Forex Market Update

AIB Treasury Economic Research Unit

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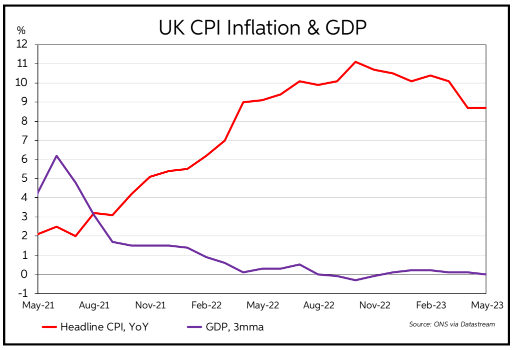
Strong H1 for sterling, but headwinds mounting

Sterling endured a difficult 2022 owing to concerns about the UK economy, especially following a badly received 'mini-budget' last autumn. Against a buoyant dollar, sterling fell to a record low below $1.04 in late September, while EUR/GBP traded to a high of 92p. More broadly speaking, the UK economic backdrop has provided a challenging landscape for sterling in recent years. Brexit has depressed trade with the EU, and thus weighed on activity. Meanwhile, very high inflation and rising interest rates have placed a considerable squeeze on real incomes.

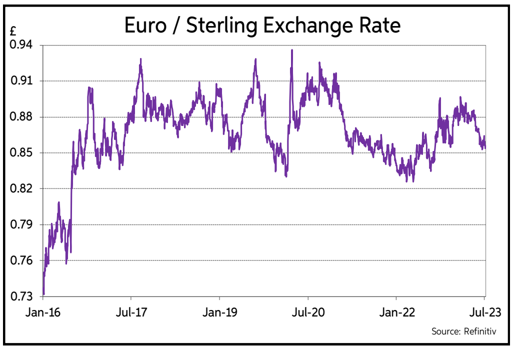


One of the biggest surprises over the first half of 2023 though, has been the strength of sterling. The pound has made gains against other majors including the dollar and the euro. The magnitude of these gains has been in the order of 4-5%. In level terms, this is reflected in EUR/GBP falling back from the 88p mark, to trade down to a low, near to 85p since mid-June. Meantime, the stronger tone to sterling was also evident in GBP/USD moving up from its early January level of $1.18 to in and around the $1.29 threshold recently.

One reason for sterling's strong performance year-to-date has been the macro backdrop, with the UK economy proving to be more resilient than anticipated. The general consensus heading into 2023 was that the UK economy was likely to enter recession this year. Indeed, the BoE, in its November 2022 forecast update, was projecting the UK economy could contract by up to 1.5% in 2023. Year-to-date though, UK macro data have tended to surprise to the upside of forecasts. Albeit, the UK economy has stagnated rather than contracted, with GDP essentially flat-lining since Q2 2022.

At the same time, over the last few months, sterling has benefitted from widening interest rate differentials, with the BoE continuing to hike interest rates. This has been in response to inflation persisting at elevated levels in contrast to marked falls in headline inflation rates elsewhere. Headline CPI remained at 8.7% in the UK in May, when it had been anticipated to fall. By comparison, inflation has fallen to 4% in the US and 5.5% in the Eurozone. Meanwhile, core UK CPI inflation unexpectedly rose to 7.1% in May. As a result, there has been a marked firming in UK rate expectations.

However, the reaction of sterling to the most recent Bank of England policy decision in June is noteworthy. At this meeting, the BoE provided a hawkish surprise, hiking by 50bps rather than by 25bps as had been expected. Yet, sterling did not register any gains following the more aggressive rate increase, or indeed, from the most recent marked firming in UK rate expectations. UK rates are now expected to peak at circa 6.5% early next year, compared to 5.5% in the run up to the June meeting. In contrast, Eurozone rates are seen topping out around 4%, while the market envisages the Fed funds rate reaching a high of 5.5%.



Historically, rate increases are a positive for a currency, when they coincide with on-going economic growth. However, continued rate increases amid a stagnant or contracting economy, dealing with elevated levels of inflation tends to play out negatively for a currency. Its appears to be the case that stagflation risks are now hindering any further momentum for sterling from additional rate hikes. At the same time, positioning data shows that the market is 'stretched' long the currency. **Thus, the near-term upside for sterling may be limited.**

We see sterling remaining confined to a narrow 85-87p corridor against the euro for the remainder of the year, but acknowledge there are risks in the short-term of the pair falling below 85p. If EUR/GBP does trade below 85p, there should be very strong support for the euro at 83-84p, which has represented the floor for the pair since the Brexit vote in 2016. Similar to the euro, sterling could make ground against the dollar, if US rates are put on hold there before elsewhere, with the potential for GBP/USD to rise above $1.30 as we enter 2024.