FX Viewpoint

Currencies
Global

GBP: The BoE delivers a cautious cut

- The BoE cut rates for the first time since early 2020…
- …but it was careful not to overpromise on follow-up moves
- The GBP is likely to weaken gradually in the months ahead

The BoE cut rates by 25bp with a narrow vote

At its 1 August meeting, the Bank of England's (BoE) monetary policy committee (MPC) voted by 5-4 to lower its key rate by 25bp to 5.00%. This marked the first reduction since early 2020 and ended a year of borrowing costs at 5.25%. The decision to cut rates was a close call, with Catherine Mann, Jonathan Haskel, Megan Greene, and Huw Pill dissenting and voting for a hold. **The MPC was careful not to overpromise on follow-up moves**, with BoE Governor Andrew Bailey saying that inflation remained "elevated", and that the MPC needed to "be careful not to cut interest rates too quickly or too much". **Our economists expect the next 25bp cut in November 2024, followed by four 25bp cuts next year**, taking the policy rate to 3.75% by the end of 2025.

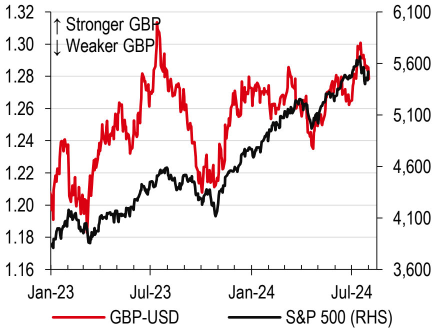
The BoE will announce the pace of next year's QT operations in September

As for quantitative tightening (QT), **the BoE thinks the QT impact is small** and could be offset by modest rate cuts "in the unlikely event" that there was an unexpectedly large tightening impact of QT. The BoE will announce the target for reducing UK government bond (known as "glit") holdings over the period from October 2024 to September 2025 in September.

As the BoE's rate-cutting cycle starts, the stretched positions are likely to weigh on the GBP

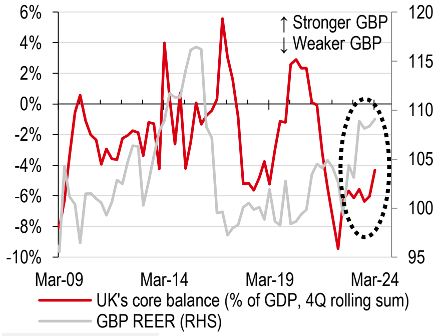
Prior to the announcement, markets priced in about a 65% chance of a rate cut and GBP-USD broke below 1.28. That said, the GBP has been the best performing currency in the G10 space so far this year (*Bloomberg*, 1 August 2024), supported by buoyant risk appetite (with the S&P 500 Index as the proxy (Chart 1)) and relatively high yields. It is also worth noting that **long GBP positions have been at all-time highs as of late** (*Commodity Futures Trading Commission* [CFTC], as of 23 July 2024). In our view, **the already stretched positions make the GBP vulnerable to the beginning of a correction when the BoE's easing cycle starts.**

1. GBP-USD and risk appetite



Source: Bloomberg, HSBC

2. The broad GBP strength has overshot fundamentals



Source: Bloomberg, HSBC

Should risk aversion increase, GBP-USD could drop faster

Meanwhile, **the broader GBP strength has been inconsistent with underlying economic fundamentals**. The UK's current account deficit has been persistent with net foreign direct investment (FDI) outflows exerting additional pressure, resulting in an ongoing deficit in the core balance (Chart 2). As such, **there is still a risk that the GBP could drop faster, if risk aversion increases**, given the UK's dependency on less stable "other investment" flows (which are short term in nature and can be volatile) and its elevated sensitivity to risk appetite (Chart 1 again).

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