4X Global Research

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

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Sterling – Fuel for thought

I will be speaking on the "Fixed Income and FX" panel at the (virtual) Global Independent Research Conference on 13th October at 12.30 (UK time). Click here for further details.

We turned bullish GBP/EUR in late-June and re-reiterated our constructive view in mid-July and early-August and the cross duly hit a 76-week high of about 1.182 on 11th August.

In line with our expectations, historical monthly seasonal patterns were up-ended thanks in part to the positive impact of international travel restrictions on the UK's tourism balance and the Bank of England turning more hawkish in absolute terms and relative to the ECB.

However, since then Sterling has weakened about 1.1% against the Euro and 1.5% in NEER terms, despite the Bank of England turning even more hawkish, markets now pricing almost three 25bp rate hikes in 2022 and a sharp widening of the Gilt-Bund yield spread.

The reason in our view is that Gilt yields have risen because of market expectations that UK CPI-inflation will rise from already elevated levels *despite* weak domestic economic growth, which renders UK financial assets (including Sterling) less attractive.

UK GDP growth slowed in July despite the government having removed on 19th July all but a few social distancing restrictions in England and PMI data suggest GDP growth remained weak in August-September. Notably the deceleration in economic growth in recent months was likely more pronounced in the UK than in the Eurozone, albeit from higher levels.

The UK economy faces a number of headwinds, namely i) acute labour shortages and supply-chain constraints and bottlenecks; and ii) multiple challenges to domestic demand.

On the demand-front the issue is not weak household purchasing power or strained corporate balance sheets but rather tepid consumer and business confidence as a result of planned tax increases in April 2022, furlough having ended on 30th September, fuel-shortages, rising CPI-inflation and likelihood that Bank of England will hike rates next year.

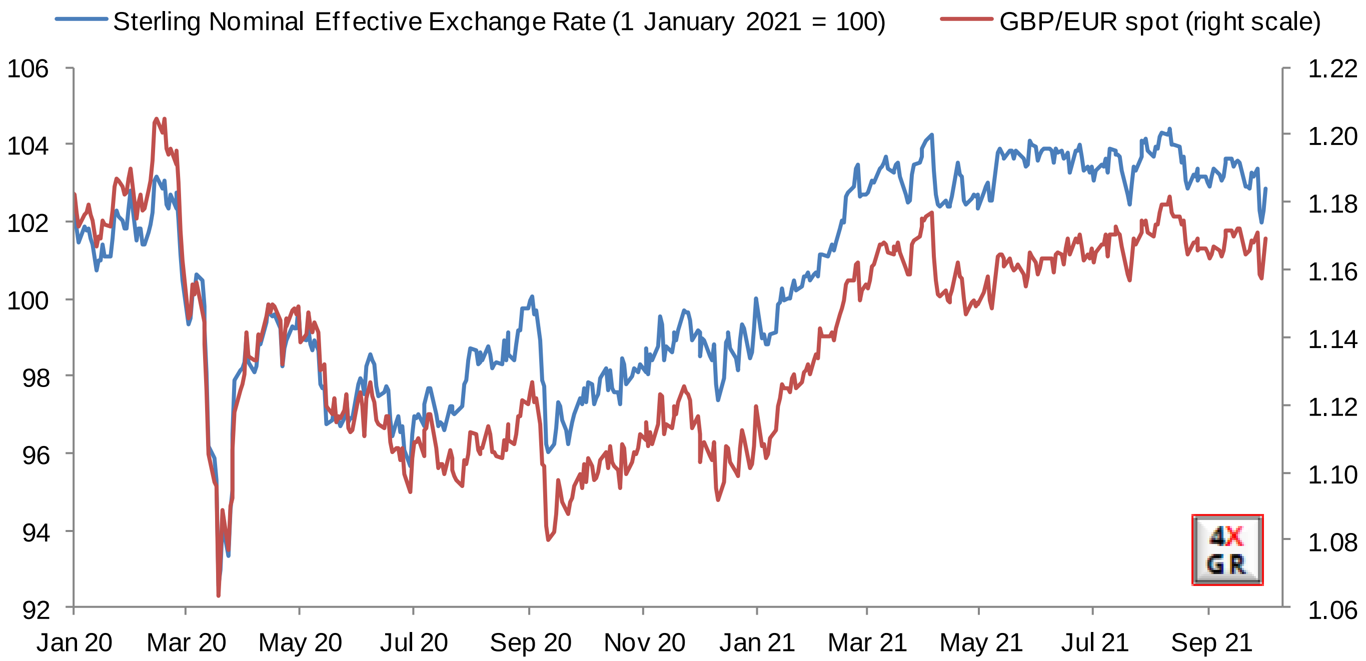
The risk is that the current shortage of fuel at forecourts will not be a one-off, in our view, because the ratio of vehicles to fuel forecourts has risen materially in the UK since 2000.

In the current context we find it challenging to build a bullish short-term case for GBP/EUR.

Sterling outperformed Euro in July and early august, in line with our expectations

Three months ago we turned bullish Sterling versus the Euro (see Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage, 29th June 2021) and we reiterated our bullish GBP/EUR view in mid-July (see Sterling's coming home…albeit slowly, 16th July 2021) and early August (see FX Focus: USD, GBP, NZD and THB, 6th August 2021). Our view was that international travel restrictions would shrink the very large UK tourism deficits typically recorded in July-August, including with Eurozone countries, and support domestic demand. This would in turn up-end Sterling's typical seasonal weakness versus the Euro in these two months. Moreover, we argued that as a result of higher CPI-inflation in the UK the risk was tilted towards the Bank of England's monetary policy stance becoming increasingly less dovish relative to the European Central Bank's which would further support GBP/EUR.

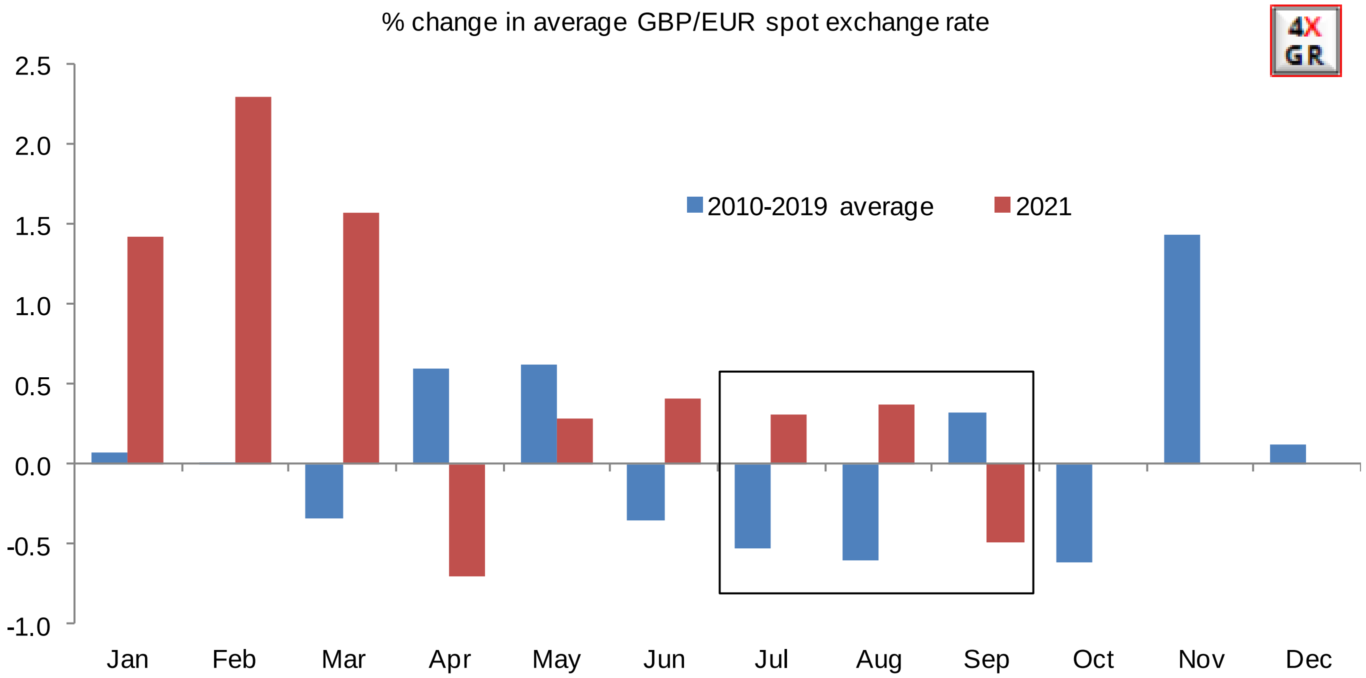
Figure 1: GBP/EUR hit its highest level since start of pandemic on 11th August but has since sold off



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

Sterling indeed outperformed the Euro throughout July-August, with the cross hitting 1.182 on 11th August, its high since the start of the pandemic in late-February 2020 (see Figure 1). This followed a hawkish turn by the Bank of England at its policy meeting on 5th August with Monetary Policy Council (MPC) member Saunders voting for an end to the QE program and the central bank revising up its peak CPI-inflation forecast to 4% in Q4 or twice its official target of 2% (see FX Focus: USD, GBP, NZD and THB, 6th August 2021). GBP/EUR averaged 1.168 in July, up about 0.3% from June, and 1.172 in August (+0.4% mom) according to our calculations. In comparison, in 2010-2019 GBP/EUR on average depreciated by respectively 0.5% and 0.6% in the months of July and August (see Figure 2). As we had predicted, historical monthly seasonal patterns were up-ended in these two months.

Figure 2: GBP/EUR confounded historical seasonal patterns in July and August…but also in September

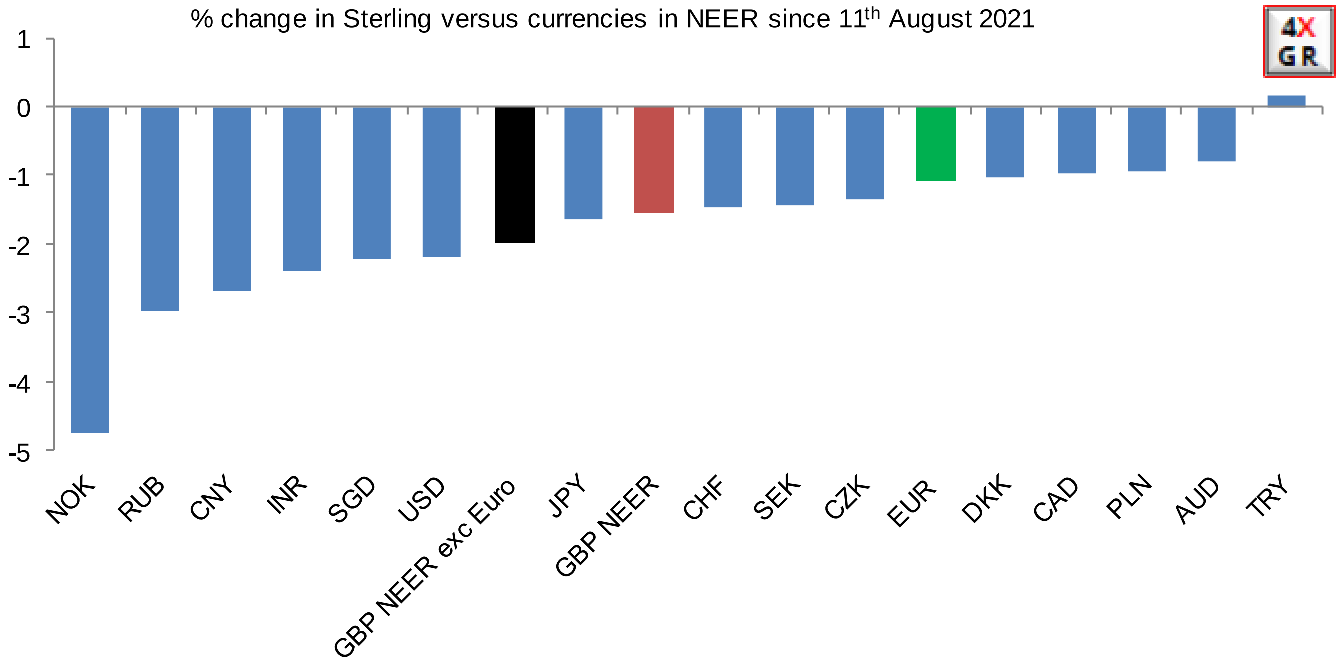


Source: 4X Global Research, Bank of England, investing.com

Sterling down versus major currencies since 11th August peak

However, since hitting a 76-week high on 11th August GBP/EUR has fallen about 1.1% at time of writing, having hit a 9-week low of about 1.158 on 29th September. Sterling has underperformed even more against most other major currencies (see Figure 3). Specifically Sterling has depreciated about 2.0% against the constituent currencies (excluding the Euro) of the trade-weighted Sterling Nominal Effective Exchange Rate (NEER). The average Sterling NEER in September depreciated about 0.5% from August, going against a historical seasonal pattern of Sterling appreciation (see Figure 2).

Figure 3: Since 11th August Sterling has depreciated against all but one of the NEER constituent currencies



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

The GBP/EUR cross has been particularly choppy this week despite the Bank of England having turned even more hawkish and markets having upped their pricing of policy rates hikes (see Figure 1). MPC member Ramsden joined Saunders in voting for an immediate end to the central bank's QE program at the policy meeting on 23rd September. Moreover, Bank of England Governor Bailey said on 27th September that all MPC members stood ready to hike the policy rate this year if needed to prevent higher inflation becoming persistent.

Markets are now pricing almost a full 25bp Bank of England rate hike (from 0.10%) by March 2022, a further 25bp hike by August 2022 and a total of almost three hikes in 2022. Two-year Gilt yields have surged about 27bp from 0.12% on 11th August to 0.39%, near their highest level since 18th March when yields briefly spiked above 0.45% (see Figure 4). In comparison 2-year German Bund yields have risen only 4bp over that period to around -0.7% at time of writing. As a result the yield spread between 2-year Gilts and Bunds has widened about 23bp since 11th August to 110bp – its widest since the beginning of the pandemic in mid-March 2020.

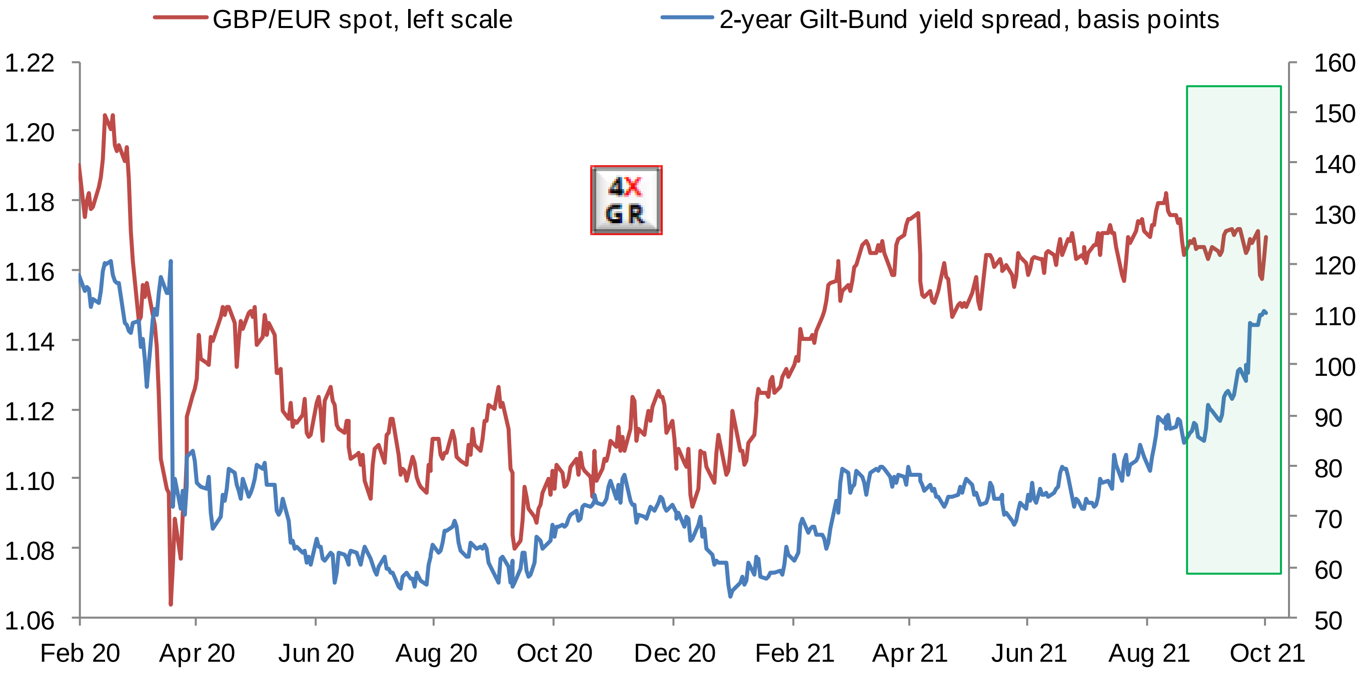
The more risk-sensitive Sterling underperformed the Euro in mid-August due to a bout of global risk aversion on 17-19 August. The latter was driven by a number of major economies (particularly in Asia-Pacific) re-introducing local or country-wide lockdowns in the face of rising cases of the more virulent Delta variant and the release of disappointing US retail sales figures for July. Moreover, the release on 18th August of ONS data showing a larger-than-expected fall in UK year-on-year CPI-inflation in July contributed to a narrowing of the Gilt-Bund yield spread, which in turn weighed on GBP/EUR in our view (see Figure 4).

Bank of England and markets turning more hawkish but for the "wrong" reasons

However, one would have expected the widening Gilt-Bund yield spread since 20th August to be supportive of GBP/EUR, as has been broadly the case since the start of the pandemic (see Figure 4). Instead GBP/EUR has been broadly unchanged (albeit choppy) despite the 2-year Gilt-Bund yield spread widening by about 26bp (see green shading).

We attribute this breakdown in the historical positive correlation to the underlying reasons why the UK rates market has turned more hawkish, both in absolute and relative terms. Specifically we would argue that Gilt yields have risen not because of market expectations that UK GDP growth will be strong and thus inflationary, which could still make UK financial assets (including Sterling) attractive to foreign investors, but instead because of expectations that UK CPI-inflation will rise from already elevated levels *despite* weak economic growth, which renders UK financial assets less attractive. In a nutshell, we think markets are starting to price in a stagflation scenario in the UK, which is arguably normally associated with emerging markets rather than developed economies such as the UK.

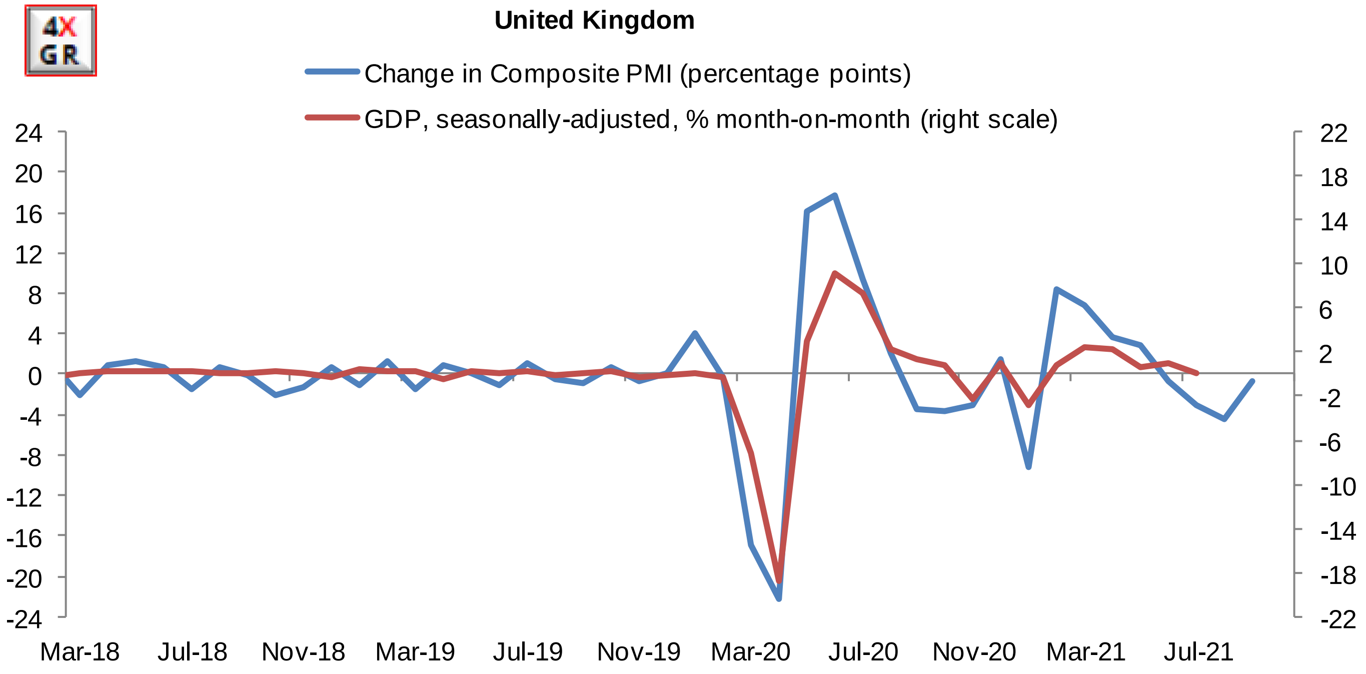
Figure 4: Positive correlation between GBP/EUR and Gilt-Bund yield spread has broken down



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

UK GDP growth slowed from 1.0% mom in June to 0.1% mom in July according to official albeit preliminary ONS data despite Prime Minister Johnson's government having removed on 19th July all but a few social distancing restrictions in England. GDP growth likely remained modest in August, due in part to a resurgence in Covid-19 cases, hospitalisation and death rates weighing on economic activity, and in September. The further fall in the UK Composite PMI in August and again in September to a seven month low suggests that UK GDP may have even contracted slightly in these two months (see Figure 5).

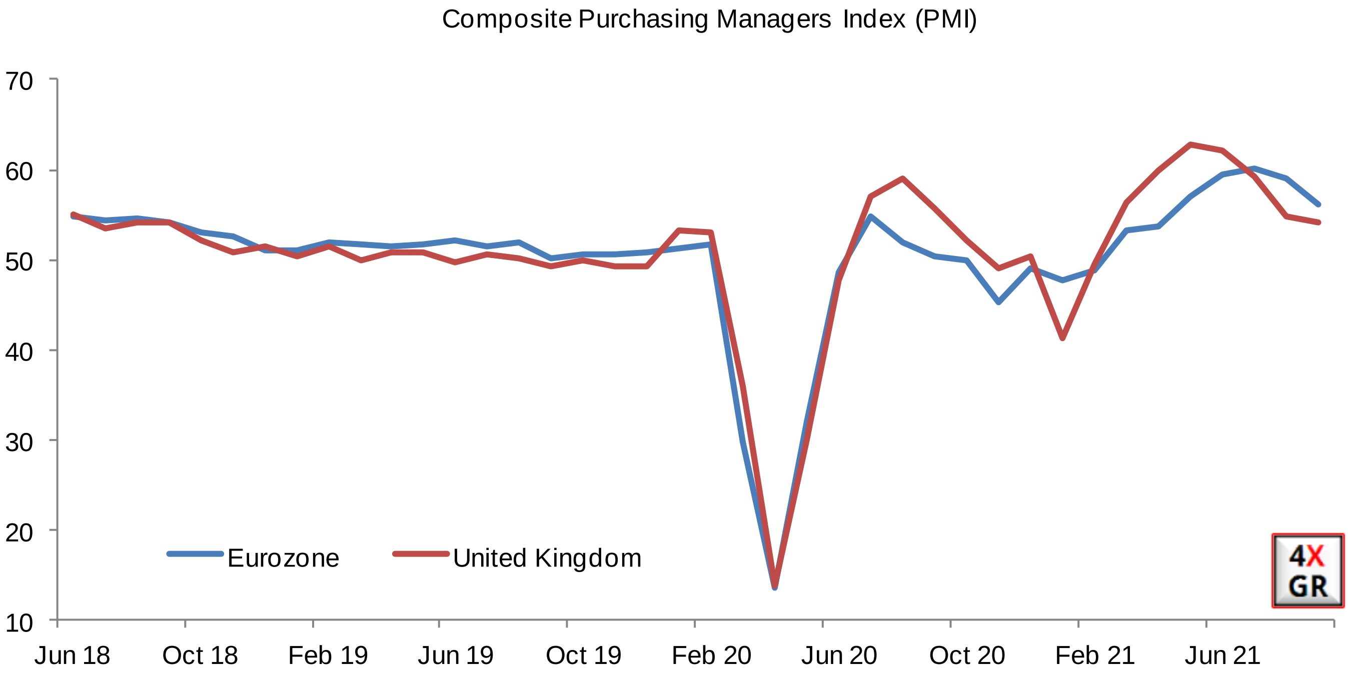
Figure 5: Fall in UK composite PMI in August and September points to weak monthly GDP growth



Source: 4X Global Research, IHS Markit, ONS

Notably the deceleration in economic growth in recent months was likely more pronounced in the UK than in the Eurozone, albeit from higher levels, based on Composite PMI data (see Figure 6).

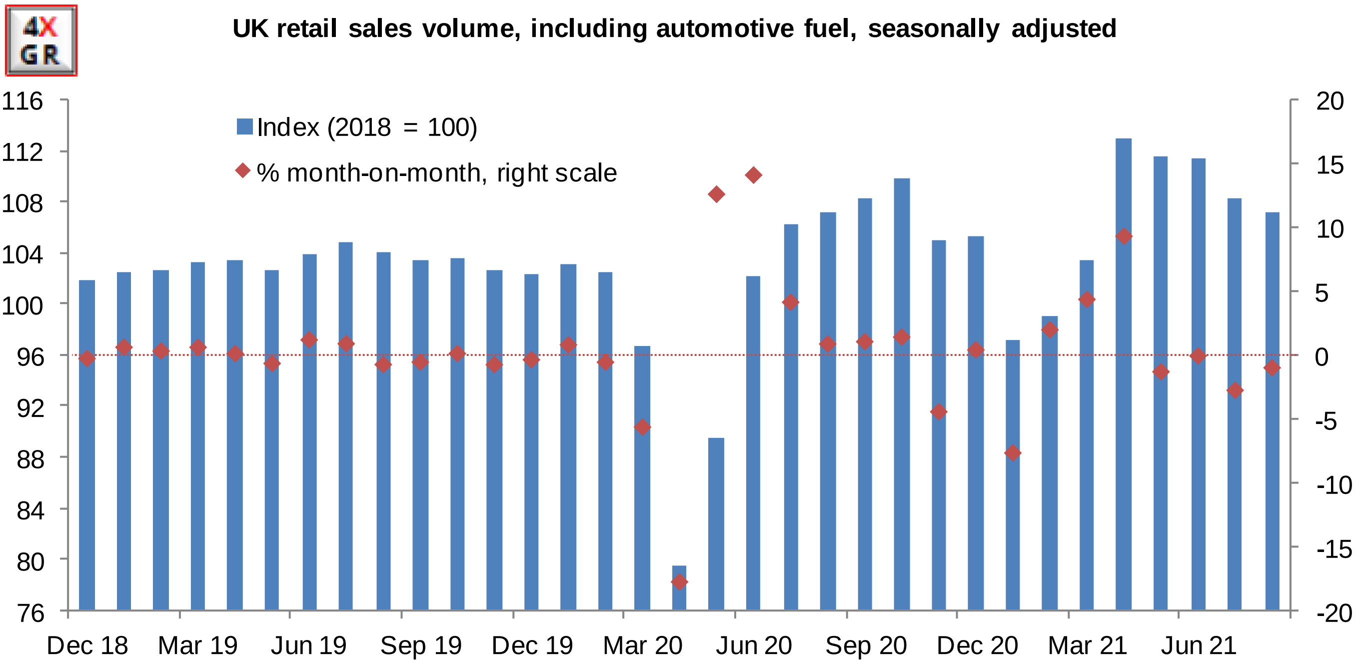
Figure 6: GDP growth was likely stronger in Eurozone than in UK in recent months



Source: 4X Global Research, IHS Markit

The unleashing of pent-up UK household demand spurred by massive savings, as forecast by Chancellor of the Exchequer Sunak and a number of MPC members, has proved short-lived and ultimately modest given weak demand in Q1 2021. The volume of UK retail sales rose sharply in April to a record monthly-high but has since fallen four months in a row by an aggregate 5.1% according to our calculations (see Figure 7).

Figure 7: UK retail sales hit record-high in April but have since contracted four months in a row



Source: 4X Global Research, ONS

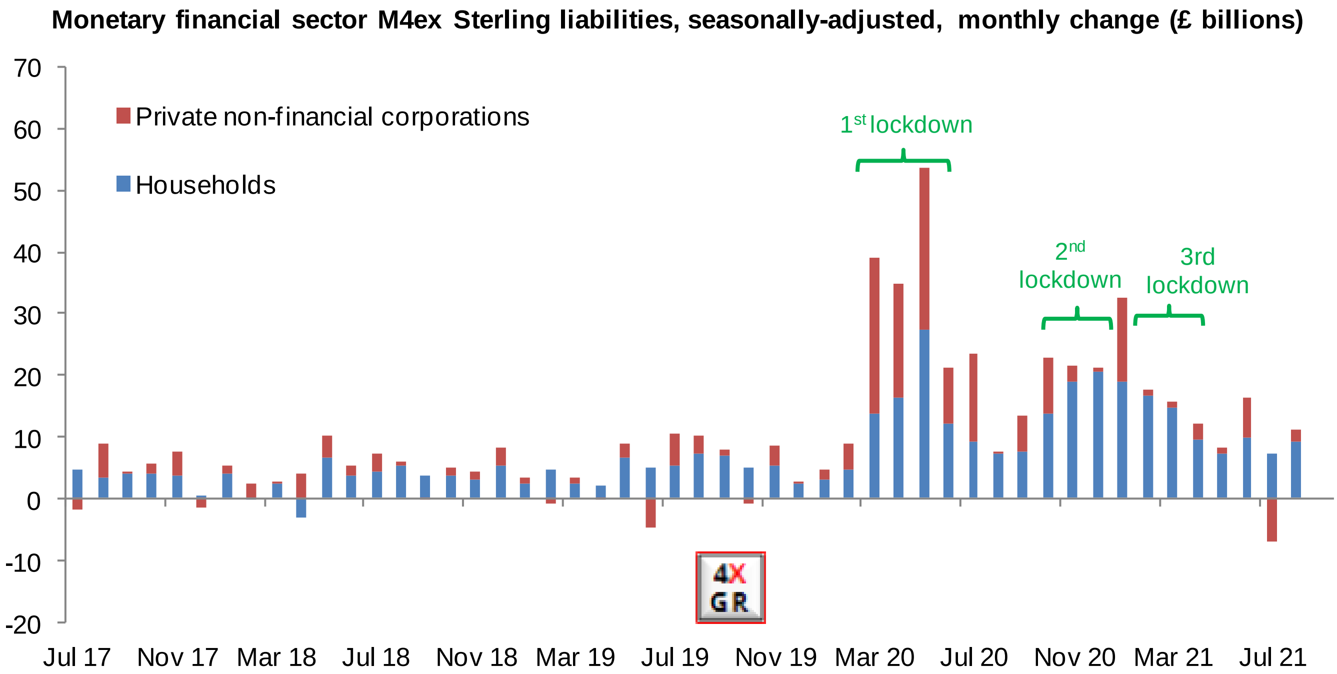
Headwinds to both UK supply and demand, including private-sector confidence

The UK economy continues to face a number of headwinds, namely i) acute labour shortages and supply-chain constraints and bottlenecks (including forecourt fuel shortages as detailed below) which are weighing on output; and ii) multiple challenges to domestic demand.

On the demand-front the issue is not such much weak household purchasing power or strained corporate balance sheets, in our view, but rather tepid consumer and business confidence as well as changing international travel patterns. Figure 8 shows that UK households' savings with commercial banks have in recent months risen more slowly but have continued to rise faster than pre-pandemic. Cautious UK households are maintaining high saving ratios by historical standards.

A number of factors, including the government's announcement of tax increases in April 2022, the end of the furlough program on 30th September, fuel-shortages, surging energy and fuel bills and likely further increase in CPI-inflation and the increasing probability that the Bank of England will hike rates next year, are weighing on confidence in our view.

Figure 8: UK households' cash deposits with banks still rising faster than pre-pandemic



Source: 4X Global Research, Bank of England

Tax hikes

The government announced on 7th September that as of April 2022 UK workers (including pensioners) and employers would pay a new 1.25% tax on their earnings (the largest personal tax rise in decades) and share dividends to pay for a £12bn a-year package to fund the National Health Service and reform social care. This announcement was in line with our long-held view that even a Conservative government would opt to hike taxes in the wake of the pandemic (see UK & Sterling facing potential quadruple whammy, 4th September 2020, and United Kingdom: Anatomy of economy on lockdown life-support, 18 June 2020).

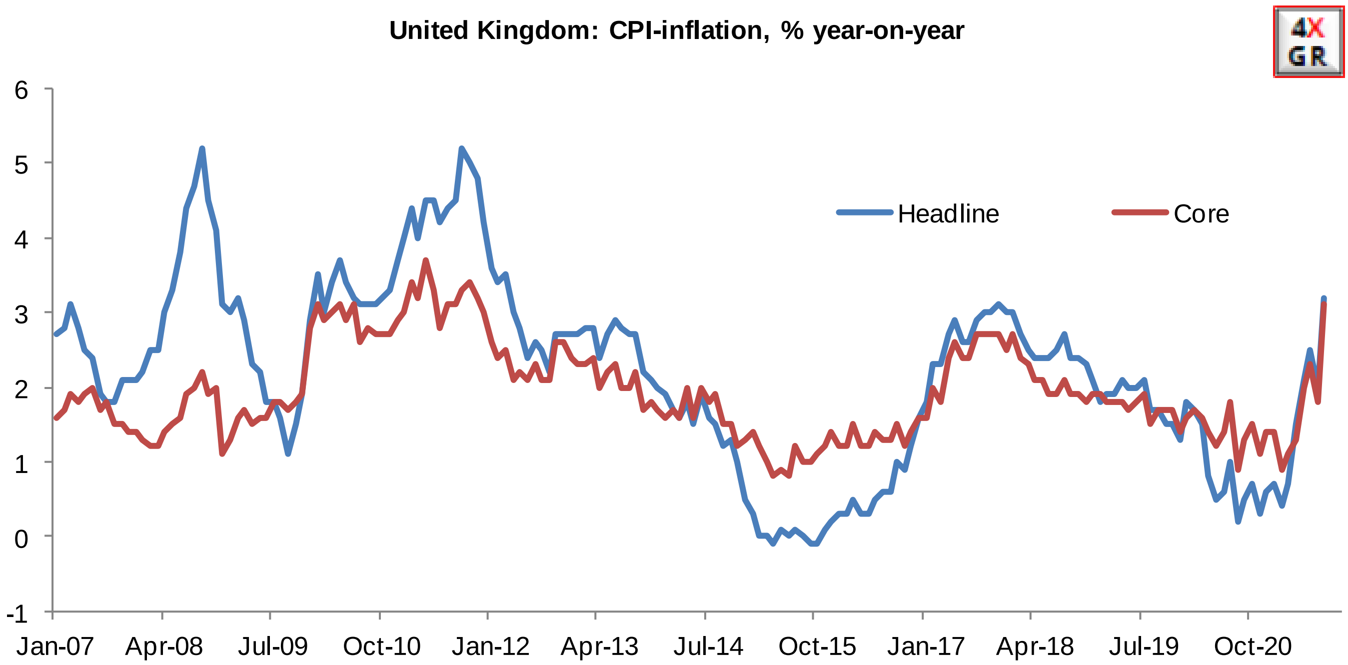
End of furlough program

The government's furlough program (officially known as the Coronavirus Job Retention Scheme), which was introduced in March 2020, ended yesterday, with the government having spent about £70bn subsidising the wages of about 12 million workers. Over one million workers are estimated to have still been furloughed as of end-September. While the end of furlough may help ease labour shortages in the UK, it is conceivable that the UK unemployment rate, an admittedly modest 4.6% in the three months to July, will rise in coming months as some of these workers are laid off and struggle to find re-employment.

Rising CPI-inflation and likely Bank of England rate hikes

UK CPI-inflation has risen and will likely rise further because of endogenous and exogenous shocks rather than strong domestic growth, in our view. Headline CPI-inflation and core CPI-inflation, which excludes typically more volatile food, energy, tobacco and alcoholic beverage prices, rose to respectively 3.2% yoy and 3.1% yoy in August – the highs in over nine years (see Figure 9). This was in line with our view that headline CPI-inflation was likely to exceed the Bank of England's peak forecast of 3% which it made back in late-June (see Sterling's coming home…albeit slowly, 16 July 2021).

Figure 9: UK CPI-inflation has risen well above Bank of England's 2% target and will likely rise further



Source: 4X Global Research, ONS

Importantly the rise in year-on-year CPI-inflation in August was not just due depressed prices last year (i.e. unfavourable base effects) as a result out of the "Eat out to Help out" scheme. Month-on-month CPI-inflation hit about 0.72% for both measures of CPI-inflation in August. This was a 10-year high for headline CPI-inflation and the joint highest measure in three years for core CPI-inflation according to our estimates.

Surging European gas prices and international crude oil prices have resulted in soaring energy and fuel bills for households and corporates (and the collapse of a number of small UK energy providers). Petrol and diesel prices have risen further since the start of the forecourt fuel crisis a week ago. Moreover, the VAT rate is due to rise today to 12% from 5% for pubs, restaurants and other hospitality businesses and is due to be increased to its pre-pandemic rate of 20% in April 2022.

As noted above Gilt yields have risen sharply in recent weeks, which will add to the private sector's cost of servicing (variable rate) loans and by extension weigh on the ability and willingness to spend and invest in our view. Moreover, expectations that the Bank of England will hike its policy rate next year from a current record-low of 0.10% (as of noted above) will further weigh on the willingness of households on variable-rate mortgages to spend today in our view.

Beyond these multiple hits to consumer and corporate confidence, we suspect that the British government's relaxation of international travel restrictions in recent months along with very UK wet weather has led to an increase in the number of UK residents travelling abroad relative to the number of foreigners visiting the UK. If this was the case this will at the margin have weighed on the UK's current account tourism balance and Sterling.

United Kingdom's fuel crisis unlikely to be a "one-off"

The United Kingdom is now one week into a fuel crisis which has seen many fuel courts (commonly referred to "petrol stations" even though they supply both diesel and petrol) running either empty or very low. To be clear this problem has not been caused by a shortage of fuel at refineries or fuel depots – fuel remains plentiful at this point in the supply chain. Instead this crisis has been caused by a shortage of Heavy Goods Vehicles (HGVs) drivers – which take fuel from depots to forecourts – exacerbated by "panic" buying.

Specifically about a week ago the media reported that a small percentage of UK forecourts had run out of fuel due to a shortage of HGV drivers, the latter caused by a combination of factors, including:

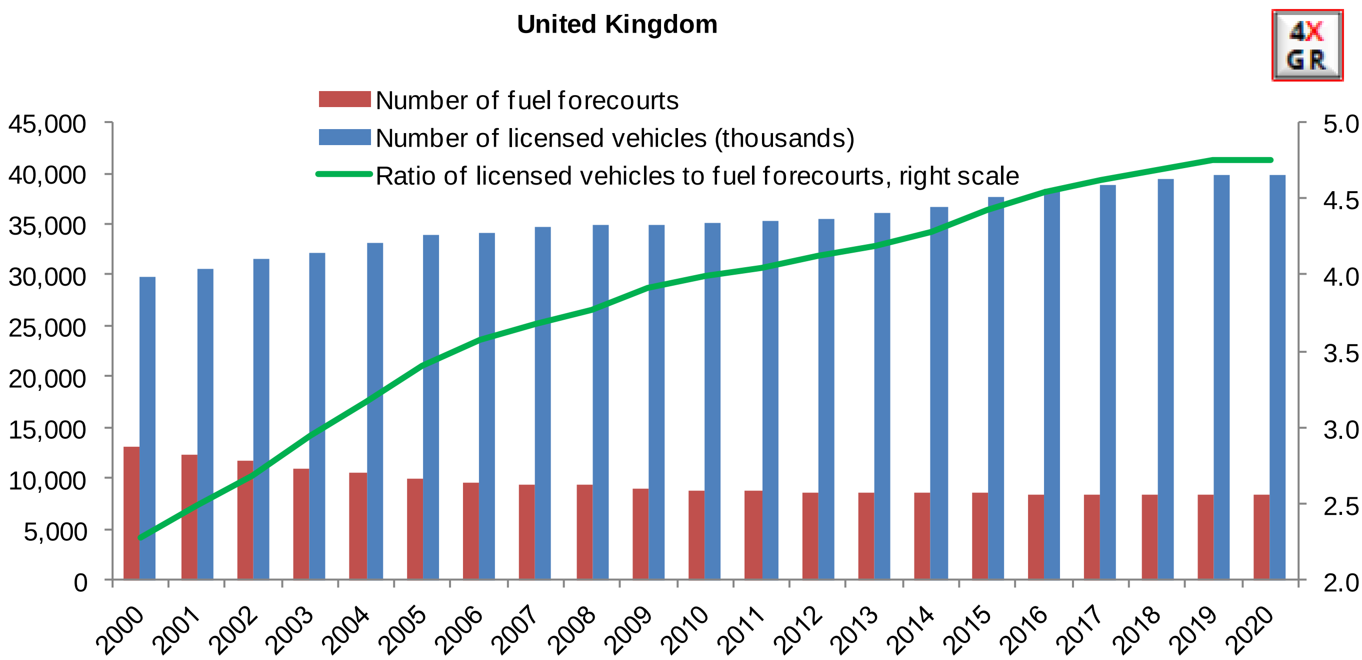
- The after-effects of the pandemic which have included HGV drivers testing positive for Covid-19 and being unable to work and delays in getting drivers HGV certified;
- Brexit which has seen a sharp fall in the number of HGV drivers from the EU; and
- The government's furlough program, which has resulted in a number of HGV drivers effectively being paid not to work;

These media headlines arguably sparked panic buying by UK motorists, resulting at one point in over half of the UK forecourts running out of fuel. This problem has been particularly acute in England and in particular in large cities where there is a high ratio of vehicles to forecourts. The government's mixed message in the past 48 hours – the supply-and-demand mismatch is stabilising but fuel shortages could persist till Christmas – has arguably added fuel to the fire.

There is another reason why we believe this fuel crisis has materialised and could occur more frequently going forward, namely a sharp rise in vehicles in the UK alongside a sustained fall in the number of forecourts in the past twenty years (see Figure 10). Between 2000 and 2020 the total number of vehicles registered in the UK, which includes private and light goods vehicles, goods vehicles, motorcycles, scooters and mopeds and other vehicles increased by about a third from just under 30 million to just under 40 million (during that period the share of less fuel-intensive vehicles such as motorcycles, scooters and mopeds has remained broadly constant at around 3% according to our estimates).

At the same time in the past two decades the number of forecourts has fallen by about 36% (see Figure 10). According to the UK Petroleum Industry Association this has been due to smaller and more remote filling stations having closed while supermarkets have rapidly expanded their large out-of-town stores and increased their share of the retail fuels market from 11% in 1992 to around 45% in 2018. Our take is that smaller, independent forecourts have struggled to compete with supermarkets' typically lower fuel prices and have found it profitable to sell up given the increase in the price of land and property in the past twenty years. This has certainly been the case in cities such as London which has seen many forecourts close and replaced with residential developments.

Figure 10: Ratio of vehicles to fuel forecourts in UK has increased sharply in past two decades.



Source: 4X Global Research, UK Department of Transport, UK Petroleum Industry Association

Note: Licensed vehicle data prior to 2014 are estimated from data for Great Britain (which excludes Northern Ireland)

The result is that the ratio of vehicles to fuel forecourts has doubled since 2020 (see Figure 10). This simple analysis admittedly likely overstates the imbalance between fuel demand forecourt supply. First, the average number of miles driven annually by motorists in England fell from 9,200 in 2002 to 6,800 in 2020 or about 26% according to the Department for Transport. Second, fuel efficiency has improved over the period so that vehicles, all other things being equal, do not have to be refuelled as often. Third, the number of Ultra Low Emission Vehicles (ULEVs) – which can run at least partly on electricity – accounted for 1.1% of all licensed vehicles in the UK at the end of 2020 compared to near zero in 2020 according to government data. Finally supermarket forecourts tend to be much larger than independent forecourts and are thus able to store far more fuel at any point in time.

Nevertheless, these trends are likely to have only partly compensated for the doubling in the ratio of vehicles to fuel forecourts since 2000. The bottom line is that when there is panic buying, forecourts are likely to run out of fuel faster than they would have done twenty years ago in our view. The number of HGV drivers may well rise in coming weeks and months – thanks to the government extending (temporary) visas to EU drivers, a speeding up of the accreditation process, increases in wages for HGV drivers and furlough having ended – which will help at least in the medium-term.

However, it does little to address the fact that there are too few forecourts in the UK relative to the number of vehicles on the road which still rely fully or partly on petrol or diesel. This is a structural problem for which there is no easy fix – which may explain in our view why the government in the past week has been very quiet on this point (more bizarrely the media has failed to mention these trends in vehicle and forecourt numbers).

In the current context we find it challenging to build a strong bullish short-term case for GBP/EUR, even at current levels.

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