bp through Sonia



Source: BofA Global Research, Bloomberg

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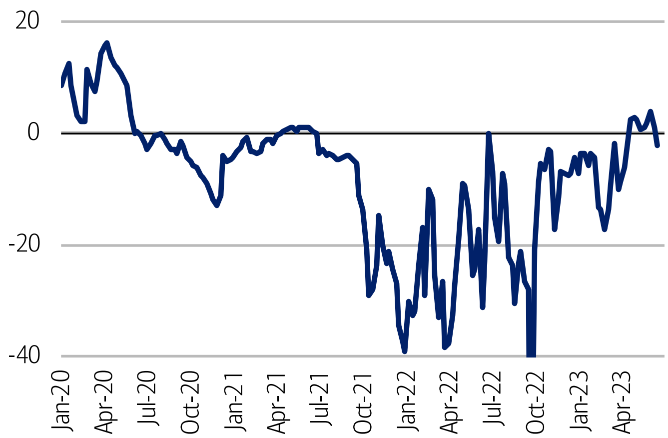
Short-dated Gilts still rich versus Sonia

Short-dated Gilts have cheapened relative to Sonia since the start of the year, but still trade as much as 50bp through Sonia (Exhibit 9).

More long end supply in Q3 means more risk to be supplied relative to the previous quarter and limited scope for short-dated Gilt underperformance in the near term, although we pencil in some in late 2023 (we see it as likely that the Autumn Statement adds to the skew shorter in Gilt sales) and towards the end of the new fiscal year.

We closed our 2s20s Gilt ASW curve steepening trade ahead of the longer Q3 2023 Gilt supply.

Exhibit 10: 6m T-bill average auction yield vs Sonia, bp
6m T-bills clear auctions close to flat to Sonia lately



Source: Bloomberg, BofA Global Research

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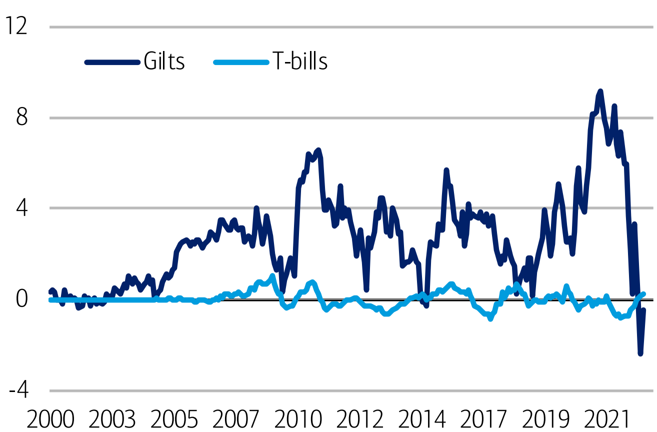
6m T-bills Sonia flat at auctions lately

6m T-bills trading around flat to Sonia at auctions lately also highlights the relative richness of short-dated Gilts as outlined above (Exhibit 10). Some of the cheapening of T-bills relative to Sonia could be attributed to a lesser post-LDI crisis demand.

Exhibit 11: Non-residents' net buying of Gilts and T-bills (12m MA), £bn
Some increase in April but still at very low levels



Source: BoE, BofA Global Research

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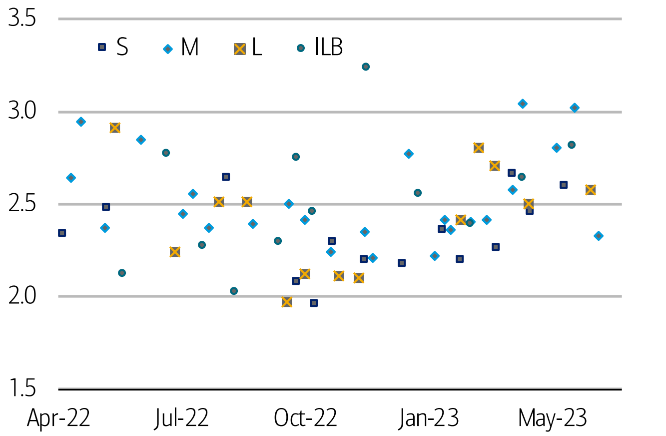
Gilt buying in April: in line with auction and sentiment statistics at the time

The data for April in BoE Bankstats report revealed that non-residents bought £14.6bn of Gilts in the month, having sold £36.0bn in the first three months of 2023 (Exhibit 11).

Domestic non-bank investors continued buying Gilts in April, acquiring £7.5bn, having purchased £63.4bn in the first three months of the year. Domestic banks were marginal buyers also, buying £1.7bn in April, having bought £6.8bn in January-March.

We wonder if US debt ceiling worries might have contributed to the increase but have no supporting evidence for that theory. Our FX and Rates sentiment (FXRS) survey has been pointing towards more favourable sentiment and positioning on Gilts also, albeit still lagging the US and Europe

Exhibit 12: DMO Gilt auction bid/cover ratio
S = "short", M = "medium", L = "long" and ILB = "inflation-linked" Gilts



Source: Debt Management Office, BofA Global Research

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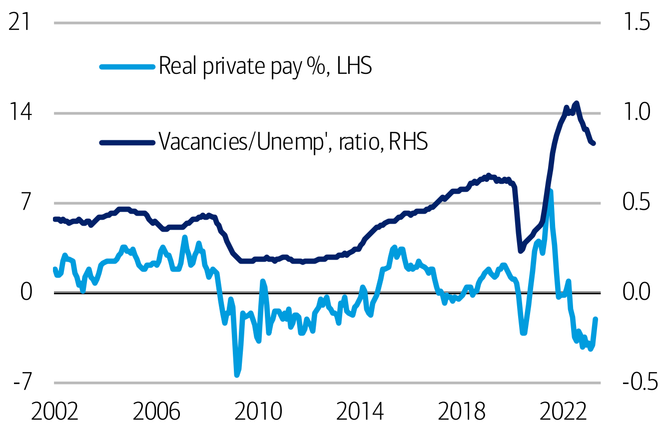
Exhibit 13: Will this old relationship re-establish itself?
Still-high vacancies/unemployment points to stubborn pay growth.



Source: BofA Global Research, Refinitiv

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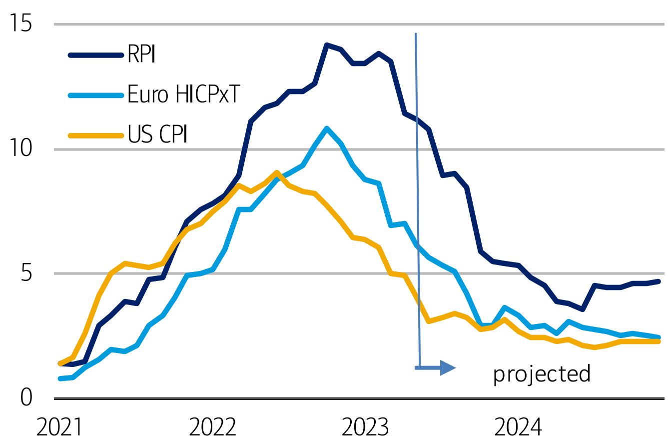
Exhibit 14: Market pricing for inflation paths, %
UK's unique problem now clear to all.



Source: BofA Global Research

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Stronger action statistics now fading

DMO Gilt auction results have been on the stronger side until May, chiming with the possibility of short covering and/or Gilt longs being initiated at the time. The strength has faded a little lately with the latest medium Gilt auction seeing lower bid/cover ratio (Exhibit 12).

Inflation and the labour market

Single month private sector regular pay growth that rebounded to 7.9% in April reflects just how hot the labour market is, despite vacancies declining from their peak.

In the past, a vacancies/unemployment rate of 0.3 or more was consistent with positive real pay growth, and it is currently 0.8 (Exhibit 13). As inflation falls, it is quite possible that positive real pay growth resumes, augmenting inflation persistence worries.

The interest rate policy tool is a blunt instrument, and one that is mainly focused on the small proportion of the population refinancing mortgages at any given time.

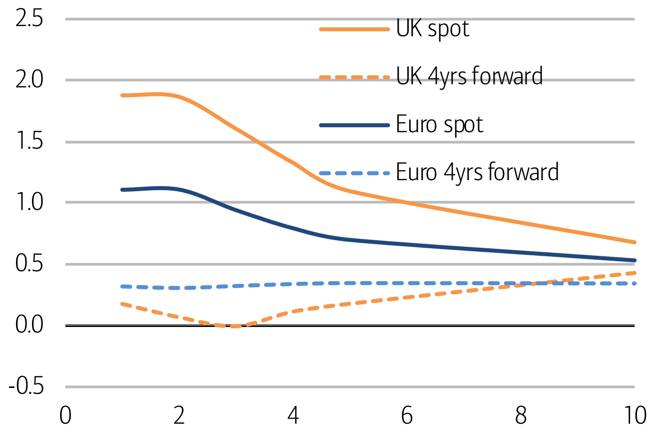
However, big inflation overshoot priced

The difficulty with expressing an inflation persistence view is that so much is already priced in the RPI swap curve and the breakeven curve (Exhibit 14).

We therefore think that the way to express concern is in the real curve. In our view, a degree of inflation persistence is priced, but not a sufficiently tight profile of real policy rates to tackle the problem.

Exhibit 15: GBP & EUR real swap curves, spot and 4y forward, %

UK curve priced to shift from well above to well below Euro.



Source: BofA Global Research

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An inverted real curve makes sense, but...

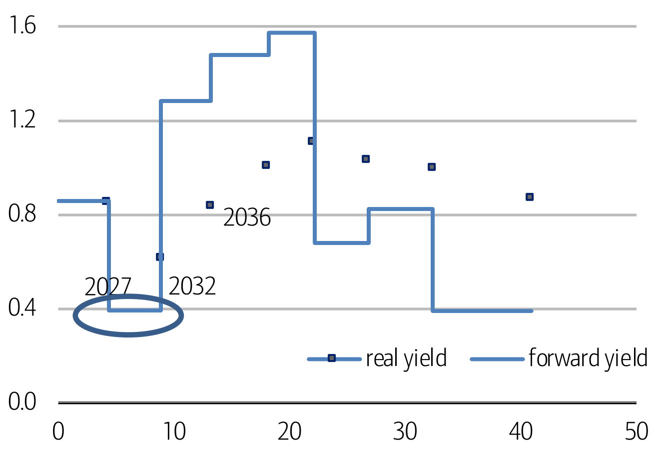
When thinking about what is priced into the UK real curve, a cross-market comparison is informative (Exhibit 15).

It is noteworthy how the real swap curve in the UK is priced to shift from meaningfully higher than Euro now to meaningfully lower than Euro over the next four years, because the UK curve inversion is more pronounced.

The four-year horizon is chosen because it aligns with an interesting situation in the UKTi curve, as we discuss below.

Exhibit 16: Real yields v duration, November maturities, %

The forward yield between 2027 and 2032 issues looks too low to us.



Source: BofA Global Research, Bloomberg

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When macro, RV and flows align

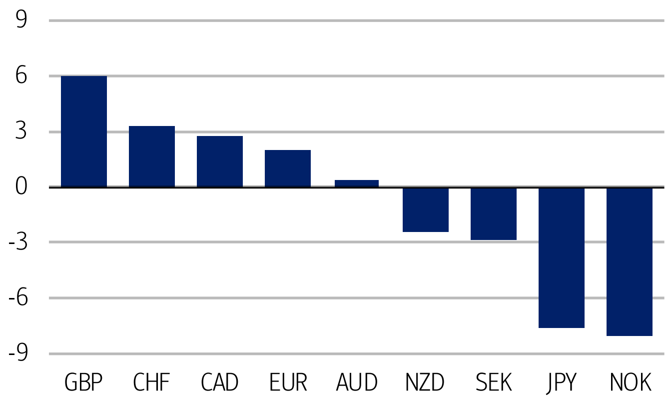
We want to be short UK linkers on a real yield basis. However, an outright UKTi short risks punitive adverse carry should inflation prints continue to surprise to the upside (Exhibit 16).

Therefore, in the 21 April Global Rates Weekly, we recommended an equal cash value shortening trade from the 2032 to the 2027 UKTi, "paying" the forward real yield in between (then +5bp). We set a target of +80bp and a stop-loss at -40bp (currently +38bp). We saw the main risk to the trade being a recession, coupled with a return to sub-2% underlying inflation, that sees policy rates return to the zero lower rate bound.

The upcoming launch of a new 10y linker, and the August extension of the Over-5y linker index should be supportive.

FX: Risks more symmetric from here

Exhibit 17: G10 FX vs USD year-to-date
GBP leading G10 FX this year



Source: Bloomberg. Data through June 16.
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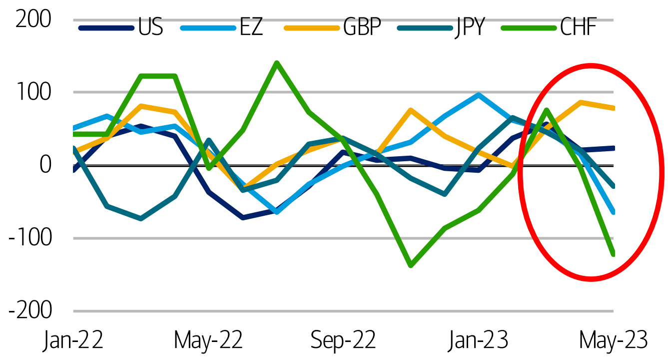
An unlikely leader

GBP has had an impressive run this year, leading G10 FX both in Q1 and so far in Q2 (Exhibit 17). It has posted positive monthly returns in trade-weighted terms each month since October-22 except December.

Exhibit 18: Data surprises (Citi index)
UK data have proven way more resilient than expected



Source: Bloomberg
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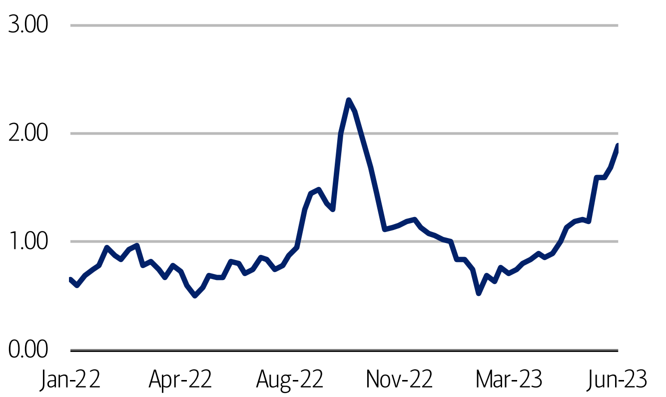
UK data much better than expected

The UK data has been considerably better than expected (Exhibit 18). Activity data has not stood out vs elsewhere despite a lower base but has proven much better than expected. Given the UK supply constraints, the stronger activity data has meant an even tighter labour market and stronger-than-expected inflation, with core CPI inflation yet to peak.

Exhibit 19: UK 2-year swap spreads, trade-weighted, percent
Higher UK rates have likely supported GBP



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.
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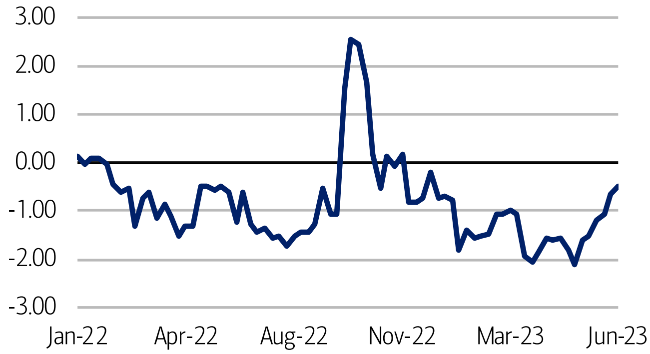
Higher UK rates have likely helped GBP

Tight labour markets, persistently high core inflation, and perhaps modestly deanchored inflation expectations (or risks thereof) have meant continuous pressure on the BoE, and wider UK swap rate spreads (Exhibit 19). Our economists expect three more 25bp rate hikes with upside risks from the BoE, but markets are currently pricing another five hikes from here. Our economists find the over-tightening risks non-existent (BoE preview: lots to do 15 June 23). Going forward, the question to us for GBP will be whether and how the BoE is willing to bring inflation back to target.

Exhibit 20: Idiosyncratic 3-month implied volatility GBP spread
GBP vol 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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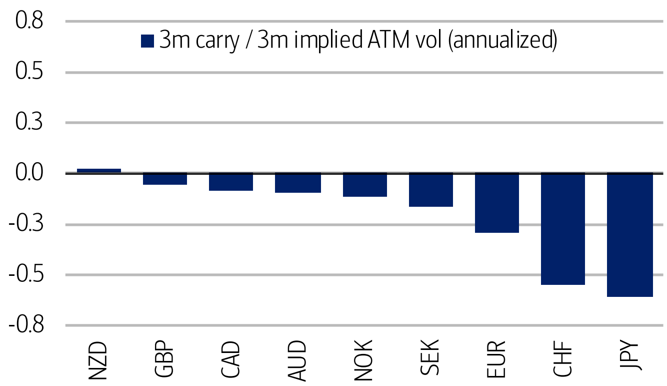
GBP vol way off Sep-22 highs

More clarity of the post-Brexit regime, better relations with the EU, and significant reduction of such as well as fiscal-related tail risks have likely contributed to the better-behaved GBP vol (Exhibit 20). Pre-election fiscal stimulus could be a two-sided risk.

Exhibit 21: 3-month vol-adjusted carry vs USD (annualized)
GBP carry not bad within the G10 FX world



Source: BofA Global Research, Bloomberg

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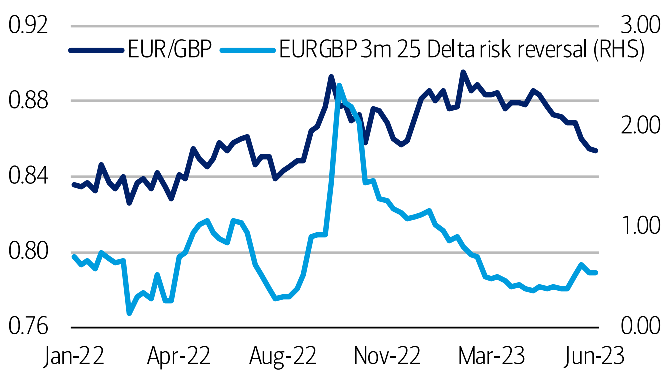
GBP carry ok by the G10 FX standards

BoE higher (and for longer) and lower vol have meant an attractive (by the G10 standards) vol-adjusted carry (Exhibit 21).

Exhibit 22: EUR/GBP vs 3mth 25 Delta risk reversal
Option skew stabilized but some scepticism remains



Source: BofA Global Research, Bloomberg

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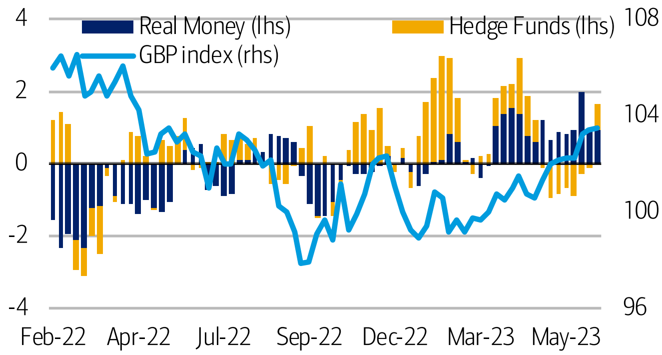
EUR/GBP option skew has stabilised

The move in EURGBP spot lower was preceded by a move lower in the risk reversals (Exhibit 22). The latter seem now stabilised and way off their Sep-22 highs. But we think some scepticism on the UK remains relative to the pre-referendum years.

Exhibit 23: BofA investor 4-week GBP flows (z-score) and GBP TWI
GBP has seen the strongest investor demand so far this year



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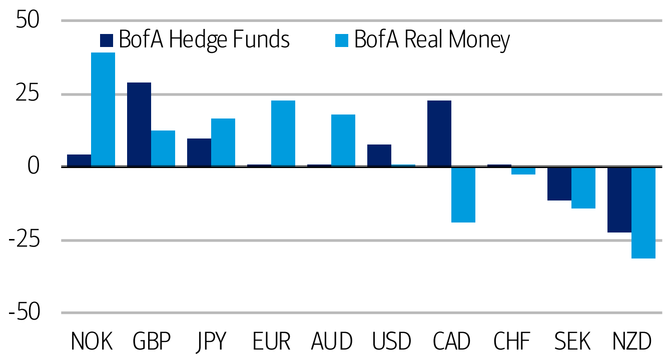
GBP an investor favourite this year

GBP has seen the strongest investor demand in G10 FX so far this year (Exhibit 23), according to our proprietary flows (Liquid Cross Border Flows: USD under pressure again 19 June 23). Both Hedge Funds and Real Money have expressed strong demand.

Exhibit 24: Latest BofA investor positioning
Investors short EURGBP and long cable



Source: BofA Securities. +50 (-50) represents a max long (short) positioning relative to history. For more details, please see Liquid Cross Border Flows: USD under pressure again 19 June 2023.
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Market short EURGBP and long cable

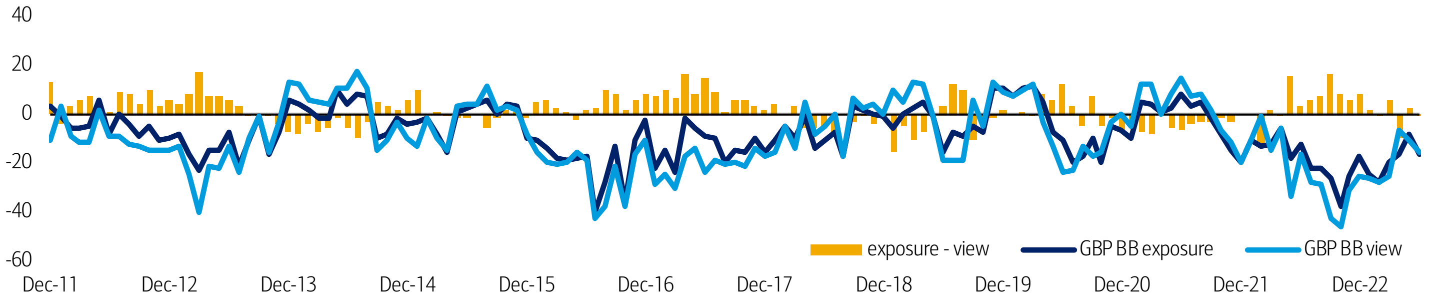
We now find both Hedge Funds and Real Money to be long cable. Hedge Funds are also very short EURGBP, but Real Money remains modestly long (Exhibit 24). While positioning is a light downside GBP risk, we do not find any position stretched.

FX and Rates Sentiment Survey

This is an excerpt from [FX and Rates Sentiment Survey – Pandemic, what pandemic?] published on 9 June 2023.

GBP is again sold, in line with last month's deterioration in sentiment, as investors take a negative view of the implication of sticky core inflation for the currency (Exhibit 25). Gilt short covering continues, even as sentiment deteriorates slightly after the latest inflation surprise (Exhibit 25, Exhibit 26, Exhibit 27 and Exhibit 28).

Exhibit 25: FX exposure and view: GBP
GBP exposures decline in line with last month's turn in sentiment



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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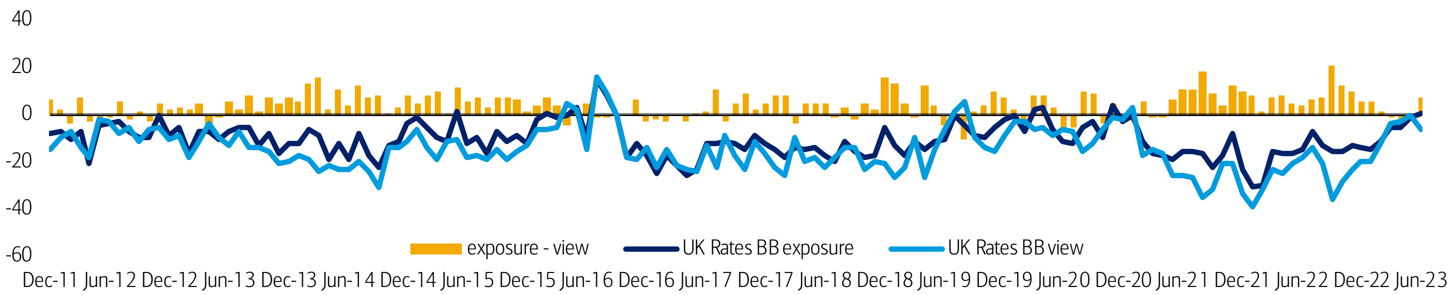
Exhibit 26: Duration exposure and view: UK
Gilt short covering continues, even as sentiment deteriorates slightly



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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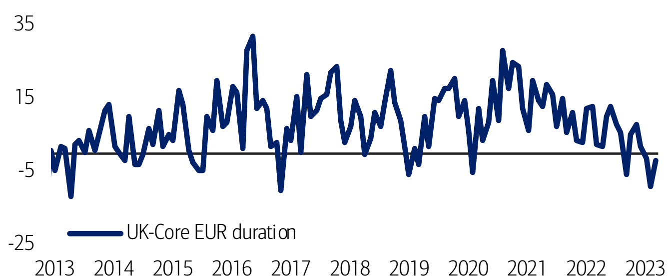
Exhibit 27: UK-Core Europe Duration Exposure
UK vs Core EUR Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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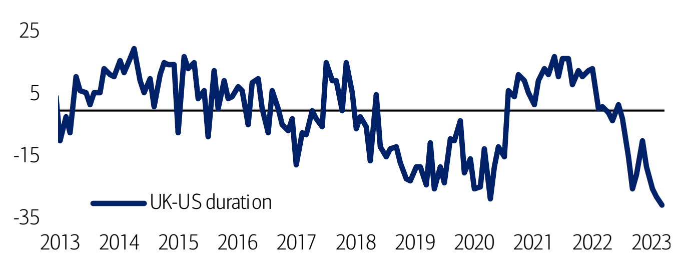
Exhibit 28: UK-US Duration Exposure
UK vs US Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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