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Q&A-Sterling vulnerable despite Brexit deal; BoE likely to avoid negative rates, but could cut to zero to ease pandemic impact: Jane Foley, Rabobank

The British pound remains vulnerable despite the UK-EU trade agreement, as the financial services sector was lightly touched on by the "skeleton deal," **Jane Foley, head of forex strategy at Rabobank,** told the Reuters Global Markets Forum on Tuesday, January 12.

The damage caused by COVID-19 and its fresh variants will hurt UK's economy, adding to the currency's vulnerability, she said.

Foley said the Bank of England (BoE) had managed to make the money market fear negative interest rates without implementing them.

"It is hoped that the fast vaccine roll-out in the UK will allow a strong recovery later in the year and that the BoE will avoid negative rates," she said.

However, rates could be cut to zero by then, she added.

Following are edited excerpts from the conversation:

Q: Considering the EU-UK trade deal, what are your FX outlooks on euro, cable and the dollar, broadly?

A: I still view GBP (British pound) as a vulnerable currency despite the UK-EU trade deal. This was only a skeleton deal and leaves services out in the cold. There are already concerns about whether equivalence for financial services can be achieved and what that means for one of the UK's biggest exports. In addition, the UK economy has been hard hit by COVID-19 and scarring will inevitably result.

Cable will be knocked around but movements in the USD, but I expect EUR/GBP will struggle to push much below 0.87 this year under the most optimistic outlook. We think that the rise in nominal U.S. yields and the expectations of more fiscal spending in the U.S. have been sufficient to trigger a wave of profit-taking in short USD positions but with real interest rates in the U.S. still very low, the USD could struggle to gains much of a purchase.

Q: To what extent do you think the actions of the European Central Bank (ECB) and Bank of England (BoE) will be influenced by the Fed and considering that, what are your views on inflation expectations in the U.S., euro zone and UK?

A: Deflation in the Eurozone means that real rates in the region are still fairly attractive compared with those in the U.S. We will be watching if this changes during the course of this year, but it might be a while before it does.

What is likely to be pivotal is a change in guidance from the Fed on rates. Currently no change is projected before the end of 2023. Will more fiscal stimulus impact this? If the Fed signals a faster start to the normalisation process in policy that will change the dynamic for the USD. Realistically, though, this is still a long way off.

Given that the Fed managed to normalise policy to some degree after the Global Financial Crisis and the ECB did not, it still seems likely that the US could recover at a better pace than the Eurozone. The ageing population and less flexible labour market suggests more 'Japanification' in the EZ (euro zone).

Q: Do you agree that these softer USD-levels will support commodity and emerging markets currencies?

A: Most commodities are denominated in USDs and this ensured a link between the greenback and the prices of commodities. Gold, however, take a lead from yields also - the higher yield in the U.S. government paper, the less attractive gold will appear (it has a 'negative yield' if storage and insurance is considered).

Also, bearing in mind there is a savings glut, if yields stay low in USDs there will be more investors hunting around for higher yields elsewhere. There is a reasonable inverse correlation between USDs and say the MSCI EM stock index.

Q: What about the prospect for negative rates in the UK? How much has recent BoE commentary altered the market's perception of the same?

A: The BoE has been quite successful in making the money market fear negative rates without having to implement them. It is obvious to everyone that there are difficulties associated with negative rates and that it would be a last resort for the BoE. Our central view is that the Bank will not go there. But to a large extent this will depend on the course of the pandemic. It is hope that the fast vaccine roll-out in the UK will allow a strong recovery later in the year and that the BoE will avoid negative rates. However, rates could be cut to zero before then.

Q: What are your views on BoE bond purchases (is there potential for trimming them going ahead) and could we possibly see more active FX management like Switzerland?

A: The SNB (Swiss National Bank) says that it has a policy on FX (foreign exchange) intervention because it cannot realistically use QE (quantitative easing) - its capital market is not deep enough. The SNB has implied that other central banks are using QE as a FX management tool. The RBA's (Reserve Bank of Australia) Lowe has blatantly admitted this.

However, for years the G7 used to issue communiques saying that markets should set FX rates and so the UK authorities would steer away from any sort of accusation that they are managing the exchange rate. Besides, the CHF (Swiss Franc) is overvalued on most measures and the SNB has had a problem with deflation for year - so desperate times require desperate measures. The BoE doesn't have the same issue with deflation or an extremely under or overvalued exchange rate.

Q: Do you think the sheer amount of UK fiscal borrowing puts a lid on BoE raising rates in the medium term, even if we see a firm recovery from the corona crisis?

A: What is interesting is that the market is linking current QE levels with the government's deficit. Insofar as the FT's (Financial Times) survey suggested that gilt investors see QE amounts has been positioned to keep rates low to allow the government access to cheap money and are less positioned towards the Bank's 2% inflation target. If this is correct, the answer to your question is yes.

Q: In closing, do you have parting thoughts for us/things to keep an eye on?

A: Keep an eye on inflation expectations - I think they will be a big driver of Fed policy and the USD in the months/years to come.