Trade Idea – Foreign Exchange

2016 UK rate hike off the table?

14th January 2016

**Market expectations shift**

- For two months the Sterling has come under considerable selling pressure against its major currency counterparts (USD, EUR and JPY). Subdued inflation, growing “Brexit” concerns and broad market volatility have all contributed to its steep decline as expectations of a UK interest rate hike have shifted from Q2-16 to Q2-17 (see Figure 1). In particular, the GBP has fallen strongly against the Euro, with the EUR/GBP breaking above its recent 0.7-0.74 range for the first time in 11 months, leaving the currency pair at levels which, in the medium term, we consider overbought. Like the US, over the course of the next three to six months we expect domestic cost pressures to boost headline inflation in the UK and allow the Monetary Policy Committee to engage in monetary tightening sooner than markets have currently priced in. An upward re-pricing of rate expectations would provide support for the GBP and create a tactical opportunity to build short exposure to the Euro against the Sterling at attractive levels.

**Figure 1**

GBP drops as market expectations shift

![GBP vs Market Expectations Chart](chart1.png)


Implied path for bank rate taken from working day averages for 15 days before 28 Oct 15 and 29 Jul 15 respectively, using the Overnight Index Swap Rate.

**Opposing forces to affect the path of inflation**

- In its meeting minutes, the Bank of England (BoE) has regularly stressed that the UK inflation outlook depends on the balance between negative external factors and domestic cost growth. While cheap oil continues to present a drag on headline inflation, the base effects of its precipitous decline in 2014/15 look set to dissipate in coming months (even in the face of recent declines). Domestically, unemployment is approaching what the BoE considers to be its long run equilibrium level of approximately 5% and hourly earnings have shown signs of improvement. But the indicator that is highlighted by the BoE as key is unit labour costs, which takes pay growth relative to productivity growth. The recent trend suggests that labour costs are indeed rising (see Figure 2) and in coming months this should allow inflation to normalise. A stronger inflation outlook will encourage market participants to price in a rate hike sooner than they are currently doing, thus creating upside for the GBP against the Euro, which itself will stay subdued from ongoing quantitative easing.

![Opposing Forces Chart](chart2.png)
“Brexit” possibility remains uncertain

- A major risk to the aforementioned view is the build-up of concerns over a “Brexit” scenario, as David Cameron attempts to renegotiate the UK’s position within the EU. The uncertainty surrounding the situation has potential to limit GBP gains, but for now clarity around the timing and the nature of any vote is very unclear and so remains to be seen.

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