MI2 Trader: Short Sterling Revisited

17th May 2021

Comment

On 14th April, we made a case for shorting Short Sterling. We specifically highlighted the Dec 2023 futures contract at 99.33 with a target of about 98.50. Since then, in price terms, nothing much has happened; the contract continues to track sideways in a consolidation.

Yet, despite this lack of market action, our emails continue to clog up with anecdotal evidence of inflation, especially in the US. However, we can't help but think that the centre of attention may be shifting ("MI2 Trader: EZ Inflation and Bund" 14th April). Indeed, this week, we have a raft of data in the UK, and while we are loath to predict the individual numbers, we are confident about the direction over the next few weeks. If CPI doesn't surprise on Wednesday, it will next time.

That brings us to the BoE. Since our note last month, the MPC has rather handily updated their latest forecasts.

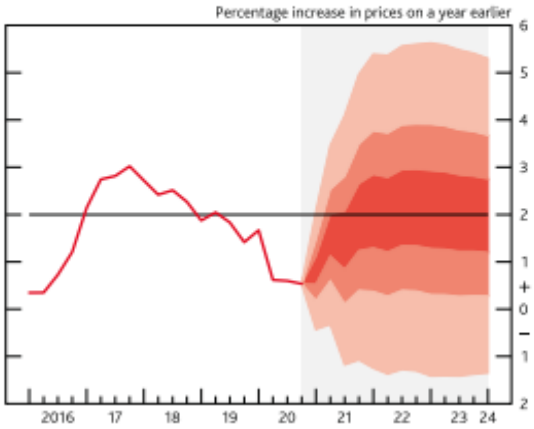
1.2: The MPC's projections

Table 1.A: Forecast summary[a][b]

	Projections			
	2021 Q1	2022 Q1	2023 Q1	2024 Q1
GDP[c]	-9.2 (-6.5)	14.2 (10.0)	1.3 (2.1)	1.3
CPI inflation[d]	0.8 (0.7)	2.1 (2.1)	2.1 (2.0)	2.0
LFS unemployment rate	5.5 (6.7)	5.7 (6.1)	5.0 (4.7)	4.5
Excess supply/Excess demand[e]	-1 (-2)	+¼ (0)	+¼ (+¼)	0
Bank Rate[f]	0.1 (0.0)	-0.1 (-0.1)	-0.1 (-0.1)	0.0

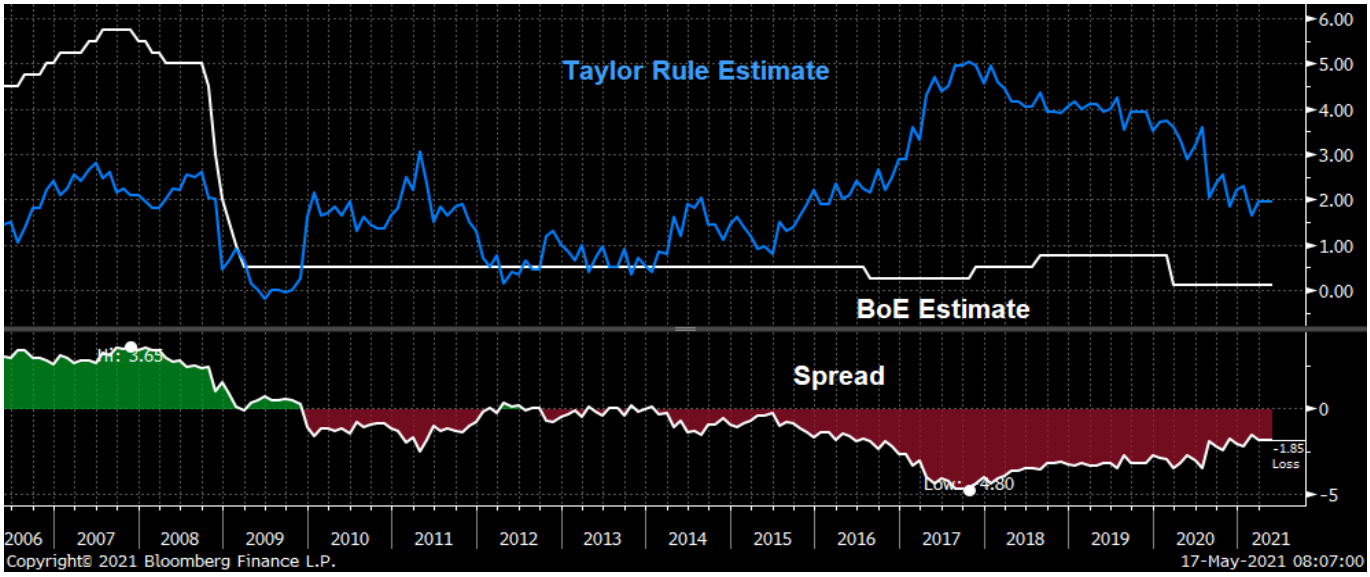
Two things struck us. First, they are chronically underestimating the degree of consumer and corporate spending likely to be unleashed as the economy reopens. The latest rather disturbing news on the Indian Covid variant aside, the UK should be the trailblazer economy of the developed world as it reaps the benefit of its successful vaccination programme. Expect 2021 growth rates to exceed BoE forecasts. Second, the inflation forecast is all very conveniently centred around the target rate of 2% all the way into the distant future. Here they expect no significant overshoot and (somewhat laughably) conceive a fairly symmetrical cone of possible outcomes with a very wide range of potential deviation. This supposedly justifies continuing QE to the end of the year (same total amount, slightly extended period.)

Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



Hence, given our own forecasts suggesting Core CPI YoY is heading to 3%, we believe that the BoE may be the next central bank to find itself "surprised" by the inflation data. Furthermore, it is worth remembering that, unlike the Fed, the Old Lady hasn't pivoted to prioritising social objectives ("The Fed: The Consequences of Woke" 28th April). Hence, it is hardly surprising that the shadow MPC is already voicing public concern about the Bank's insouciance, stressing the likely impact of recent extraordinary monetary growth. Expect more criticism to pile on as the strength of the growth and inflation numbers become apparent.

Finally, unfashionable as it might be, if we look at the UK Taylor Rule and very generously adjust it for zero per cent real rates, it still flags about 2% for Bank Rate versus the current 0.10%. Are we really going to be only 20bps higher be Q2 2023?



Trade

The trade is the same as before, the confidence in timing building. Sell (more) L Z3 around the 99.30 mark. Expect to run it through this month and next month's data. The stop can be tweaked down a little from 99.50 given the way it has traded over the last month, and the target remains around 98.50. If we get a lurch lower this week, take back the extra and pull down the stop to just above 99.30. Excellent risk reward under the new constellation.