FX Viewpoint

Currencies
Global

The GBP to take a turn for the worse

- The GBP has been supported by its high yields, but this looks to have gone beyond what the relationship implies
- The start of the BoE's rate-cutting cycle and persistent external imbalances could erode the recent GBP gains…
- …especially if volatility rises suddenly and other investment flows retreat quickly

The GBP is propped up by its relatively high yields against a backdrop of low market volatility…

The GBP is the second best performing G10 currency so far this year, with the USD being top in the performance stakes (*Bloomberg*, 9 May 2024). The outperformance has been **supported by its nominal yield advantage**; but this looks to have gone beyond what the relationship implies (Chart 1). With the backdrop of lower FX market volatility, the higher-yielding GBP has also been supported by **carry trade activities**. However, there are two key reasons that should see the GBP's fortunes take a turn for the worse:

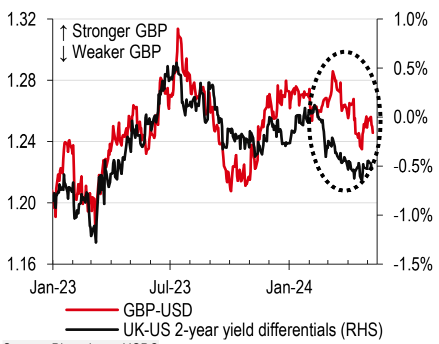
…but the GBP is likely to weaken when the BoE starts to ease

1. **The start of the Bank of England (BoE)'s rate-cutting cycle should see the GBP weaken.** On 9 May, the BoE kept its key rate on hold at 5.25% for a sixth consecutive meeting. The monetary policy committee voted 7-2 for no change, with Deputy Governor Dave Ramsden joining Swati Dhingra in voting for a 25bp cut. **Our economists expect the BoE to begin cutting rates in June**, which should start mechanically compressing the GBP's yield vs other currencies whose central banks are likely to be slower to cut, like the AUD and the NOK, or even hike, like the JPY, over time. Given the degree of the GBP's outperformance this year, the beginning of the BoE's easing cycle could have a bigger impact.

The GBP could also face a difficult period against low-yielding currencies, should 'other investment' flows retreat quickly (i.e., carry trades unwind)

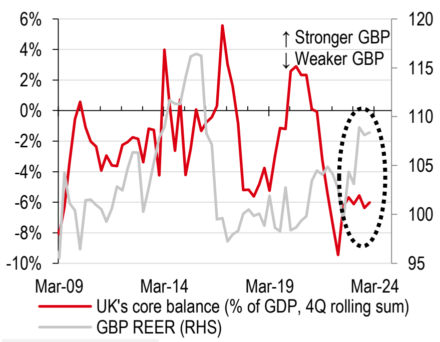
2. **External imbalance:** The UK's current account deficit has been persistent with net foreign direct investment (FDI) outflows exerting additional pressure, leaving the **core balance deficit stabilising at just over 5% of GDP** (Chart 2). This is closer to the level last seen near the Global Financial Crisis in 2008. Admittedly, the GBP has not always fully reflected these structural weaknesses, but it is not something one should completely ignore. The broader GBP strength is inconsistent with underlying economic fundamentals**.** There is still a risk that the GBP could drop faster if risk aversion increases, given **the UK's dependency on less stable 'other investment' flows** (which are shorter term in nature and can be volatile) and its elevated sensitivity to risk appetite.

1. GBP-USD is high vs that implied by its yield differentials



Source: Bloomberg, HSBC

2. The broad GBP strength has overshot fundamentals



Source: Bloomberg, HSBC

The GBP is sandwiched between two negative forces that could erode its recent outperformance, in our view.

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