Market Watch

Sterling plunges

Summary
Sterling fell over 7% from Thursday's close to its intra-day lows today against the US dollar as the government announced plans to cut taxes and increase spending.

The GBP is likely to remain vulnerable in the near term. Technical support for GBP/USD at 1.05, a break of which may open the path to 1.00.

Fiscal stimulus and GBP weakness positive for large cap UK equities. The stimulus should be a positive for growth, while GBP weakness should support corporate earnings of companies with significant overseas revenue.

Fiscal stimulus in the works
The new UK government enters the stage with the economy in a dire situation. It is difficult to imagine a more difficult macro situation for the incoming government. Headline inflation is a whisker away from double-digits and core inflation is running at over 6%. One key driver of this inflation is rising electricity bills in the face of gas shortages as Russia curtails exports in response to increased sanctions, which in turn were a response to the war in Ukraine. The combined impact of the hit of rising energy bills to consumer purchasing power and the rapid increase in interest rates – the Bank of England has hiked interest rates by 2% this year with more likely in the coming months – means consensus expects a full year economic recession in 2023.

No easy policy fix. Of course, there is no easy fix to the situation. Falling growth expectations and very high inflation rates are being witnessed across the developed world, but the situation in Europe is more severe given its reliance on Russian gas. The UK government clearly wants to ease the burden of increased electricity prices on consumers. To achieve this, the government has unveiled a fiscal stimulus which includes tax cuts worth GBP 45bn and support for covering energy costs worth GBP 60bn over the next 6 months. While this is a direct positive for the economy, the picture is muddled by the fact that it may put additional upward pressure on inflation, requiring the Bank of England to tighten monetary policy even more aggressively than it was.
intending to (the weaker GBP will also increase inflationary pressures to some degree). Meanwhile, the fiscal stimulus will add to the government’s funding requirements at a time when the BoE was already intending to sell GBP 80bn of government bonds in the coming 12 months to reduce the size of its balance sheet. There are concerns that investors will require a higher risk premium to fund this deficit, both in terms of a weaker GBP and higher local currency bond yields.

**Economic outlook remains fragile.** Overall, the UK economic situation is likely to remain fragile. At the margin, this stimulus might reduce the downside risks for the economy in the coming 12 months, but it is unlikely to result in a significant upgrade to growth expectations.

**GBP still vulnerable to further losses near-term**

The GBP tumbled to a record low on Monday as investors closed long positions and stop losses were likely triggered after the newly announced UK fiscal plan by Finance Minister Kwarteng spooked markets. GBP/USD fell more than 7% from Thursday’s close to today’s intra-day low of 1.0382 before rebounding. EUR/GBP, though, continued to ascend as inflation concerns weighed on the GBP – our short-term bullish EUR/GBP trade is up 3.1% since inception as of this morning (see our Daily FX Navigator for more).

Markets are now speculating whether an emergency BOE meeting, rate hike or even an intervention would be called to stem the decline in the pound. However, the latter seems to be unlikely, or at best, ineffective. The UK’s FX reserves stand at around USD 110bn vs 1.2tn for Japan, limiting the BOE’s ability to stabilise the GBP through direct intervention.

While stagflationary and negative real yield dynamics continue to weigh on the GBP, the focus is shifting towards growing twin deficit (fiscal and current account) which adds further downward pressure. The next key support for GBP/USD sits at 1.05, and a break below this could see the pair head towards parity.

**The case for UK large cap equities**

Risk-off sentiment took hold in the UK stock market. Global recessionary fears have triggered a massive sell-off in risk assets over the previous weeks. UK equities were no exception, with the FTSE 100 Index dipping around 2.5% from last Thursday’s close to intra-day lows on Friday. The decline is likely to extend near-term as the market prices in weakening economic figures.
**UK equities remained a preferred region.** That said, we still view UK equities positively and expect the region to outperform broader equity markets in the coming 12 months, amid its heavy weighting in defensive sectors such as energy and financials, as well as high dividend yield. We expect the proposed package of tax cuts by Chancellor Kwarteng and further fiscal stimulus to support corporate earnings, while GBP weakness provides further tailwinds for companies and sectors with significant overseas revenue.

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