Sterling: how low could it go?

Economic commentary

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Key points

- The US dollar continues its strong run as the Federal Reserve keeps up its aggressive tightening of monetary policy. The US policy rate is now expected to top out at 4.50-4.75% early next year.

- Sterling has lost more ground against the dollar than any other major currency, with the exception of the Japanese yen. This reflects not only the more relaxed approach to monetary tightening being taken by the Bank of England, but also the UK's big current account deficit, the prospect of a steep increase in government borrowing, and post-Brexit frictions with the EU.

- HSBC has therefore revised down its forecasts for the sterling/dollar exchange rate, with the pound now expected to fall to $1.10 by the end of this year, before settling at around $1.08 during 2023.

- With currency markets often liable to overshoot, a fall in the value of the pound to parity with the dollar can't be ruled out. But even if that were to happen, it's unlikely that parity would be sustained.

In the past few weeks, any mention of sterling has usually been accompanied by the phrase: "trading at its lowest level against the dollar in 37 years". The pound has shed more than 16% of its value against the dollar since the start of the year, so that on the morning of 22 September it was trading at just over $1.12. The recent weakness has arisen partly from decisions on the other side of the Atlantic by the Federal Reserve about US interest rates, but also reflects mounting evidence that the UK's economy is slipping into recession. Sterling's weakness has even revived speculation that it could fall as low as parity against the greenback. This piece sets out to explain why sterling has come under such heavy selling pressure, and how far it might yet have to fall.

King dollar

Before getting into sterling's particular problems, it's important to appreciate that the recent movements have been largely down to developments on the other side of the exchange rate, namely a stronger dollar. In sterling's case, for instance, the 16% fall against the dollar, since the start of the year, compares with a decline of just 4% against the euro. The pound is by no means the only currency that has suffered against the rampant dollar, although the Japanese yen is the only major currency to have experienced a steeper decline, losing more than a fifth of its value since January. In recent years, the euro has traded against the dollar in a narrow range of $1.10-1.15, but has now found itself below parity. The upshot is that in trade-weighted terms the dollar is at its highest level in two decades.

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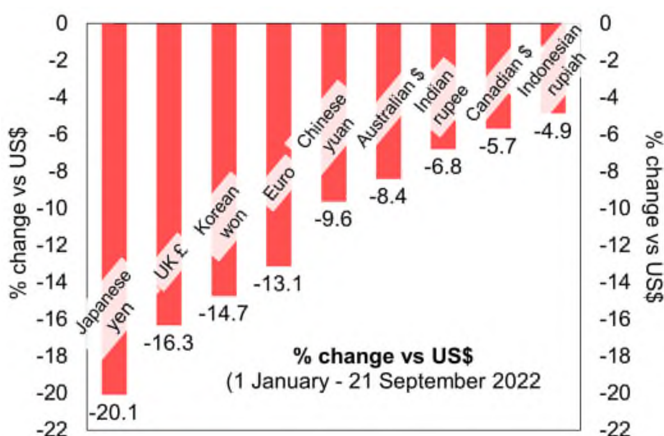
The reason for the dollar's bull run isn't hard to find. Having made a belated start to tightening monetary policy, back in March, the Federal Reserve has since adopted an aggressive stance in raising interest rates in order to get control of inflation. Although the initial rate hike was a timid 25 basis points, the pace has since stepped up markedly, with the Fed now having delivered three consecutive rises of 75 basis points at its policy meetings in June, July, and on 21 September. Moreover, the statement which accompanied the September announcement, and the forecasts made by individual members of the rate-setting committee, have made it clear that rates are heading higher than the markets had bargained for. The Fed sees the fight against inflation as its over-riding priority, and seems quite prepared to tip the US economy into a recession to win the battle.

Expectations that the Fed would maintain its aggressive stance were heightened by US inflation data for August. Although the annual rate fell slightly compared with July, easing back from 8.5% to 8.3%, 'core' inflation, which strips out food and energy prices, continued to rise, with prices increasing by 0.6% in the month of August alone. With inflation having escaped from the narrow confines of food and energy to the wider economy (as indeed it has in other major economies), it's becoming all too apparent that getting it back under control is going to be a harder and longer fight than the policymakers had anticipated.

Most analysts have therefore lifted their forecasts for US interest rates, and HSBC now expects the federal funds target rate to peak at a range of 4.50-4.75% in February of next year. These developments are likely to boost the dollar still further, especially as other major central banks are not, for the moment at least, signalling any intention to raise their interest rates as quickly or to the same level. By way of example, HSBC thinks that the European Central Bank will call a halt to its rate hikes once the deposit rate reaches 2.00%.

The strength of the dollar is therefore set to persist until the Fed starts to signal that the cyclical peak for interest rates is in sight, and especially when it begins to hint that rate cuts may be on the way. But both of these points could be some way off.   Although the US economy is grappling with surging food and energy costs, just like everybody else, it isn't in the same predicament as most other countries when it comes to natural gas. It has abundant domestic supplies, with prices being about a fifth of those prevailing in Europe and Asia. The USA doesn't, therefore, face the prospect of massive price hikes and the rationing of industrial use during the coming winter. In other words, America does not face the same heightened recession risk that many other advanced economies are facing. The upshot is that the Fed can do more, and indeed may have to do more, in the way of rate hikes in order to curb domestic demand and squeeze out inflation, compared to other central banks.

The US dollar reigns supreme in 2022



Source: Refinitiv Datastream

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Twin deficits

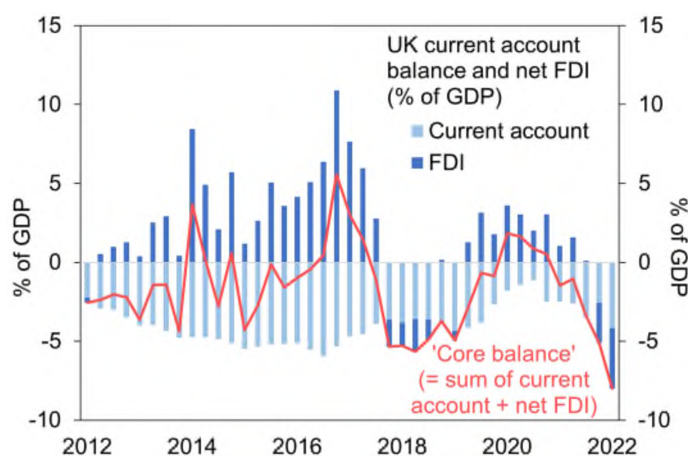
Although dollar appreciation clearly explains a large part of sterling's recent weakness, there are also domestic factors at work. The likelihood of a recession in the UK, which indeed may have already begun, is a factor often cited in media reports for the pound's weakness. Clearly, the challenging growth outlook isn't helpful, and the response to last week's release of retail sales figures is a reminder of how markets react to negative economic news. Yet, here again, the UK is not alone in facing such a predicament, and indeed could well get through the coming winter with a smaller decline in its economic activity than some other countries, notably Germany. Russia has never been an important supplier of gas to the UK, and the energy price support packages announced by the government will help to sustain economic activity.

Unfortunately, it's not just the UK's immediate growth outlook, which has prompted the markets to take a bearish view of the pound. To start with, there is the old chestnut of the balance of payments. The deficit on the current account has widened considerably during the past year, thanks in part to the surging cost of imported energy products, but also due to the lacklustre revival in UK exports. Another factor that has negatively affected the current account is the revival of outbound tourism as the world has re-opened after the Covid pandemic, with the money spent by Brits as they take holidays abroad representing imports of services.

The shortfall on the current account is now at the highest level ever recorded, reaching 8.3% of GDP in the first quarter (figures for the second quarter will be released on 30 September). The shortfalls on the current account have to be financed by net inflows of foreign capital. Some of those flows may be long-term investments in new projects or in the acquisition of British businesses, but if demand is still insufficient, then the price of the pound against other currencies will fall until sufficient short-term funding can be attracted.

Besides the widening current account deficit, a troubling development of the past year or so has been the negative balance on foreign direct investment (FDI), which is the part of the capital account related to long-term investment flows. The upshot is that during the year to March, the UK's 'core balance', which aggregates the current account position and the FDI position, was in deficit to the tune of just over 8% of GDP. There's no rule which says that the markets must sell the pound when such and such a measure gets to a particular level, but with the shortfall as big as it is, sterling will remain vulnerable until such time as the gap narrows.

The deterioration of the UK's 'core balance'



Source: ONS

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The upcoming fiscal statement by the Chancellor of the Exchequer, coming hard on the heels of announcements of expensive energy support packages for households and businesses, could also have an adverse influence on the trajectory of the pound. The government borrowing requirement will inevitably climb in coming months, although precisely how much it rises will depend on what happens to the price of natural gas. It's not too far-fetched to envisage that a budget deficit which only a few weeks ago was forecast to come in at just under 5% of GDP for the 2022/23 fiscal year, could balloon to 8-9%.

Finally, sterling continues to face an element of political risk from the 'unfinished business' hanging over from Brexit. The most important of these is the Northern Ireland Protocol, and the threat by the British government, now enshrined in legislation, to unilaterally suspend some elements of the Protocol. Given the already-weak performance of the UK's exports, a further deterioration in relations with the EU, potentially leading to trade sanctions in the form of tariffs and quotas, would go down badly in the currency markets. In this context, the tough rhetoric of the new Prime Minister, during her time as Foreign Secretary, is hardly likely to calm the nerves of investors.

Further to fall

With all these considerations bearing down on the pound, HSBC has cut its short-term forecast for sterling. Instead of expecting it to settle at around $1.16, it's now forecast to depreciate to $1.10 by the end of this year, settling at around $1.08 early in 2023. Given that many commodities and imported raw materials are priced in dollars, sterling's recent leg down, and the prospect of more to come, will mean that the rate of consumer price inflation won't fall quite as quickly as it otherwise would. With the euro also expected to lose further ground to the dollar, steadying at around $0.95 during 2023, the exchange rate between the pound and the euro is forecast to be at around €1.14, making one euro worth 88 pence. This is roughly where it is today, but still represents a fall of 3% from its level just a month ago.

It's possible that sterling could fall even further than these forecast levels in the months ahead. A fall to parity against the dollar is not expected, but can never be entirely ruled out, given that currency markets are notoriously prone to bouts of overshooting. What happens is that markets sometimes overdo their response to economic news or political developments, with a sharp movement then being partially corrected. So, even if sterling did fall to parity with the dollar, it probably wouldn't remain there for long.

In view of the fickleness of foreign exchange markets, it's worth finishing by briefly considering what it might take to flip sentiment towards the pound from negative to positive. Obvious developments that might make the pound more attractive to investors would be a marked decline in the price of natural gas (which among other things would make the government's support packages cheaper); evidence that those support packages are helping to ward off recession; intimations from the Bank of England that it might raise UK Bank Rate closer to where the Federal Reserve is heading; and a more constructive relationship with the EU over post-Brexit frictions, in particular with regard to the Northern Ireland Protocol.

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