LEE HARDMAN
Currency Analyst,

Global Markets Research
Global Markets Division for EMEA
T: +44 (0)20 7577 1968
E: lee.hardman@uk.mufg.jp

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How will the GBP be impacted by policy changes under new PM Truss?

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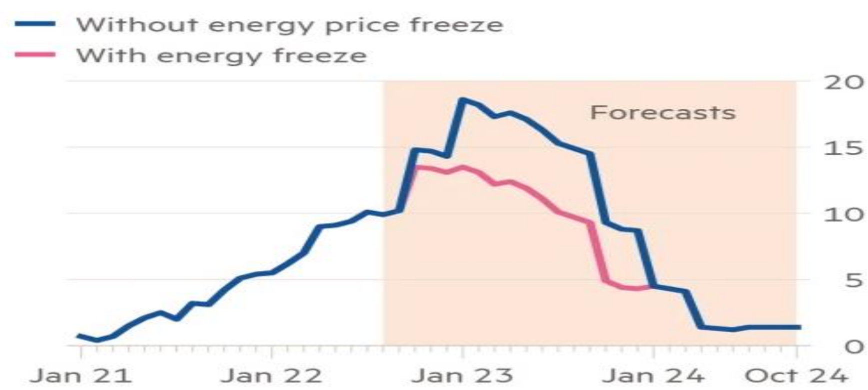
- *New PM Liz Truss is set to outline plans for significant fiscal stimulus including further support to combat the energy crisis and lower taxes.*
- *New measures will help to improve UK growth and inflation outlook. Normally an improving cyclical outlook and higher rates would encourage a stronger GBP but structural problems from twin deficits remain a concern as financing conditions tighten.*
- *We are not yet confident that the lows are in place for cable as the USD continues to strengthen broadly.*

A weaker GBP & more inverted UK rate curve

It has been an eventful week for the pound and the UK rate market which are currently in the process of digesting the potential impact from Liz Truss becoming the new Tory leader and Prime Minister. While the victory for Liz Truss was widely expected, the big surprise for UK markets this week has been the news that she is planning to provide even more substantial support for households and businesses to help combat the negative impact of higher energy prices. The news reports have not been denied by the government which is expected to announce tomorrow the details of the support package. According to Bloomberg, the government is planning to freeze household energy bills until April 2024, and to offer a discount scheme for businesses. It has been estimated that the scheme could cost around GBP130 billion to cover households and up to GBP40 billion to cover businesses although the final cost will depend heavily on the trajectory of wholesale gas prices. According to the documents viewed by

ENERGY PRICE FREEZE TO IMPROVE NEAR-TERM INFLATION OUTLOOK



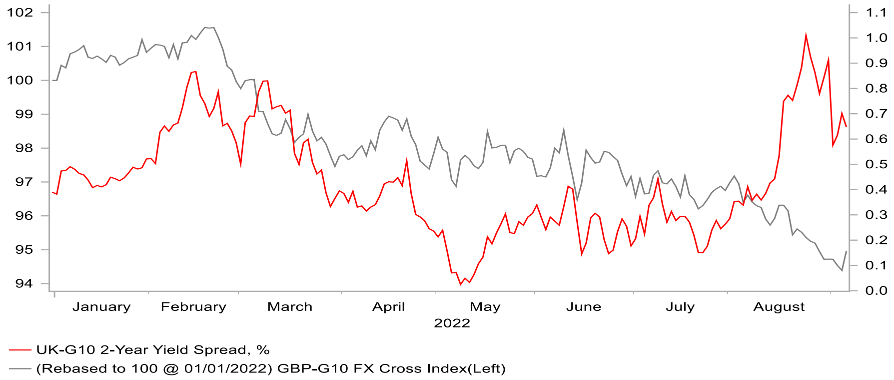
Source: Financial Times

Bloomberg, energy suppliers will "receive funding from the government" to cover the difference between wholesale market costs and what they are allowed to charge customers. As currently structured, those costs would be financed out of government borrowing. It has also been suggested that the government could de facto repurpose COVID-related guaranteed loans to energy suppliers to offset the losses from the lower price caps. Commercial banks would lend out the funds to energy suppliers backed by government guarantee to cover losses. The loan guarantee scheme would mean that the private sector takes on the debt, and the government guarantee is viewed as a contingent liability. But it would be more costly for the private sector to finance rather than the government. The new energy price support package comes on top of support offered so far totalling GBP37 billion including a GBP400 rebate on energy bills this winter for all households and additional means tested payments. In addition to the energy price relief measures, Prime Minister Liz Truss is also expected to quickly deliver on her campaign pledge to lower taxes. During her campaign she pledged to lower taxes including reversing a GBP12 billion increase in national insurance contributions and plans for a GBP17 billion a year increase in corporation tax.

Macro implications: stronger growth & lower inflation

One clear macro impact from the bigger than expected fiscal support package is that it should help to dampen the risk of a sharper slowdown/ deeper and more prolonged recession in the UK. The hit to households and businesses from higher energy prices will be significantly reduced by freezing prices well below the current price of natural gas. Over the summer period the price of natural gas in the UK has surged higher by around 220% from the lows recorded in early June. Ofgem recently announced that the energy price cap for households was set to rise again in October from the current level of GBP1,971 to GBP3,549 per year for an average household. The planned 80% increase in energy price caps will no longer take place under the government's proposals. According to press reports, the government will either freeze the price cap at the current level of GBP1,971 or set it at GBP2,500. The additional GBP500 increase in the cap would be almost fully offset by the government's previous plans to provide a GBP400 rebate on energy bills this winter for all households that would be topped up further with means tested payments. The price cap freeze would provide even more relief for households if extended beyond the winter as it has been estimated that the price cap could rise even more sharply again in 1H of next year up to over GBP6,620 in Q2. In the BoE's latest economic forecasts from August, they had projected that typical annual household fuel bills would increase by around 75% in October.

HIGHER UK RTAES HAVE FAILED TO ENCOURAGE STRONGER GBP



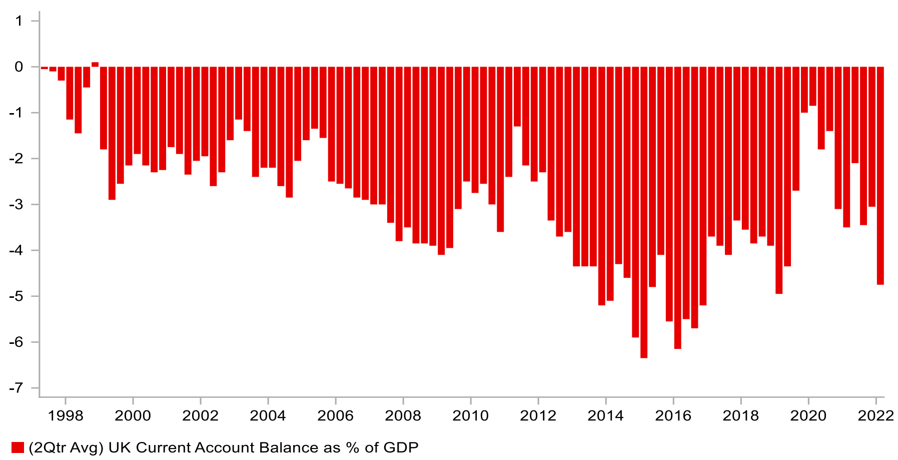
Source: Bloomberg, Macrobond & MUFG GMR

The bigger energy price hit to incomes prompted the BoE to forecast that the UK economy would enter into recession in Q4 and continue to contract for five consecutive quarters through 2023. The baseline scenario projected a peak to trough fall in output of 2.25%. In light of the government's new plans for further significant energy price relief and tax cuts, we expect the BoE to scale back their forecast for the economic slowdown in the UK. It will mean that the unemployment rate is unlikely to rise as much as forecast back in August when it was projected to increase to 6.25% by the end of the forecast period up from the most recent reading of 3.8%. One risk to the more favourable growth outlook is posed by the increased likelihood of energy rationing. If there is less demand destruction as prices for households and businesses are frozen below market levels, then it could place more strain on existing energy supplies over the winter period.

The energy price freeze would also help to significantly lower the near-term outlook for inflation. If the energy price cap for households is frozen at the current level or at GBP2,500 it would mean that annual household fuel bills will increase by less than the 75% increase that the BoE had been assuming in October. As a result, the BoE is likely to revise lower their forecast for the inflation peak from just over 13% set in August. An energy price cap freezing would give us more confidence that inflation is close to peaking having already reached 10.1% in July before falling back more sharply towards the BoE's inflation target in 2023. The BoE was already expecting in August that inflation would fall back close to 5.0% by the end of next year, and it could now reach those levels sooner if the energy price cap freeze is implemented.

On the other hand, the energy price cap freeze is likely to raise the BoE's inflation outlook beyond the near-term. With the UK economy likely to slow/contract less than expected due to the smaller hit to households and business from higher energy prices, the BoE is likely to scale back expectations for how much spare capacity is set to open up in the UK economy over the forecast period. In the August MPR, the BoE was forecasting that excess supply in the economy would rise to 3.75% of potential GDP by the end of the forecast period. As a result, the BoE expected inflation to continue falling over the forecast period until it was significantly undershooting the 2.0% target in early 2025 when it was expected to fall to just 0.8%. After incorporating additional fiscal stimulus, the BoE is likely to revise inflation forecasts higher for years beyond 2023.

TIGHTENING GLOBAL FINANCIAL CONDITIONS UNFAVOURABLE FOR GBP



Source: Bloomberg, Macrobond & MUFG GMR

BoE policy implications:

We expect the BoE to initially welcome the energy price cap freeze as it helps to significantly lower the outlook for inflation in the near-term. There is less immediate risk that inflation expectations become unanchored if inflation peaks out sooner and falls back quicker in the year ahead. It should ease some of the immediate pressure on the BoE to keep raising rates more "forcefully" at upcoming policy meetings. It shifts the balance of risks back in favour of a 50bps hike at next week's MPC meeting rather than a larger 75bps hike. The UK rate market is already moving towards this view. Market participants are now pricing in 65bps of hikes. With inflation set to remain elevated in the near-term and the BoE wary over the medium-term inflationary impact from significantly fiscal stimulus, we expect the BoE to keep raising rates heading into next year although we remain sceptical that rates will rise as high as currently priced into the UK rate curve. The UK rate market has moved aggressively in recent weeks to price in a higher terminal rate of closer to 4.25% by the middle of next year compared to pricing of around 2.75% in late July. After which the UK rate market is expecting the BoE to quickly begin cutting rates from the 2H of next year. The additional fiscal stimulus could encourage the BoE to keep policy tighter for longer until they are more convinced that upside inflation risks have eased on a sustainable basis.

FX implications

The GBP has been volatile in recent days as market participants weigh up the impact of potential policy changes under the new leadership. The GBP initially staged a rally when press reports emerged over much larger energy price relief measures. It saw cable briefly hit an intra-day high of 1.1609 while EUR/GBP fell to a low of 0.8567. However, those initial gains for the GBP have been quickly reversed resulting in cable falling to a fresh year to date low of 1.1406 as the USD continues to strengthen more broadly.

The initial price action fits with our own caution over trying to chase the GBP higher in the near-term on the back of the bigger fiscal stimulus package. In normal circumstances the bigger fiscal stimulus should encourage a stronger currency by improving the cyclical outlook for the UK economy. The downturn for the UK economy is now likely to be less than feared. At the same time an easing of upside inflation risks in the near-term should help to ease stagflation fears in the UK which have been weighing on GBP performance. It could allow the GBP to benefit more from the recent move higher in UK that have risen more sharply than in other major economies resulting in widening yield spreads in the GBP's favour. It has been notable though that the GBP has failed to strengthen on the back of favourable yield spread developments which continues to cast doubt on whether the GBP will benefit from an improvement in the cyclical outlook in the UK. Interestingly, the GBP sold off today as the UK rate market moved to pare back near-term BoE rate hike expectations following the testimonies from MPC members including Governor Bailey before parliament. Yet the GBP did not strengthen when rate hike expectations were ramped up. It is a clear indication that price action remains bearish for the GBP in the near-term.

The continued weakness in the GBP could reflect concerns that improved cyclical support for the GBP will be outweighed by persistent negative structural factors. The UK's trade and current account deficits have both widened sharply at the start of this year. The bigger fiscal stimulus will reinforce those wider deficits. At the same time, the ongoing tightening in global financial conditions is making it more challenging for the UK to fund the wider external deficit keeping downward pressure on the GBP given its role as an adjustment mechanism. In these circumstances, we are not yet confident that the GBP has bottomed against the USD. For those looking to express GBP upside potential on the back of the improved UK cyclical outlook, short EUR/GBP could offer a better risk/ reward balance.

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