4X Global Research

Olivier Desbarres ▌contact@4xgr.com ▌+44 (0) 20 3811 0454

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UK & Sterling facing potential quadruple whammy

Sterling has enjoyed a strong, if bumpy ride, since late-June. It has been the second strongest major currency against the US Dollar and appreciated 3.7% in NEER term, thanks in part to a build-up of speculative long-Sterling positions.

Markets have seemingly taken heart from government measures to support the economy, including the labour and housing markets and service sector, the Bank of England's so-far unflinching commitment to quantitative easing and the sharp rebound in economic activity in June-August.

At the same time markets have seemingly ignored the British economy's material underperformance relative to other major economies in Q2 and the government's arguably incompetent and incoherent handing of the covid-19 pandemic.

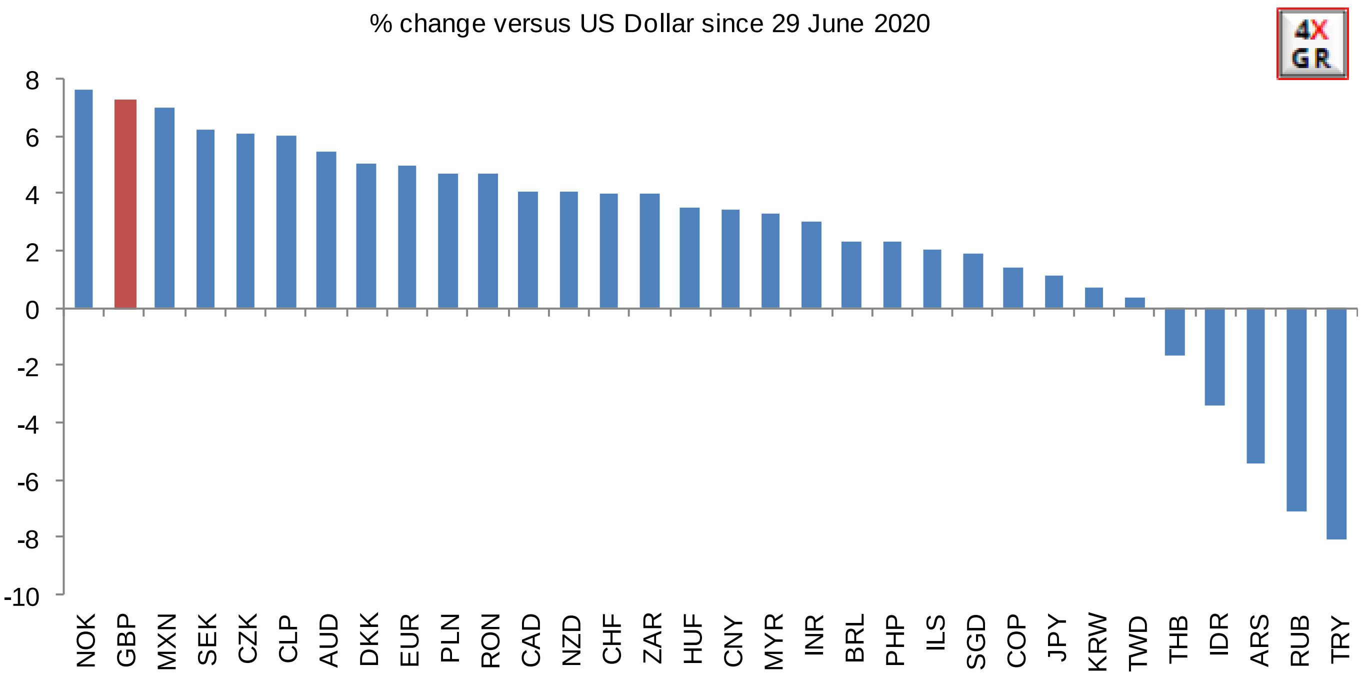
However, the economy faces a potential quadruple whammy in coming months of fiscal stimulus measures being unwound, a no-deal Brexit, higher taxes and a re-tightening of national lockdown measures in the event of the number covid-19 cases rising sharply during the winter months.

This leaves Sterling vulnerable, in our view, particularly in the context of relatively elevated long Sterling speculative positions.

Sterling has outperformed all but one other major currency since end-June

Sterling's 9-week rally has been impressive – among 32 major currencies tracked it has only been outperformed by the Norwegian Krone (see Figure 1).

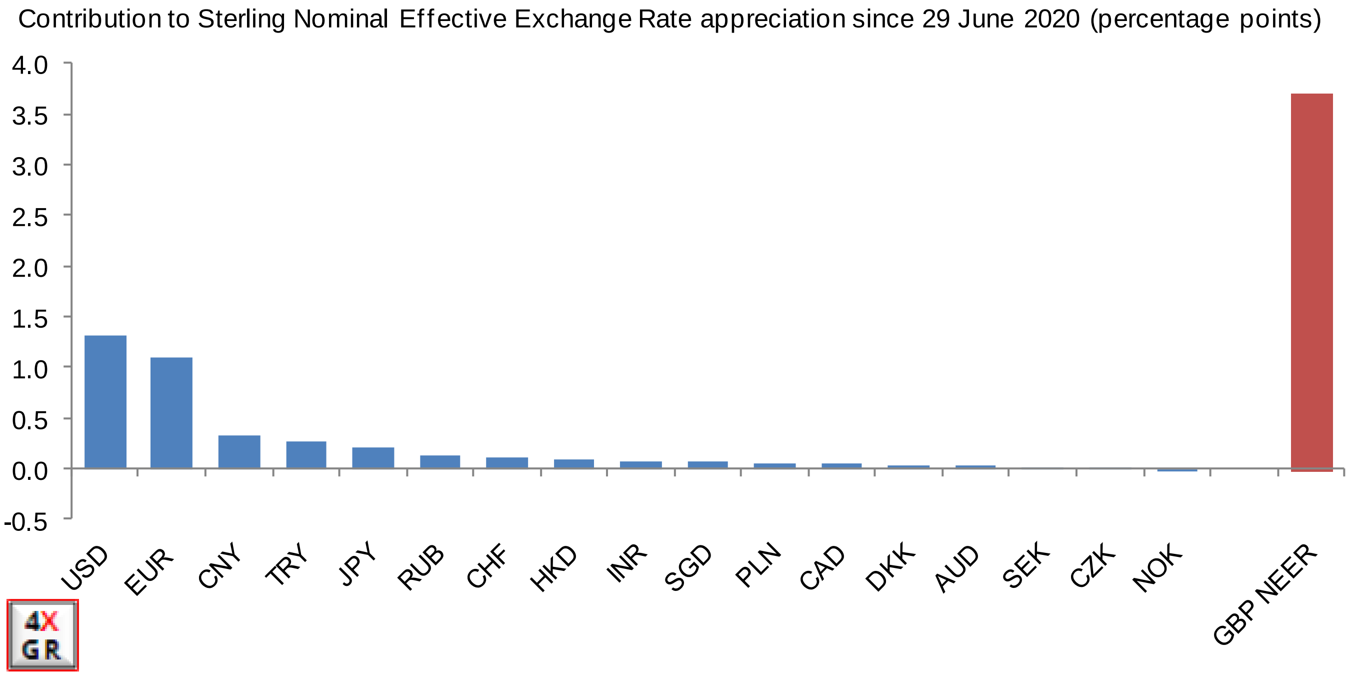
Figure 1: Sterling has been second best performing major currency since late-June



Source: 4X Global Research, investing.com

Sterling's 7% appreciation against a weaker US Dollar has accounting for about 1.3 percentage points of the 3.7% gain in the Sterling Nominal Effective Exchange Rate (NEER) since late-June, according to our estimates (see Figure 2).

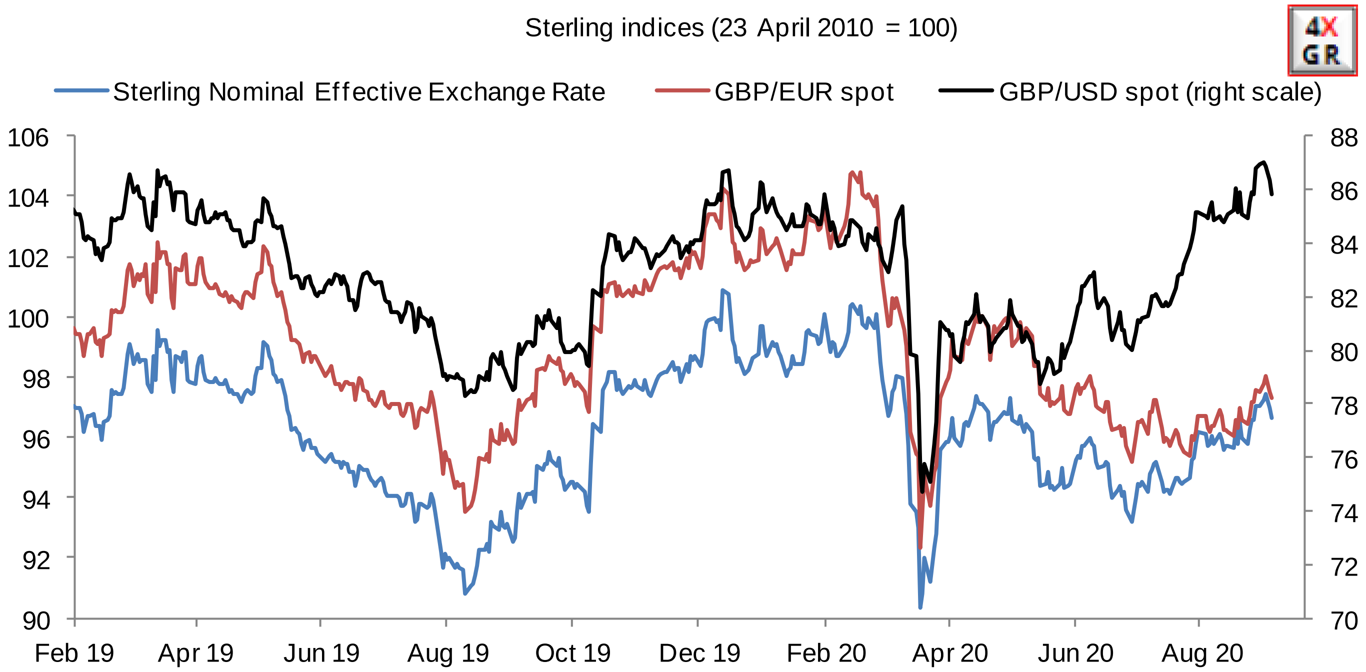
Figure 2: Sterling has appreciated against all of the United Kingdom's major trading partners' currencies



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

Despite Sterling's 0.6% sell-off in the past two trading sessions the NEER remains within striking distance of the 6-month high recorded on 2nd September (see Figure 3).

Figure 3: Sterling NEER has weakened in past 48 hours but is still within striking distance of 6-month high

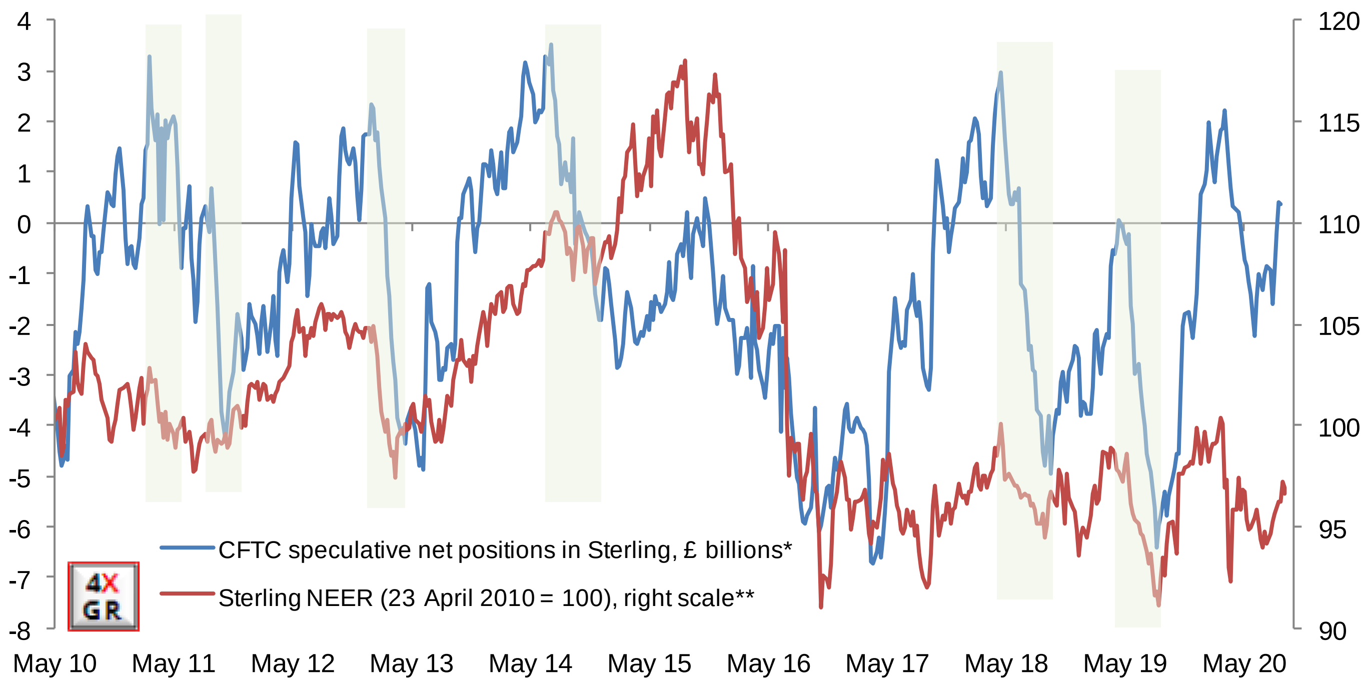


Source: 4X Global Research, Bank of England, investing.com

Markets buoyed by aggressive UK fiscal and monetary policies and growth rebound

We partly attribute Sterling's appreciation to the build-up of net speculative long-Sterling positions to a 21-week high of £0.4bn on 18th August. Figure 4 points to a reasonably strong historical correlation between "non-commercial" (speculative) Sterling positions and the Sterling NEER. Speculative positions (net buying or selling) have a direct impact on a currency as well as an indirect impact, to the extent that they colour the perception that other investors (including asset managers) may have of a currency's prospects.

Figure 4: History suggests Sterling's sell-off could accelerate if large long-GBP positions are unwound

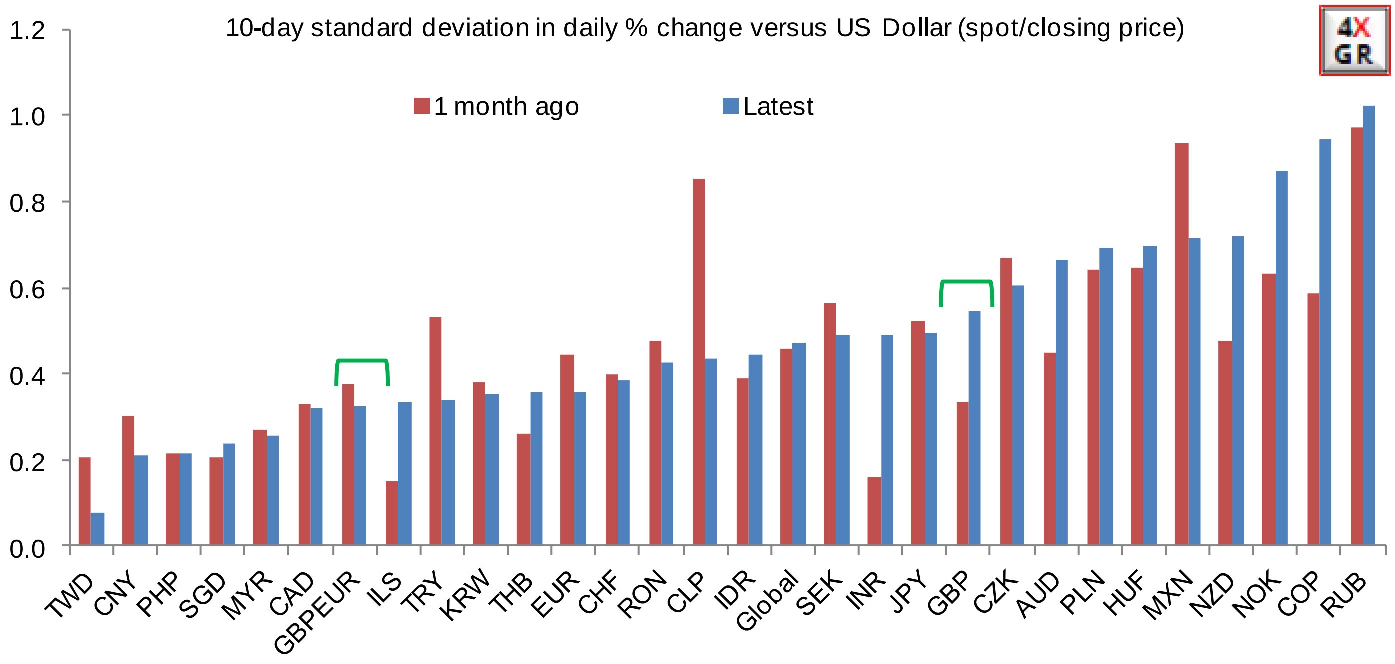


Source: 4X Global Research, Bank of England, Commodity Futures Trading Commission, investing.com

*Note: * Weekly Commitment of Traders (COT) data for "non-commercial" US futures positions in Sterling (last data point 25th August 2020); ** Nominal Effective Exchange Rate, Bank of England trade weights (daily data)*

The build-up in speculative positions may explain in part why Sterling's climb has been bumpy. Our measure GBP/USD realised volatility – the 10-day standard deviation in the daily percentage change in the spot (closing) price – has almost doubled in the past month even if it remains only slightly higher than its 2019 average. In the past ten trading sessions GBP/USD has been one of the most volatile Dollar crosses among developed currencies (see Figure 5).

Figure 5: GBP/USD volatility has almost doubled in past month



Source: 4X Global Research, BIS, investing.com

Note: Global is realised volatility in a turnover-weighted basket of 32 major currency pairs against the US Dollar. Currency pairs are AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD, SEK, ARS, BRL, CLP, COP, MXN, CZK, HUF, PLN, RON, RUB, ZAR, TRY, ILS, CNY, IDR, INR, KRW, MYR, PHP, SGD, TWD and THB.

Nevertheless, markets have seemingly taken heart from government measures to support the economy, including the labour and housing markets and key service sector.

- The Coronavirus Job Retention Scheme ("furlough" scheme) has seen 9.6 million employees receive 80% of their salary (up to £2,500/month) at a cost of £35.4bn to the Chancellor of the Exchequer, according to official data (see United Kingdom: Back to 1999…and to the Future, 26th June 2020).

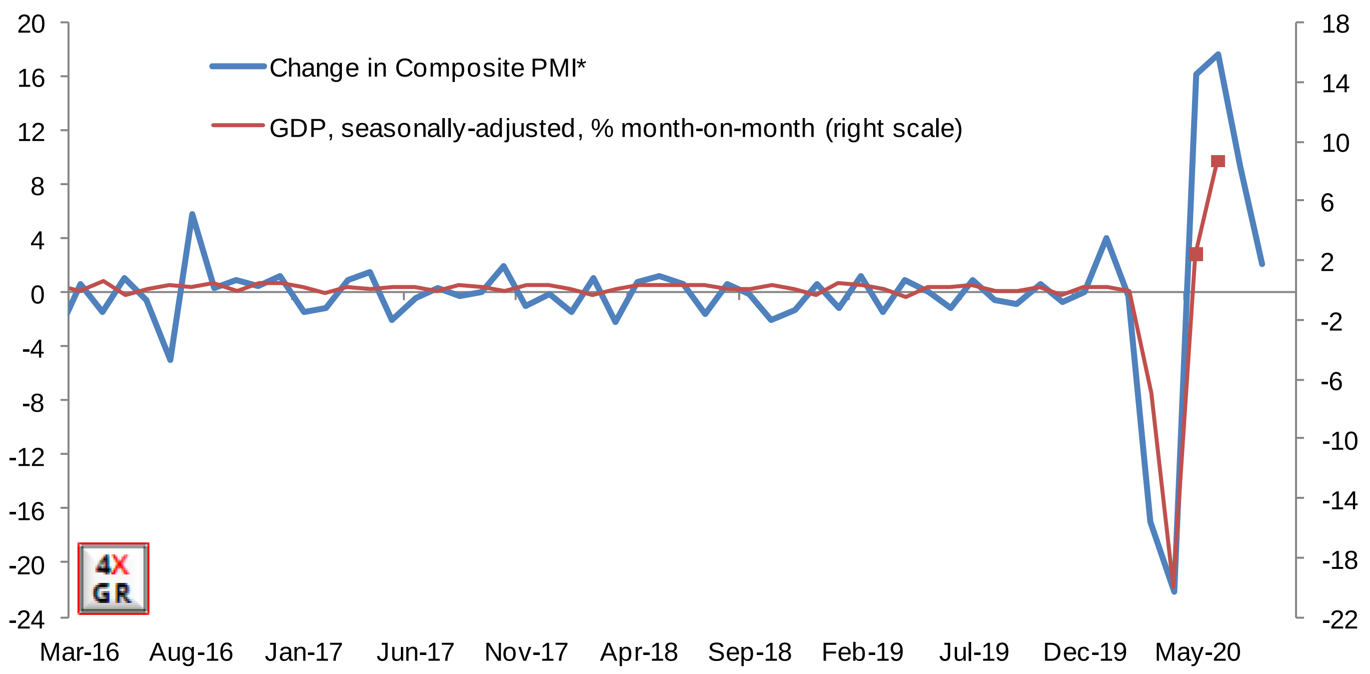
- The Self-Employment Income Support Scheme (SEISS). The first tranche paid out about £7.8bn between mid-May and mid-July in the form of a one-off grant (capped at £7,500). Claims for the second and final tranche opened on 17th August, with £769mn worth of claims made (grant was capped at £6,570).

- The decision on 8th July to up the threshold on stamp duty on property purchases in England and Northern Ireland from £125,000 to £500,000 – which will remain in effect until 31st March 2021 – has seemingly given the domestic property market another leg-up, even it has been uneven and may prove temporary. UK property prices, seasonally-adjusted, rose 2.0% mom in August, the largest monthly increase in 16 years, to an all-time high average of £224,123, according to the Nationwide Building Society.

- The government's innovative "Eat Out to Help Out" scheme, which ran throughout August, has cost £400-500mn but on the whole been successful in reviving a beleaguered restaurant sector (and many restaurants have opted to extend at their own cost this price-discount scheme).

Prime Minister Johnson's government's fiscal largess has in large part been made possible by the Bank of England's so far unflinching commitment to quantitative easing, underpinned by its decision at its 19th March emergency meeting to increase its planned holdings of UK government bonds (gilts) and corporate bonds under its Asset Purchase Facility[1] by £200bn to £645bn. We will explore this theme and the likelihood of UK tax hikes in our next report.

Figure 6: Composite PMI data suggest GDP growth slowed from record-high in June but remained positive



Source: 4X Global Research, IHS Markit, Office of National Statistics

*Note: * Weighted average of manufacturing and services Purchasing Managers Indices*

These stimulative fiscal and monetary policy measures, alongside a gradual easing of national lockdown measures, particularly in the critical hospitality, leisure and entertainment industries, have contributed to a sharp rebound in UK economic growth, albeit from a very low base. UK GDP growth surged to a record-

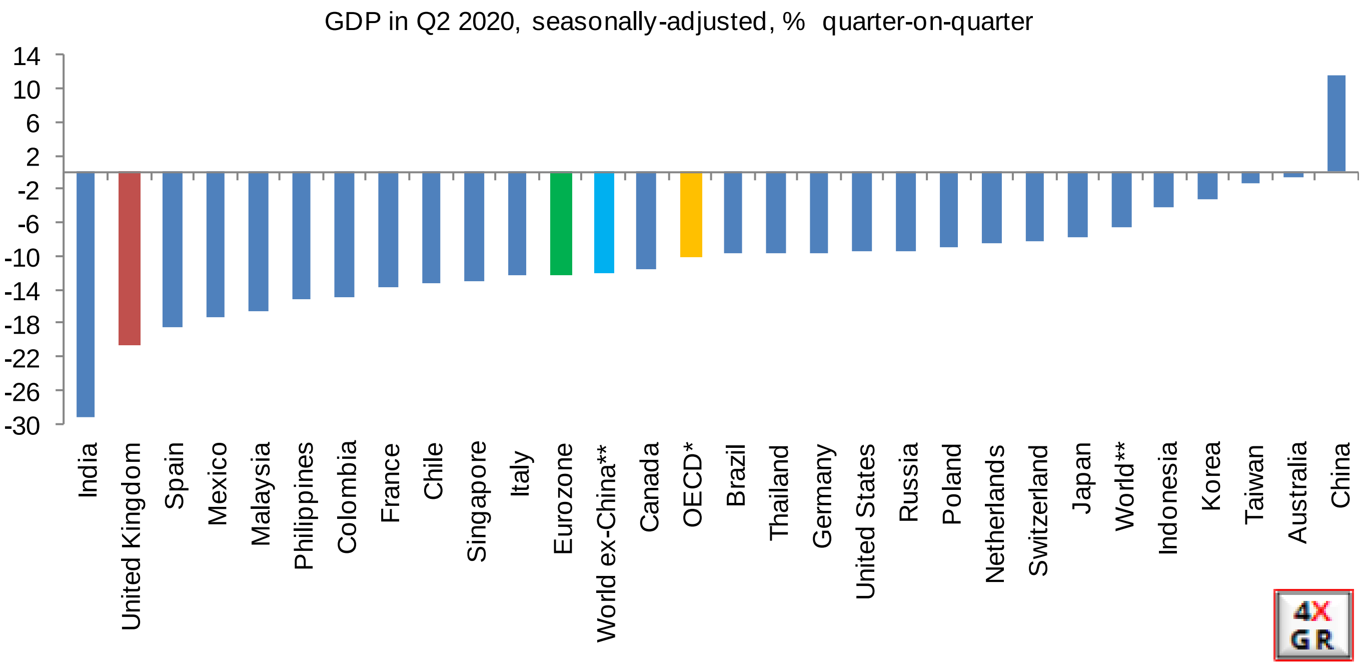
[1] The Bank of England's total holdings amounted to £445bn as of 18th March and the central bank had effectively hit the ceiling on the amount of gilts and corporate bonds it could purchase.

high 8.7% month-on in June and composite PMI data suggest that GDP growth slowed but remained positive in July and August (see Figure 6).

Markets have seemingly turned blind eye to UK' underperformance on a number of fronts

At the same time markets have seemingly ignored the British economy's material underperformance relative to other major economies in Q2 and the first half of 2020 and the government's arguably incompetent and incoherent handing of the covid-19 pandemic.

Figure 7: The UK's 20.4% qoq GDP contraction in Q2 was the second largest among major economies



Source: 4X Global Research, Eurostat, IMF, national statistics offices, OECD

*Note: * Organisation of Economic Cooperation and Development (latest data); **4X Global measure using PPP-weights*

Despite the central and local government's total expenditure surging to £355bn (17.7% of annual GDP) in April-June from £256bn (11.5% of GDP) in the corresponding period of 2019, UK GDP contracted a seasonally-adjusted 20.4% quarter-on-quarter in Q2, in line with our forecast of 20.6% qoq (see Retail Sales Key to UK Economic Growth Recovery, 30th July 2020). This was not only the largest fall in quarterly GDP since World War Two but also the second largest contraction among major economies which have so far released Q2 data[2], after India (-29.3% qoq), a far poorer country with arguably far less fiscal and

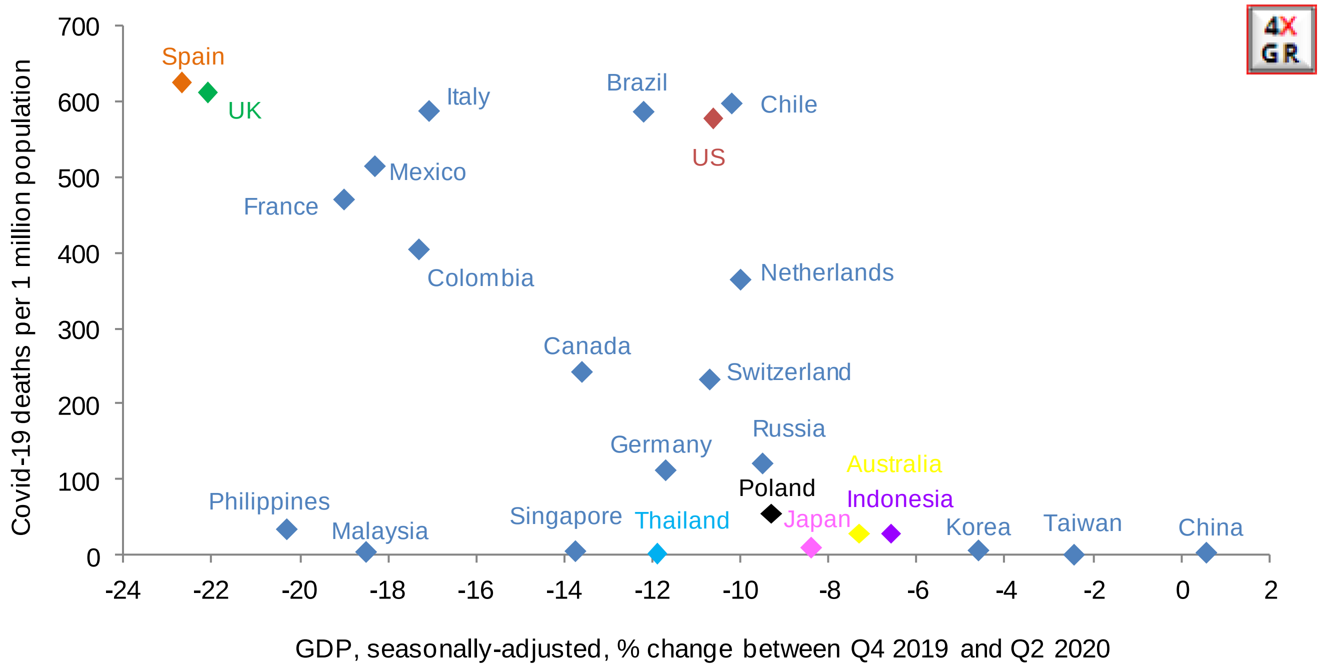
[2] South Africa is due to release Q2 GDP data on 8th September (consensus forecast is -11% qoq according to a recent Reuters poll) and New Zealand on 16th September (investing.com consensus forecast is: -1.0% qoq).

monetary firepower than the UK (see Figure 7). In comparison GDP in the Eurozone and OECD contracted by "only" 12.1% and 9.8% qoq, respectively. Similarly, GDP in the United States – another service-based, developed economy – contracted "only" 9.5% qoq, less than half as much as in the United Kingdom.

In the first half of 2020 the UK's GDP contracted about 22% with GDP in June back to the level which prevailed in late-2009, in line with our forecasts (see United Kingdom: Back to 1999…and to the Future, 26th June 2020). Among major economies this was the third largest GDP contraction after India (-26.6%) and Spain (-22.7%).

The British government's record is further tainted by the fact that the UK has to date recorded one of the highest Covid-19 death rates-per-capita in the world, behind only on Peru, Belgium and Spain, with all the usual caveats of how Covid-19 deaths are measured and recorded across countries (see Figure 8).

Figure 8: Covid-19 pandemic has extracted a high cost from the British population and economy



Source: 4X Global Research, Eurostat, IMF, national statistics offices, OECD

UK economy faces potential quadruple hit, starting with unwinding of fiscal measures

The hit to the British economy from the country-wide lockdown, which only started to be eased in June, was assuaged by the government's introduction of a vast number of never-previously tried fiscal measures, including its furlough scheme for employees and the SEISS (see above).

However, the furlough scheme as of 1st September will only pay 70% of wages up to a cap of £2,187.50, with employers having to pay national insurance and pension contributions and 10% of wages to make up the 80% total up to a cap of £2,500. Moreover, as of 1st October the government will pay only 60% of wages up to a cap of £1,875, with employers having to pay national insurance and pension contributions and 20% of wages to make up 80% total up to a cap of £2,500. The furlough scheme will come to an end on 31st October so that as of 1st November employers will have to pay the entirety of their employees' wages along with national insurance and pension contributions.

Anecdotal evidence suggests that many employers, faced with reduced demand for their products and services, will be unable to meet their employees' wages and will be forced to lay off staff. If this proves to be the case the unemployment rate, which has been artificially kept in check at about 4%, could rise sharply towards year-end. This would likely have a significantly negative impact on the UK's aggregate wages and in turn on consumer demand and ultimately headline economic growth.

Moreover, the closing date for applications for the second and final one-off grant under the SEISS scheme is 19th October 2020. After that data self-employed workers will be unable to access this scheme and for many this conceivably will mean a significant reduction in income, which would add to the drag on consumer demand and GDP growth.

Spectre of higher taxes and spending cuts looms large

The Chancellor of the Exchequer Rishi Sunak has in recent weeks alluded on a number of occasions to the likelihood that the government will increase UK taxes. The timing of such an announcement remains uncertain but it could be as early as the Autumn Budget which based on precedent would take place in October or November (although should the UK be hit by a second-wave of Covid-19 cases the budget could be delayed till Spring 2021 and be replaced with a "mini budget" this autumn).

We think Sunak is in part being driven by the negative optics of a Conservative government running a persistently very high budget deficit. We would argue that a combination of tax hikes and spending cuts could weigh on already modest economic growth and in turn on Sterling – a theme we will explore in greater detail in our next report.

Risk of no-deal Brexit slowly coming into focus

Since the United Kingdom officially exited the European Union on 1st January, markets' focus has understandably been on the devastating impact of the Covid-19 pandemic and associated government measures. However, the UK's transitional agreement with the EU whereby the UK remains a member of the Single Market and Customs Union, ends on 31st December and there has in recent weeks been renewed focus on the British government's progress (or lack thereof) in securing a new trade with the EU.

Both sides are currently deadlocked over the issue of British state subsidies and UK fishing rights, with the EU's chief negotiator, Michel Barnier, having said that weekly negotiations could not progress until these two critical issues had been addressed. While the past few years suggest that both sides may be willing and able to compromise, Prime Minister Johnson has said that the UK would not seek an extension to its transitional agreement. If he sticks to his guns, time is of the essence as the EU has stipulated that a deal needs to be reached by October in order to allow the British Parliament, European Parliament and European Council sufficient time to vote through such a deal.

Should the UK and EU fail to reach an agreement on a new trade deal the UK would on 31st December (at midnight) revert back to World Trading Organisation commercial rules. Such a scenario would mean an end to frictionless, duty-free access to the EU and higher tariffs on British exports of goods and services to the EU, as well as customs controls. Given that over 40% of the UK's total exports go to the EU, the negative impact on the UK economy would likely be material in our view, as we discussed in Final Twist in Brexit Plot, 14th September 2018.

Ascribing odds to such a scenario remains an exercise in faith as well as rigorous analysis but the risk, in our view, is that over coming weeks financial markets start pricing in the possibility of a "no-deal" Brexit, which would in turn weigh on Sterling, UK equities and gilts. Figure 4 shows that historically an unwinding of substantial speculative long Sterling positions would result in a sharp correction in the currency.

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