4X Global Research

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Sterling's coming home…albeit slowly

Despite buoyant domestic expectations (or at least hope) football will not be coming home after the England football team lost on penalties to Italy in Sunday's final of the Euro Championship but Sterling is arguably coming home, albeit slowly.

The GBP/EUR cross has this week traded mostly above 1.17, a level which has proven hard to break. GBP/EUR is up about 0.6% since late-June, in line with our modestly bullish view, and we expect further modest appreciation in the remainder of Q3 (see "*Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage*", 29th June 2021).

The catalyst for Sterling's outperformance versus the Euro has arguably been the widening differential between UK and Eurozone CPI-inflation, the Bank of England's more hawkish rhetoric relative to a still very dovish European Central Bank and markets upping their pricing of Bank of England policy rate hikes.

The recent hawkish pivots by Monetary Policy Council members Ramsden and in particular Saunders may not yet enjoy consensus support. However, it is increasingly clear, in our view, that the MPC is divided (and vocally so) as to if and when it should prematurely terminate its QE program and when it should start hiking its policy rate.

The rates market, which is now pricing in 21bp of Bank of England hikes by mid-September 2022, is seemingly siding with the hawks which is in turn providing some ammunition (even if still a little blunt) to Sterling bulls.

We expect reasonably robust UK GDP growth in coming months to push headline CPI-inflation above the Bank of England's "peak forecast" of 3% yoy. We are thus sticking to our view that the gap between UK and Eurozone growth and CPI-inflation will widen further and see the Bank of England becoming increasingly hawkish, in absolute terms and relative to the ECB.

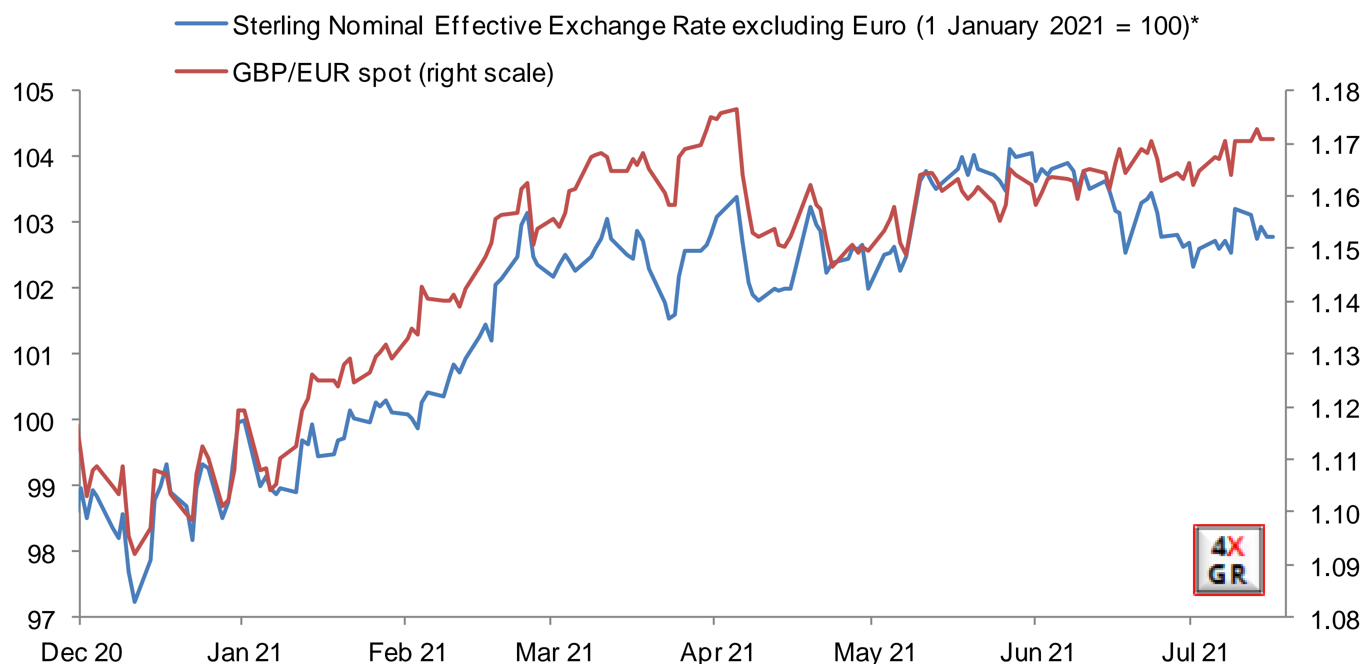
Finally, the typically very large UK tourism deficits, including with Eurozone countries, are likely to be far smaller than normal in July-August, which could in turn up-end Sterling's typical seasonal weakness versus the Euro in these two months.

GBP/EUR cross gravitating above key 1.17 level

Despite buoyant domestic expectations (or at least hope) football will not be coming home after the England football team lost on penalties to Italy in Sunday's final of the Euro Championship but Sterling (the currency, rather than English striker Raheem Sterling) is arguably coming home, albeit slowly. We expect further modest appreciation in the GBP/EUR cross in the remainder of Q3.

The GBP/EUR cross has this week traded mostly above the 1.17 level. We think this is significant as GBP/EUR had in the prior month repeatedly failed to remain above 1.17, let alone build on its modest gains (see Figure 1). The GBP/EUR cross has appreciated about 0.6% since late-June, in line with our modestly bullish view (see Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage, 29th June 2021). The catalyst for Sterling's (modest) outperformance versus the Euro has arguably been the widening differential between UK and Eurozone CPI-inflation, the Bank of England's more hawkish rhetoric relative to a still very dovish European Central Bank and markets upping their pricing of Bank of England policy rate hikes.

Figure 1: Sterling flat-lining against most major currencies but slowly pulling away from Euro



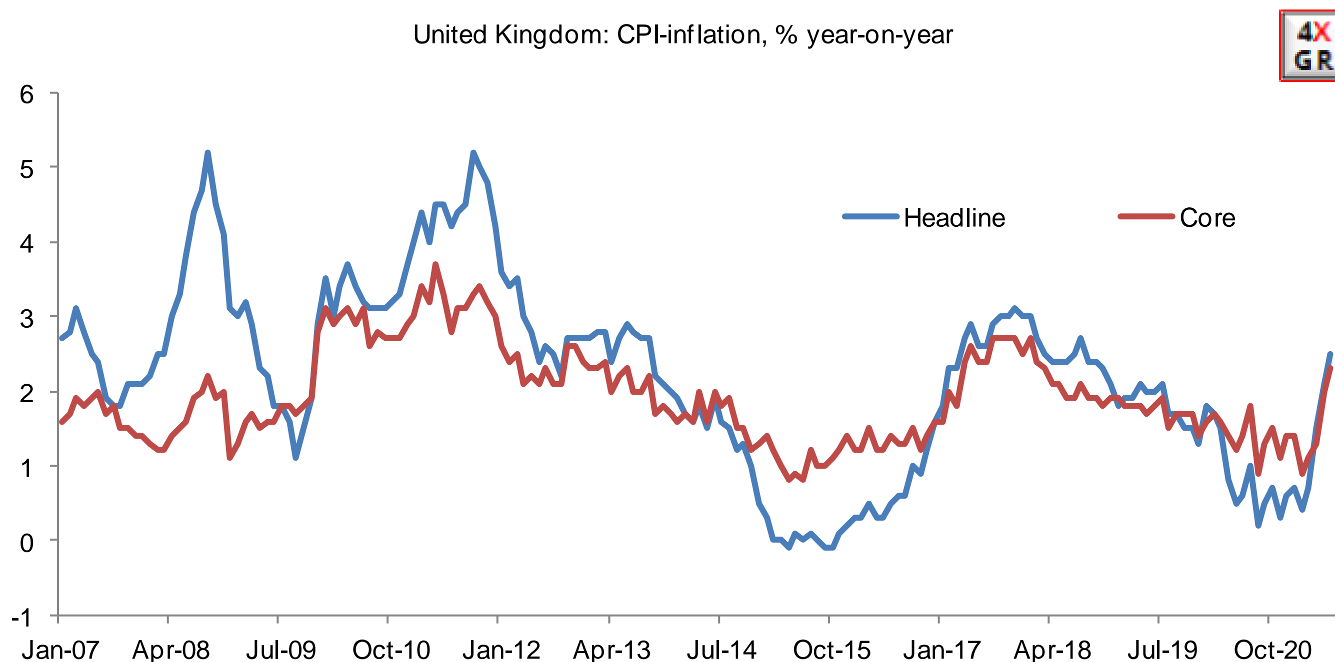
Source: 4X Global Research, Bank of England, investing.com

*Note: * Trade-weighted basket of Sterling versus currencies of United Kingdom's main trading partners, excluding Euro*

UK CPI-inflation rising and likely to exceed Bank of England peak forecast of 3.0%

According to ONS data released on 14th July UK CPI-inflation rose faster-than-expected in June. Core CPI-inflation, which excludes energy, food, alcohol and tobacco prices, rose from 2.0% yoy in May to a 41-month high of 2.3% yoy while headline CPI-inflation rose from 2.1% yoy to a 3-year high of 2.5% yoy (see Figure 2). Monthly headline CPI-inflation averaged 0.6% mom and core CPI-inflation 0.5% mom in Q2, evidence that the rise in year-on-year inflation was not just due to "unfavourable" base effects (a depressed consumer price index during the peak of the pandemic in mid-2020).

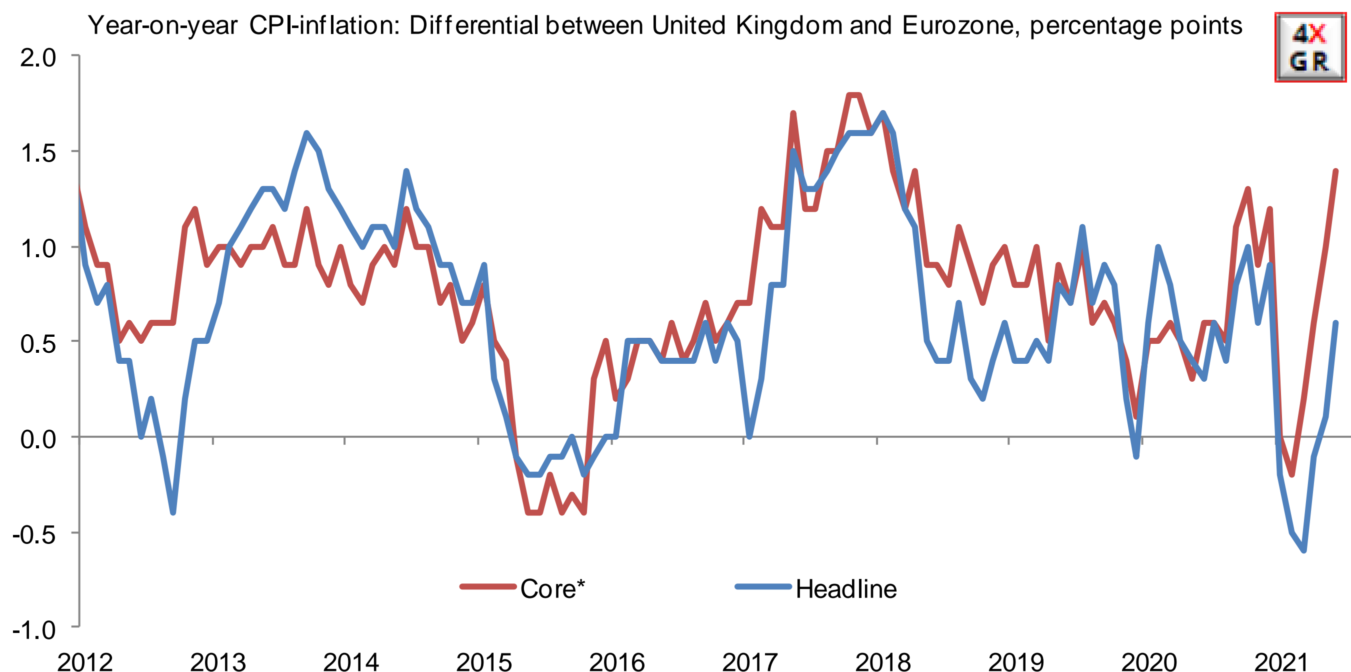
Figure 2: UK year-on-year CPI-inflation rising rapidly and not just because of unfavourable base effects



Source: 4X Global Research, ONS

While UK CPI-inflation has been more modest than in the United States the gap between UK and Eurozone year-on-year CPI-inflation widened further in June. The gap in headline CPI-inflation rose to a six-month high of 0.6 percentage points while the gap in core CPI-inflation rose to a 42-month high of 1.4 pp (see Figure 3). The lifting of lockdown rules and social distancing measures in the UK has preceded Eurozone countries by about six weeks on average, according to our estimates, which has in turn supported faster economic growth in the UK, based on a number of metrics including PMI figures. Unsurprisingly demand-pull inflationary pressures have been stronger in the UK.

Figure 3: Widening gap between UK and Eurozone inflation indicative of stronger UK-demand pull pressures



Source: 4X Global Research, Eurostat, ONS

*Note: * Excludes energy, food, alcohol and tobacco prices*

Bank of England slowly but surely turning more hawkish, ECB still very dovish

The Bank of England has so far stuck to a reasonably dovish script despite upward revisions to its near-term forecasts for GDP and CPI-inflation. However, two Monetary Policy Council (MPC) members (Ramsden and Saunders) have clearly turned more hawkish since Wednesday's CPI-inflation release as we detail in the timeline below. Markets are now pricing 21bp of Bank of England policy rate hikes by mid-September 2022 versus 14bp only a week ago.

- **22nd June: Bank of England policy meeting, first signs of less dovish outlook**

All nine MPC members vote in favour of keeping the policy rate at its record-low of 0.10% at the 22nd June Bank of England policy meeting. Once again only one MPC member – Andy Haldane who attended his last meeting – voted in favour of shrinking the Bank of England's planned purchases of Gilts by £50bn to £825bn. The MPC revises up its GDP level forecast for Q2 2021 by 1.5% from its May Monetary Policy Report and forecasts headline CPI-inflation to pick up further above the MPC's medium-term target of 2% and to likely exceed 3%. However Governor Andrew Bailey, like his counterpart at the Federal Reserve, reiterates the bank's official view that this inflation spike is likely to be "transitory."

- **9th July: GDP growth disappoints in May**

According to ONS data UK GDP growth slowed to only 0.8% mom from 2.0% mom in April, despite the further easing of lockdown and social distancing restrictions on 17th May. Service-sector output growth slowed by two-thirds to 0.9% mom in May, suggesting that UK households only partially took advantage of the relaxation of social distancing rules pertaining to the hospitality sector as well as indoor and outdoor entertainment. As a result GDP in May was still 3.3% below its pre-pandemic level (December 2019).

- **14th July: CPI-inflation in June surprises to the upside**

See above. GBP/EUR cross rises to 13-week high of 1.175 following the inflation release (see Figure 1).

- **14th July: MPC member Ramsden issues hawkish warning**

In the wake of the inflation release MPC member Dave Ramsden argues that i) the CPI-inflation increase in June was larger than the Bank of England had expected; ii) UK headline CPI-inflation could peak at 4% and be more persistent than assumed by the central bank, iii) the pre-Covid output high recorded in Q4 2019 could be regained in Q3 2021 and; the Bank of England was likely to need to tighten policy "sooner" than previously thought. The GBP/EUR cross stabilises just above 1.17.

- **15th July: Governor Bailey plays down need to tighten monetary policy**

In an interview for BusinessLive, published Thursday morning, Bank of England Governor Bailey reiterates his view that the inflation spike is likely to be transitory, suggests that the central bank will take its time to assess the data and rejects suggestion that the Bank of England is being casual about inflation.

- **15th July: MPC member Saunders suggests bank's QE program could be cut short**

MPC member Michael Saunders, in an online webinar, argues that "it *may become appropriate fairly soon to withdraw some of the current monetary stimulus in order to return inflation to the 2% target on a sustained basis. Options might include curtailing the current asset purchase programme – ending it in the next month or two and before the full £150bn has been purchased – and/or further monetary policy action next year*." Saunders, who in previous MPC meetings has voted to keep the policy rate and modalities of the QE program unchanged, suggests he is prepared to change his vote at the next policy meeting on 5th August. Like Ramsden he forecasts that headline CPI-inflation was likely to hit almost 4% by end-year and that high inflation could be persistent.

The Bank of England's current target for UK government bond purchases (Gilts) is £875bn. As of 14th July the Bank of England had purchased £814.7bn of Gilts, leaving about £60.3bn to purchase. If the Bank of England sticks to its current target and continues to purchase Gilts to the tune of £3.4bn a week, the QE program will run another 18 weeks (i.e. until mid-November), according to our estimates (see Figure 4).

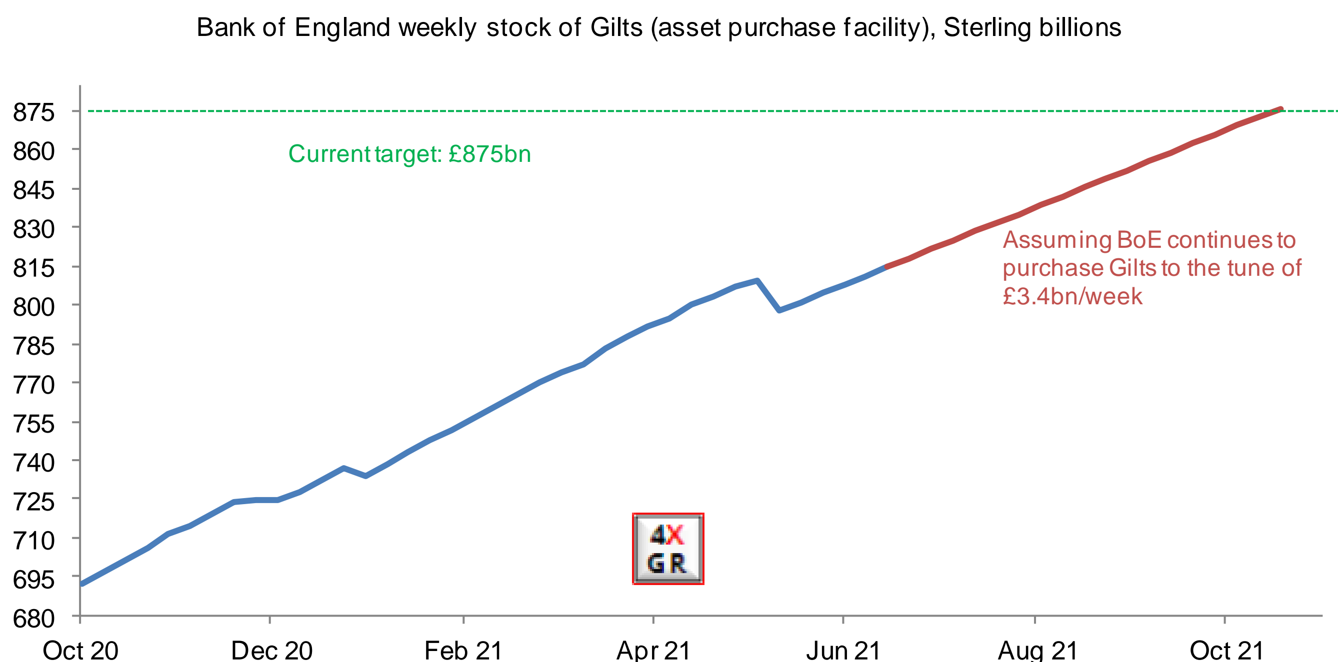
However, if as Saunders suggests the Bank of England stops buying Gilts in **one** month's time, the central bank will have purchased about £830bn of Gilts, or about £45bn short of the target (as noted above now former MPC member Andy Haldane had also suggested that the Bank of England shrink its Gilt-purchase

target by £50bn). If, as Saunders suggests, the Bank of England stops buying Gilts in **two** months time, the central bank will have purchased about £844bn of Gilts, or about £31bn short of the target.

- **1st September: New MPC member**

Catherine Mann to join Bank of England as MPC member and Chief Economist (replacing Andy Haldane), taking the total number of MPC members back to nine.

Figure 4: Question marks as to whether Bank of England will cut short its Gilt-purchase program



Source: 4X Global Research, Bank of England

The hawkish pivots by Ramsden and in particular Saunders (who throughout the Covid-19 pandemic advocated loose monetary policy) may not yet enjoy consensus support within the MPC. However, it is increasingly clear, in our view, that the MPC is divided (and vocally so) as to if and when it should prematurely terminate its QE program and when it should start hiking its policy rate. The rates market is seemingly siding with the hawks which is in turn providing some ammunition (even if still a little blunt) to Sterling bulls.

In comparison the European Central Bank (ECB) has maintained a very dovish policy stance, even if some of the more hawkish members – including Board Member Schnabel – have suggested that the ECB should start tapering its QE program. ECB President Lagarde on 8th July announced the findings of the central bank's (delayed) monetary policy strategy review. The main innovation is that going forward the ECB will have a symmetric inflation target of 2% and allow temporary inflation overshoots (until now the ECB had

targeted inflation of "below but close to 2%"). With Eurozone headline CPI-inflation running at only 1.9% yoy in June, this policy change suggests that the ECB will maintain very loose monetary policy near-term. Specifically we expect the ECB to only start tapering its bond purchases in Q4 2021 and to end its asset purchases in Q2 2022.

UK-Eurozone economic growth and inflation gap likely to widen further in coming months

We expect reasonably robust UK GDP growth in coming months to push headline CPI-inflation above the Bank of England's "peak forecast" of 3% yoy. If, as MPC member Ramsden forecasts, the pre-Covid output high recorded in Q4 2019 is indeed regained in Q3 2021 this would imply monthly GDP growth of about 1.1% mom from June through to September, according to our estimates.

We are therefore sticking to our view, expressed a fortnight ago, that "*slightly faster GDP growth in the UK than in the Eurozone in coming months will result in a further widening of the differential between UK and Eurozone year-on-year CPI-inflation […]. If this proves to be the case we think that while the European Central Bank will maintain a very dovish outlook for Eurozone monetary policy in coming months, the risk is tilted towards the Bank of England adopting a progressively less dovish stance*." (see Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage, 29th June 2021).

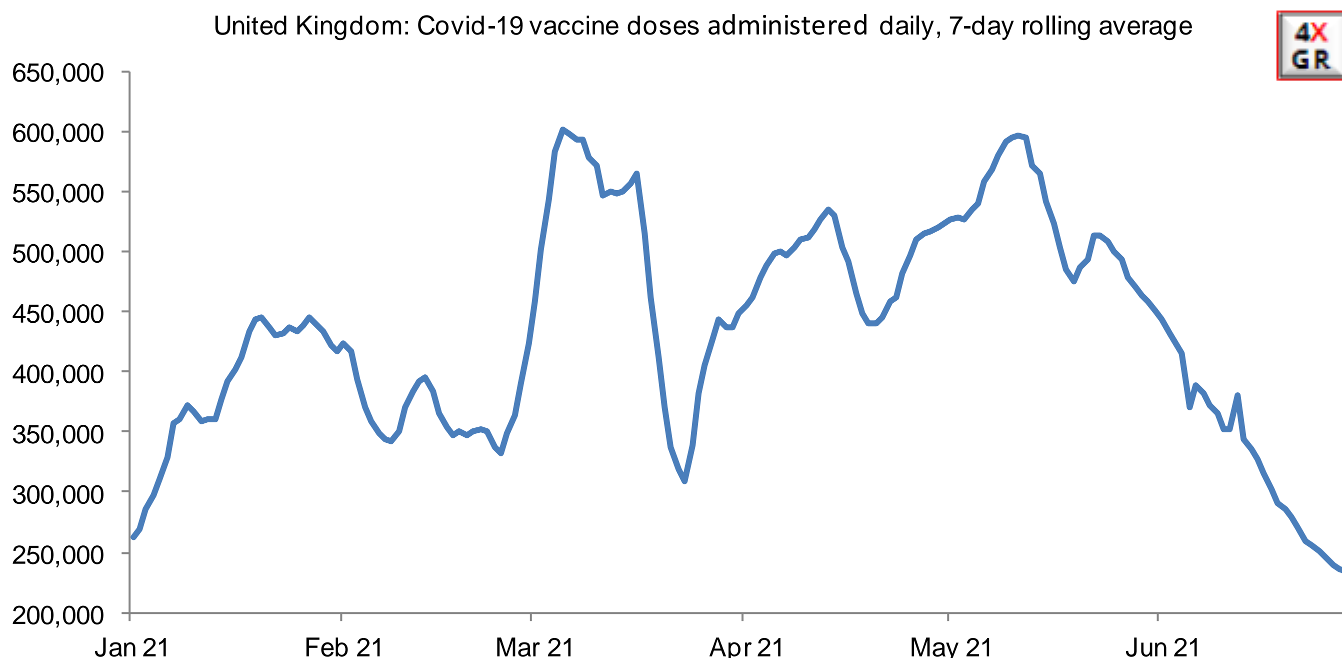
Figure 5: UK households' savings increased £213bn between February 2020 and May 2021

Source: 4X Global Research, Bank of England

The recent pick-up in the number of Covid-19 cases and hospital admissions in the UK, as a result of the more virulent Delta-variant, will likely temper consumer confidence and spending, at least near-term, in our view. Nevertheless, we think that travel restrictions and the lifting of most remaining social distancing restrictions in England on 19th July will stimulate domestic spending by UK households which have deposited about £213.5bn (11% of GDP) in savings with domestic banks in the past 15 months according to Bank of England data (see Figure 5).

Moreover, despite the pace of daily vaccination in the UK having slowed sharply in the past six weeks to below 250,000 currently (see Figure 6) we estimate that the UK will have double-vaccinated 80% of its adult population – a threshold which most health bodies estimate would convey herd-immunity – by end-July. In comparison France is about five weeks behind based on its current daily vaccination rate.

Figure 6: Daily vaccination rate has slowed sharply but UK close to the vaccination “finish line”



Source: 4X Global Research, Our World in Data

Finally, international travel restrictions in the UK and Eurozone, while admittedly fluid, are likely to result in far smaller net outbound tourism from the UK this summer than compared to previous “normal” years, in our view. If this holds true, the typically very large UK tourism deficits, including with Eurozone countries, are likely to be far smaller than normal in July-August, which could in turn up-end Sterling’s typical seasonal weakness versus the Euro in these two months (see Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage, 29th June 2021).

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