British Pound (GBP) Crash

GTSF Investments Committee | September 28, 2022

Jake Sherwood, Macro Analyst

GBP weakens

Broader dollar strength has put pressure on all global currencies including the British Pound. GBP/USD struggles to find a bottom, which was exacerbated by the UK Chancellor Kwasi Kwarteng revealing large tax cuts and increased borrowing over the weekend. The sterling has been in a downtrend against the dollar and euro for the entire year, as inflation has hit the UK harder than most other european countries. After CPI data from the United States, and the hawkish comments from Fed Chair Powell at the FOMC meeting, GBP/USD fell to the 1.1491/1.1409 level which marked Mar 2020 and Oct 2016 troughs and met support in the mid-1.13s. After the Chancellor's announcements, the British pound dropped to 1.035 overnight on Sunday, below the previous record of $1.05 set in February 1985. UK Gilts (bonds) also sold off alongside the Sterling briefly reaching above a 5% rate for the 30 year gilt. The move in bonds has largely reversed on Wednesday, with 30yr yields dropping from just over 5% all the way down to 3.93%, appreciating 25% in price in a single day. This price action comes as a result of Bank Of England's announcements to begin open market purchases or long-dated UK bonds, with purchases of about £1b of Gilts, lower than their £5b limit. The large sell off in bonds put pensions funds across the UK at risk of insolvency, with a senior banker from London stating there were no buyers of long-dated UK gilts Wednesday morning until the BOE decided to intervene in the bond market. Pension funds in the UK invest typically more than half of their assets in bonds, hedging their exposure through gilt derivatives managed by liability-driven investment (LDI) funds. When yields go up too fast, as happened over the past couple weeks, these funds need to provide more collateral to LDI funds as their underlying assets become loss-making. 30-year gilt interest rate swaps GBPSB6L30Y=, rose 360 bps this year and 120 bps in the last few days, before the BoE stepped in. This made it increasingly difficult for these funds to hedge their gilt exposure. Essentially, the BoE has admitted to being the only marginal buyer of their own long-duration debt, which most economists expect to have negative implications for their credibility and currency strength over the long run. It is also becoming increasingly problematic that credit markets in Europe cannot function properly without daily government intervention.

Potential Balance of Payments Crisis

There is an important debate on whether or not the UK is facing an "EM-style" balance of payments crisis. A BoP crisis, or "currency crisis", is when the lack of capital inflows in a country makes it impossible for them to fund necessary expenditures like critical imports or debt repayments. In developed G10 countries, an increase in rates will attract capital inflows and subsequently strengthen their currency. For an EM currency, large rate hikes often have the opposite effect, causing capital outflows to accelerate due to a loss of credibility. This can be seen with a country like Argentina, which has 75% interest rates currently but has continued to see significant devaluation against the dollar. However, it is our view that characterizing the current problems in the UK as an "EM-style" balance of payments crisis is off the mark, with a strong rally in UK bonds on Wednesday bringing some credibility to this assumption. BoP crises typically feature a fixed exchange rate regime and a lot of external debt denominated in foreign currency; neither of these apply to the UK. That being said, structural economic issues still exist in the UK with an expanding fiscal deficit against an already wide current account deficit. It is reasonable to assume this growing fiscal deficit will expand the current account deficit, which reached a record -8% of GDP in 1Q22. Exhibit 3 shows that there is a strong correlation between relative strength in the sterling and current account balance. Moving forward, a key driver for GBP will be the BOE response to inflation. Exhibit 5 shows that higher deficits in G10 tend to require higher yields to attract international investment, and at the current rate of -6%, at least a 5% rate would be necessary. It is our view that any aggressive rate hikes and fiscal austerity will be counteracted by slowing economic growth further weakening the sterling.

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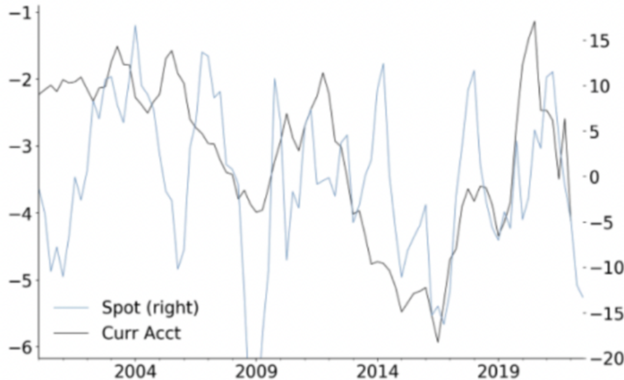
Exhibit 3: A sustained-wide current account (and twin deficit) has historically coincided with weaker GBP

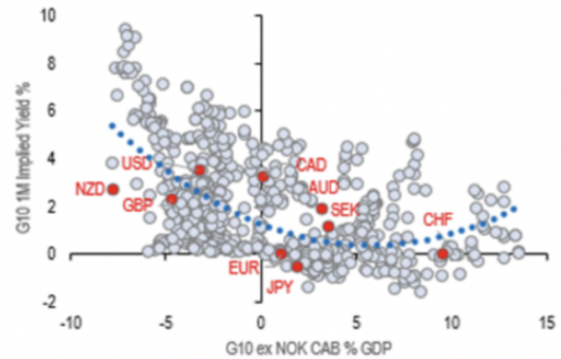
LHS: Current Acct, % GDP (4Q Avg thru 1Q'22); RHS: GBP/USD, YoY % Chg



Source: J.P. Morgan

Exhibit 5: Historically, large current account or twin deficits have required higher policy rates in G10 and EM

(X): G10 current account balance, % GDP. All ccys (ex-NOK) since 2000. (Y) 1m implied yield

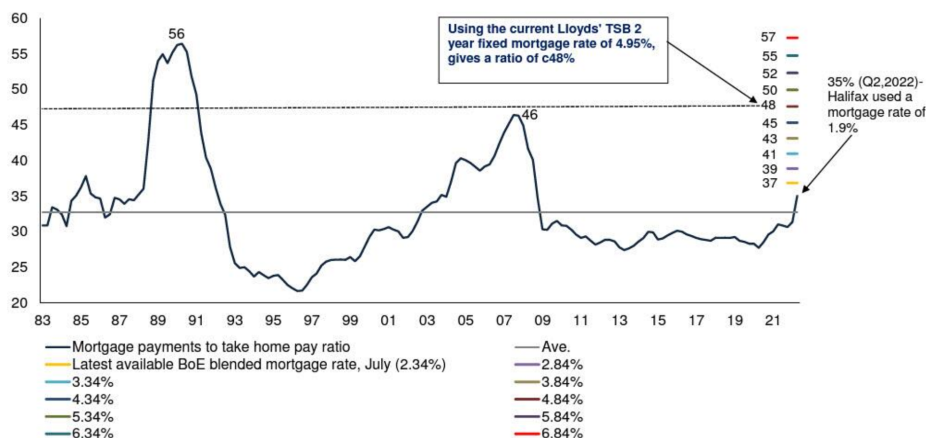


Source: J.P. Morgan

UK Mortgage Rate

With housing affordability already at decade lows in the UK, rising rates have made it even more challenging for new home buyers. On top of that, variable mortgage rates make up 26% of the total outstanding mortgages in the UK, as opposed to less than 5% in the United States. Variable rates in the UK are dependent on the BoE's bank rate, which is currently 2.25% with an expected terminal rate close to 6%. Markets are also now pricing in a 62% chance of a 125bps rate hike at BOE next meeting on November 3, which will immediately increase mortgage payments for 26% of homeowners. Numerous mortgage lenders in the region including Virgin Money, Skipton Building Society and Halifax stopped offering new mortgages in response to the rising cost of funding. UK Finance expects rising mortgage rates to hit the lowest income households the hardest, and estimated that three in 10 could struggle to pay their bills after refinancing.

Figure 1: UK mortgage payments to take home pay ratio (%) using real time new mortgage rates with incremental +50bps scenarios from levels seen in Q2 plus a note of where fixed rates are now.



Source : Halifax (using the monthly average rate for new advances to households from the BoE; a 70% LTV loan; average post-tax earnings taken from Halifax), Deutsche Bank

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