NatWest Markets FX: Protect against Sterling parity risks

NatWest

Summary

- Risks are mounting that the GBP/USD exchange rate will hit parity (1.00), or that the British pound trades even lower
- Worries over the outlook for the UK economy has already caused the pound to slide by about 5% against the USD in August 2022. This was its biggest monthly fall since the Brexit referendum in 2016
- Looking at the currency options market reveals that market participants see a greater than one-in-four chance that the GBP/USD exchange rate will hit parity over the next twelve months. Currency technical analysis suggests that if one pound sterling equals less than 1.1323 this quarter, it could slide to a value of around 0.9500 – a considerable devaluation
- Higher inflation, higher commodity and energy costs, soaring financing costs and potentially a credit crunch could further strengthen the already elevated USD. Furthermore, UK businesses also face the prospect of wage bills spiralling higher amid the backdrop of high inflation and a tight labour market
- Although such an extreme scenario is not our central case, major events including Brexit, Covid-19 and Russia's invasion of Ukraine in relatively quick succession, call for proactive management of direct and indirect consequences of such a scenario for UK companies
  - For some of the risks, there is no hedge available in the market, hence we focus on the FX risk, which can be hedged using a variety of strategies. The positive news: these FX hedges can also act as macro hedges for other risks due to the correlation between a weaker pound and other risks for businesses
- In this article, we outline
  - the operational risks for businesses, which may get accentuated if the pound continues to weaken
  - the probability of GBP/USD hitting parity over the next twelve months
  - various macroeconomic factors which could lead to a materially stronger USD

Risks for the corporate sector

A multitude of corporate risks are currently playing out simultaneously. These include:

Higher financing costs and credit crunch	Mortgage borrowers have some (temporary) protection from fixed-rate products. However corporate borrowing is typically defined by a spread over financial market swap rates, that have already fully-priced expectations that the BoE (Bank of England) will tighten its policy (e.g. 2-year sterling swap rates ~3.90%, 5-year swap rates ~3.40%). **Consequently, UK corporates requiring liquidity may face a challenging borrowing environment and may struggle to service their debts as consumer demand weakens.**
FX depreciation impacting margin and trade volume	The UK is a very open economy with imports accounting for an estimated ~30% of the CPI (Consumer Price Index) and RPI (Retail Price Index) baskets. With a weaker pound, businesses relying on importing goods and services will need to pay more, but may not be able to pass on all cost increases to their customers. We estimate that a sustained 10% depreciation in the pound sterling will raise import price inflation by around 5½% points, which in turn can boost CPI inflation by around 1½ to 1¾% points. A weaker pound can therefore lead to more imported inflation, which will further exacerbate risks for businesses.
Wage inflation	Corporates are also facing, and paying, higher wages. Although private sector wage inflation at 5.9% year-on-year in Q2 2022 is some way below CPI (10.1%) and RPI (12.3%) inflation, these are nevertheless sizeable rises which increase the financial pressure in firms. SMEs (small to medium enterprises) are especially feeling the burden as they typically have less pricing-power than large multi-nationals.
Energy and commodity cost shock	Although corporates will absorb some of the energy and commodity cost shock, they will also be compelled to pass on some of these costs. These pipeline pressures underpin our distinctly 'sticky' UK CPI and RPI inflation forecasts.
Weaker consumer demand	UK consumers are pessimistic about the economy. The BoE has warned that the UK will fall into recession and predicts that the economic contraction is expected to last for the following five quarters. Consumers will likely reduce their spend in non-essential categories.

What do the currency option markets and technical analysis imply for the GBP/USD exchange rate?

View from the currency option markets

NatWest Markets' head of currency options trading, Henry Drysdale, suggests that option premia for both currency pairs, EUR/USD and GBP/USD, are poised to rise in the coming months. He says, "Even on a medium-term historic basis, volatility does not look elevated in either the EUR/USD exchange rate or the GBP/USD rate. We think that the market hasn't yet sufficiently priced in a premium for the increased uncertainty for the months ahead."

Looking at the option markets can also be a handy way to gauge the probability of spot trading at or below a specified level. Currently, option markets imply a more than 25% chance of the GBP/USD exchange rate hitting parity over the course of next 12 months* - a more than ten-fold jump since the beginning of this year (refer to Chart 1).

Chart 1: Option markets now imply a one-in-four chance of GBP/USD hitting 1.00 over the next 12 months

Note: (*) a one touch option is an option which pays off if the underlying spot hits the strike price once before the option expires (and does not need to exceed this level at the time of expiry). The price of such an option is expressed as percentage of a specified payoff. The chart for the price of GBP/USD parity one-touch option refers to the period 5 September 2020 to 5 September 2022. Spot reference on 5 September 2022 was 1.1500.

Source: NatWest Markets

What currency technical analysis tells us

The GBP/USD exchange rate has been in decline since the global financial crisis in 2008/2009. Piers Leslie of Fact Not Fiction Forecasting Ltd says, "There is a potential risk that if the GBP/USD exchange rate closes below 1.1323 in this quarter, the pound could drop further; to as far as the 0.9500 area." This would mean that one British pound would be worth less than 1 US dollar – for the first time in history.

Factors which could drive the GBP/USD and EUR/USD exchange rates even lower

We see four major factors that will likely put further pressure on sterling and euro

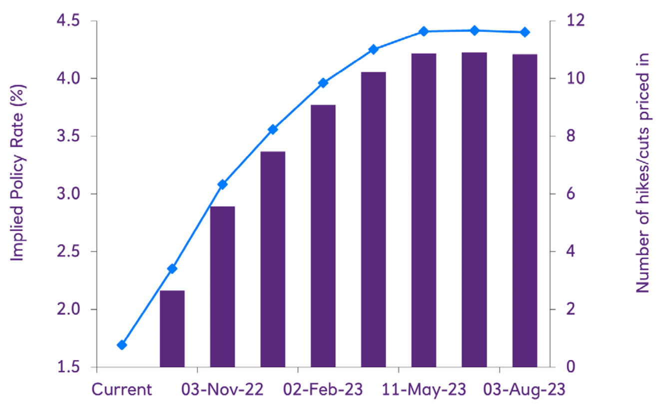
1. Monetary policy tightening will contribute to the UK's economic recession

The current market pricing for the BoE looks extremely hawkish with a terminal bank rate close to 4.5% by June 2023, versus ~3% in early August and ~2.5% in May 2022 (refer to Chart 2 for market pricing of UK interest rates). We expect this monetary policy tightening to contribute to an economic recession in the UK (refer to Chart 3 for NatWest Markets' forecast of UK quarter-on-quarter GDP (Gross Domestic Product)).

NatWest Markets' FX strategist Neil Parker comments, "Money for discretionary purchases is likely to be diverted to paying for higher mortgage interest costs and necessity goods such as food, energy, and fuel. That in turn could mean that the pound shrinks far more than central banks currently expect. Also, in the US, there are clear signals of a downturn in the making. However, the US tends to be the beneficiary of safe-haven flows, as it was during the financial crisis in 2008."

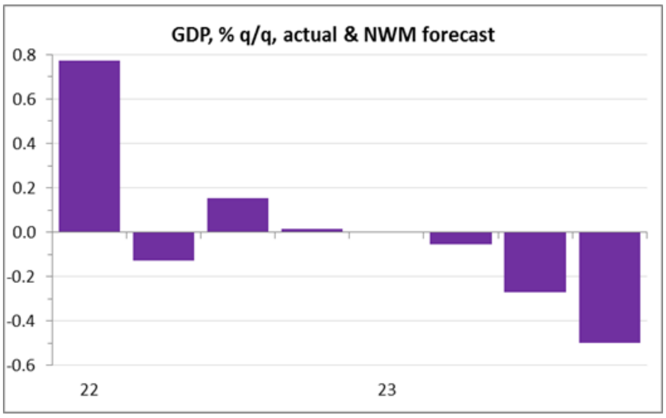
The UK needs to attract capital to fund a large and growing balance of payments deficit. The change in the BoE's reaction in August – where a more gradual policy tightening sought to control inflation while avoiding recession, gave way to larger rate rises and an acceptance that this would result in recession – has made this harder. Currency weakness, driven by BoE policy that forces inflation yet higher, has the hallmark of an uncontrollable downward tail spin for sterling through the autumn.

Chart 2: Market Pricing of UK interest rates



Source: Bloomberg, as observed on 02 September 2022

Chart 3: UK GDP % quarter-on-quarter, actual and NatWest Markets forecast



Source: ONS, NatWest Markets

2. The US continues to be seen as a safe habour from the inflation storm

The energy crisis is more acute in the UK and EU than it is in the US. NatWest Markets' chief UK economist Ross Walker says, "By the end of this year we forecast UK domestic energy prices to have risen by 175% year-on-year versus just 15% in the US. To the extent that this presents a double-whammy to the economy and currency – higher inflation but also weaker growth – it will tend to magnify downside pressures on the pound."

Currently the market is implying around 150 basis points of hikes for the Fed, and a potential rate cut starting in the spring of 2023. This seems too light to us in terms of hikes. We certainly think that there's little chance of cuts eight months from now, given how persistent certain components of the US CPI are.

On the other hand, the market is pricing 200 basis points of hikes from the ECB (European Central Bank) and then a stable rate for a prolonged period. Once again, we don't see this as sensible. NatWest Markets' global head of G10 spot trading, Tashen Kandasamy, says, "Given the gas shortages facing Germany and much of the rest of the continent this winter, we think the Eurozone economy is set for a sharp recession as consumer spending and industrial production falls precipitously. We think another 100 basis points is possible, but if anyone is going to be cutting in 2023 it will be the ECB and not the Fed. Therefore we think that rate differentials will continue to weigh on EUR/USD." (Refer to Chart 4 for the correlation between EUR/USD and rate differentials since Jan 2020).

3. Fiscal slippage

- The UK's economic fundamentals suggest that policymakers may have less leeway for 'unconventional' policy action, such as, for example, the fiscal stimulus during the COVID-19 pandemic. The fiscal outlook already appears significantly weaker than in the latest forecasts published by the OBR (Office for Budget Responsibility) in March 2022. Overall, debt levels are already very high as a percentage of GDP (Gross Domestic Product).
- In our forecasts, the gross supply of gilts, and net of BoE activity, is set to surge from an average of around GBP100 billion a year during the previous decade to an average of around GBP270 billion per year over the four years (see Chart 5). As there is already a substantial amount of UK government borrowing to be funded, seemingly without quantitative easing, further fiscal slippage would increase the risks of a further depreciation in the pound as it would limit the scope of the government to help offset the impact of higher prices.

Chart 4: Rate differentials will continue to move against EUR/USD into year end

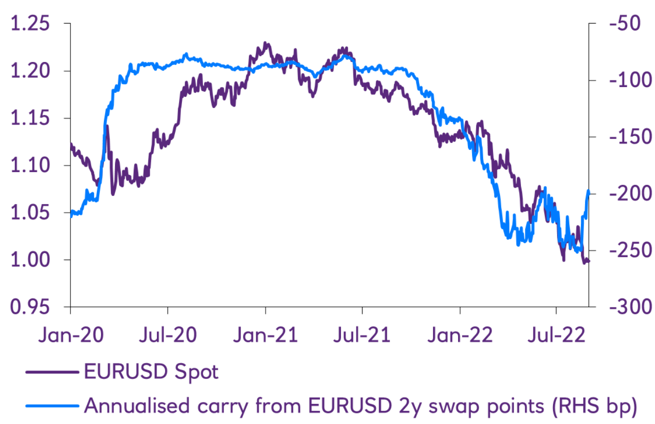
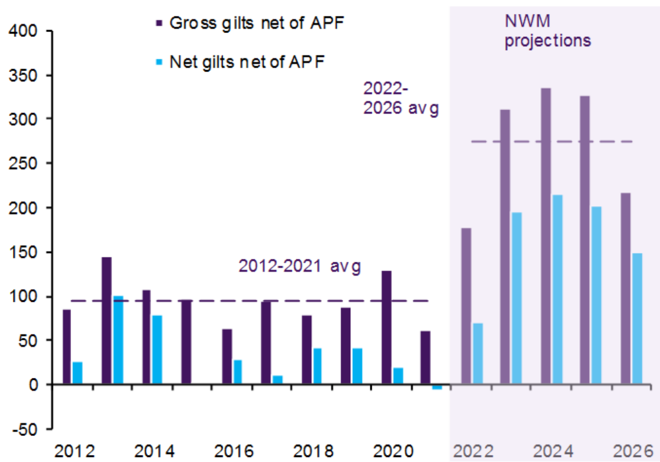


Chart 5: NatWest Markets' projections of gilts supply



4. Political risks

Conventional macroeconomic and monetary policy factors, whilst not obviously supportive of sterling, are probably not sufficient to propel GBP/USD to parity in the near-term. By contrast, 'political' factors appear to be potentially more explosive. These include:

- **BoE's independence at risk?** Or is it mere rhetoric? – The most troubling tail-risk for sterling would be any perceived curtailing of the BoE's operational independence. At this point it is extremely unclear what the Liz Truss government will do. During her campaign, Ms Truss stated, "I want to change the BoE's mandate to make sure in the future it matches some of the most effective central banks in the world at controlling inflation." (03 August 2022).
- **UK-EU trade war** – This is perhaps more of a 'slow burn' than the risks relating to curtailing BoE independence. But the UK's trade trends already look materially worse, and an escalation of these pressures via, for example, the imposition of tariffs or quotas on UK exports by the EU in response to a perceived breach of the Northern Ireland Protocol, could conceivably trigger a 'panic' sell-off in sterling.

Conclusion

- Europe is in the eye of a cost of living storm. The storm has potential to reach hurricane strength during the autumn as the prospects of deep recession increase.
- Political and policy factors increase the risk of a sharp fall in the pound. Fears of GBP/USD trading at parity come into focus while the EUR/USD rate may hit 0.90.
- Technicals: A clear quarterly close below 1.1323 could leave the door open for a break of parity down to 0.95.
- A scenario of further strength in USD can be intertwined with higher inflation, higher commodity and energy cost, soaring financing costs and potentially a credit crunch. UK businesses also face the prospect of wage bills spiralling higher amid the backdrop of high inflation and a tight labour market.
- Businesses which need to buy USD for their operational needs and are concerned about the risks highlighted above, could consider increasing their USD hedge ratios.