

FX Viewpoint

Currencies
Global

GBP: Running out of steam

- ◆ The GBP's year-to-date outperformance has been supported by both rates and positive risk appetite ...
- ◆ ... but GBP-USD looks rich relative to its rate differential amid overly dovish market expectations for the Fed's policy rate
- ◆ Should markets pare back Fed rate cut expectations and/or global risk appetite falter, the GBP may face downside risks

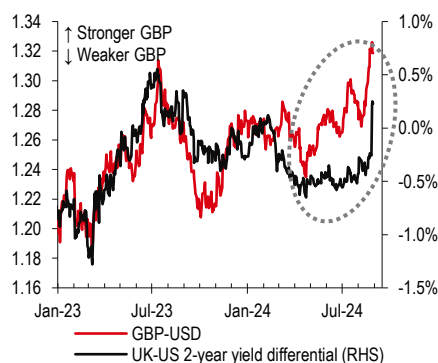
As we approach September, the GBP retains its title as the best performing G10 currency so far this year, with a year-to-date gain of about 3.5% against the USD (*Bloomberg*, 29 August 2024). **Both rates and positive risk appetite have been crucial to the currency's resilience.**

However, **GBP-USD looks rich relative to its rate differential** (Chart 1), which has been driven by the overly dovish market expectations for the Federal Reserve's (Fed) policy rate path. We remain unconvinced that the Fed will match the current market expectations of about 100bp of rate cuts by year-end (*Bloomberg*, 29 August 2024). A paring back of Fed rate cut expectations is likely to move in favour of the USD, further stretching the mismatch between GBP-USD and its rate differential, unless GBP-USD moves lower. In addition, **a slower-than-expected pace of Fed easing** (when happen) **could weigh on global risk appetite**, removing another pillar of support for the GBP.

While we look for a weaker GBP, we acknowledge that **not all elements pose downside risks**. The UK narrative could offer some support for the GBP. For example, the UK's activity surprise index has been relatively stable and even began to move higher again in August, outperforming the Eurozone's one and matching the US's one (Chart 2).

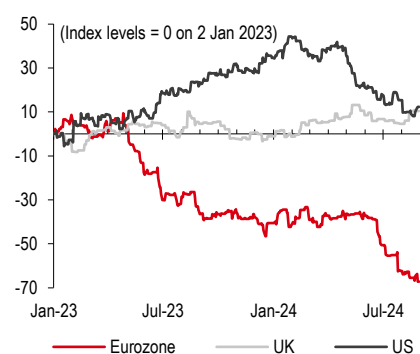
Unlike the Fed where we believe market expectations are overly dovish, **pricing for the likely Bank of England (BoE) rate path seems to be plausible**. Markets are now pricing in about a one-in-four chance for a 25bp rate cut at the 19 September BoE meeting, with **a rate cut in November being fully priced in (which our economists agree)**. Before the end of 2024, markets expect around a 50% chance that there will be a total of two cuts, rather than one (*Bloomberg*, 29 August 2024).

1. GBP-USD vs rate differential



Source: Bloomberg, HSBC

2. HSBC activity surprises indices: US, UK and Eurozone



Source: Bloomberg, HSBC

The GBP is the best performing G10 currency so far this year ...

... but the GBP could face a double whammy of an increasingly stretched position relative to rates and a weaker risk appetite

Economic activity in the UK looks less subdued than in the Eurozone

Market pricing for the BoE seems plausible, with no urgent need for a cut in September

Disclosure appendix

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