Sterling's Rally May Be Ending

From a currency viewpoint, one of the biggest surprises over the first half of 2023 has been the strength of sterling. The pound has made gains against the other major currencies 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 above the 88p mark, to trade to down near to 85p since mid-June. Meanwhile, the stronger tone to sterling was also evident in GBP/USD, with the pair moving up from its early January level of $1.18, to close to the $1.28 threshold in the past month.

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

At the same time, over the last number of months, sterling has benefitted from widening interest rate differentials, with the Bank of England 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. 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 over the course of the last few months.

However, the reaction of sterling to the most recent Bank of England meeting and policy announcement in June is noteworthy. At this meeting, the Bank provided a surprise in hiking by 50bps rather than the expected 25bps. 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 6.5% early next year, compared to 5.5% in the run up to the June Bank meeting. In contrast, Eurozone rates are seen topping out around 4%, while the market envisages the US 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.

It appears to be the case that stagflation risks in the UK are now hindering any further upward momentum for sterling from additional rate hikes. At the same time, positioning data shows that the market is very long the currency. Therefore, sterling could struggle to make further gains during the

second half of this year. Indeed, 83-84p has been the floor for EUR/GBP since the Brexit referendum in June 2016.

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