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Sterling…a lot of bad news in the price

Global FX: Sterling's resilience - One of the key questions we get asked on currencies is whether we should expect another downward leg in sterling. We think most of the weakness is behind us and expect cable to stabilise around current levels this year. One reason is we expect Brexit talks to make some progress towards some kind of compromise deal, balancing free trade and free movement of people. Perhaps more importantly, a lot of bad news is already in the price. The latest commitment of traders report showed that speculative net short positions in sterling are the largest ever (these data are up to last Tuesday when sterling was under pressure). This suggests the market is already positioned for weakness. Nevertheless, sterling has not hit new lows on a trade-weighted basis (the low was set on 12 October 2016). In fact recently sterling has been very resilient. Sterling has not weakened substantially when negative Brexit-related news came to the fore again and UK economic data came in weaker than expected. In contrast, sterling has tended to respond positively to supportive news such as stronger-than-expected UK data. As sentiment in financial markets is relatively constructive and political risks are in the US and in the eurozone, sterling is mainly behaving on cyclical news. It strengthened on today's higher than expected inflation data (see below) as the economy is pretty resilient. Overall, sterling's behaviour signals that most of the negative news and Brexit uncertainty is reflected in the price. This is also reflected in its under-valuation versus long-run fundamental metrics at current levels, especially versus the US dollar. For instance, the Purchasing Power Parity level for GBP/USD is 1.44 (Georgette Boele)

UK Macro: Core inflation rise mainly due to sterling – UK headline CPI inflation rose to 2.3% yoy in February, up from 1.8% in January, taking it above the BoE's 2% medium-term target. Unlike in many other countries, this is not just an energy-price story. Indeed, most of the rise in the headline was driven by a jump in core inflation. Core inflation rose to 2% from 1.6%. In October, core inflation stood at just 1.2%, so this represents a strong upward trend. The rise in core inflation is mainly – but not exclusively - driven by the sharp fall in sterling. The collapse in the pound has led to a surge in import prices, which is lifting core goods prices. Indeed, CPI industrial goods ex. energy inflation accelerated to 0.8% yoy from 0.1% in February and compared to -0.6% yoy in October of last year. Over that time horizon, around three-quarters of the rise in core inflation is due to the sterling effect. The rest seems to be due to knock-on effects from the rise in energy prices rather than domestic price pressures. Service sector inflation rose to 2.8% yoy in February, compared to 2.6% in January and 2.4% in October. However, a large part of that is due to a rise in transportation prices, which are very likely pushed up by past rises in energy inflation. We think core inflation will rise further in coming months as the impact of sterling continues to feed through. Core inflation is likely to end up above 2.5%. Our base case is that the BoE will look through this rise in inflation and keep interest rates on hold as exchange-rate driven inflation tends to be relatively transient. However, recent MPC communication suggests that some members are getting nervous about inflation. So the risks of a rate hike have increased over recent weeks. (Nick Kounis)