GBP: pounding above its weight; are our forecasts under threat?



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- **The GBP's resilience vs the USD and its outperformance vs the EUR so far this year has surprised us and reflects the positive impact of several key drivers that, if sustained, could pose risks to our current GBP/USD and EUR/GBP forecasts:**
  - **The UK economy has proven to be more resilient so far in 2026 than forecasted by us and the market. Some of the strength should linger due to still-buoyant AI-investment, but high energy costs and fresh fiscal austerity measures as part of the Autumn Statement could hurt households' real purchasing power and, together with a lacklustre services sector outlook, drag down growth in Q426 and beyond.**
  - **UK markets expect four rate hikes in the coming months, making the BoE one of the most hawkish central banks and the GBP one of the most attractive high-yielders in G10. We doubt that the MPC would meet these hawkish expectations, however, and further worry that the correlation between the GBP and gilt yields could turn negative once again if tighter financial conditions make the BoE more dovish.**
  - **France's fiscal problems continue to contrast with the 'prudence' of the Burnham government and boost the appeal of the GBP as a safe-haven EUR-proxy. Furthermore, the mining-heavy UK stock market has attracted investors looking to cut their exposure to Eurozone and US equities. These positives could linger for now, but a renewed UK growth underperformance could rekindle fiscal risks and undermine the appeal of GBP-denominated assets.**
- **We continue to assess the impact of the above drivers on our FX outlook. We would delay any decision on the GBP forecasts, however, until after next week's Autumn statement and the BoE policy meeting the week after. Ahead of the former, we expect Chancellor John Healey to focus on measures to meet immediate fiscal demand and boost the government's fiscal headroom with a mix of extra taxes and net borrowing.**
- **The Chancellor may thus delay tackling the UK's long-term fiscal challenges to the March 2027 budget. Given the scale of the current public spending plans, gilt and GBP investors should remain wary about any further rise of state borrowing and any fiscal austerity measures needed to mitigate it. We also think that while the BoE would raise rates in November, it will remain cautious in its outlook and noncommittal about future rate hikes.**
- **We remain ready to adjust our near-term GBP forecasts in response to the recent FX market moves. We are sceptical, however, that any notable upgrade of our longer-term outlook for the GBP vs the USD and the EUR is needed. Indeed, we already expect GBP/USD to move closer to 1.39 and EUR/GBP to trade around 0.84 in the next six to twelve months.**

Fig 1. GBP forecasts

GBP

Forecasts	Dec-26	Mar-27	Jun-27	Sep-27	Dec-27
GBP/USD	1.31	1.32	1.34	1.37	1.39
EUR/GBP	0.86	0.86	0.85	0.84	0.84

Source: Crédit Agricole CIB

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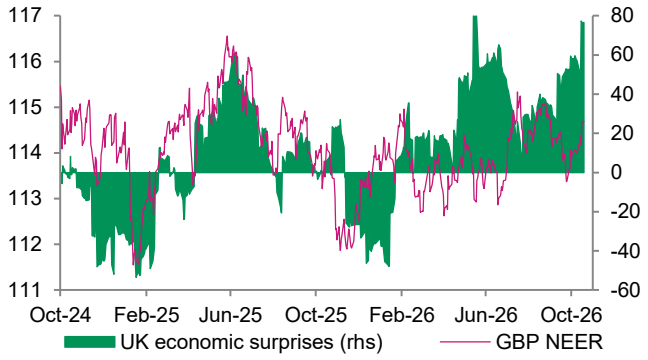
GBP: pounding above its weight

The GBP's resilience vs the USD and its outperformance vs the EUR so far this year has surprised us and reflects the positive impact of several key drivers that, if sustained, could pose risks to our current GBP/USD and EUR/GBP forecasts. We continue to assess the impact of the above drivers on our FX outlook. We would delay any decision on the GBP-forecasts, however, until after next week's Autumn statement and the BoE policy meeting the week after.

The UK economy riding the AI investment wave, for now

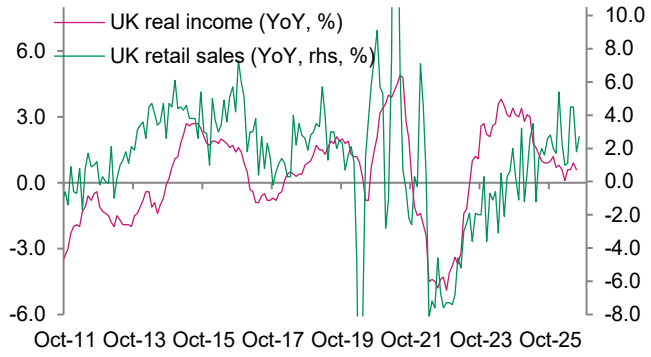
The UK economy has proven to be more resilient so far in 2026 than forecasted by us and the market. Some of the strength should linger due to still buoyant AI investment. In turn, positive economic surprises out of the UK could remain a boon for the GBP (Figure 2). High energy and growing borrowing costs coupled with fresh fiscal austerity measures as part of the Autumn Statement and next year's March budget could hurt households' real purchasing power and thus domestic demand, however (Figure 3). All this, together with a lacklustre services sector outlook, could drag down economic growth in Q426 and beyond. As a result, our UK economist has recently also downgraded her 2027 outlook.

Fig 2. GBP NEER vs UK economic surprises



Source: Crédit Agricole CIB, Bloomberg

Fig 3. UK real income vs retail sales volume growth rate

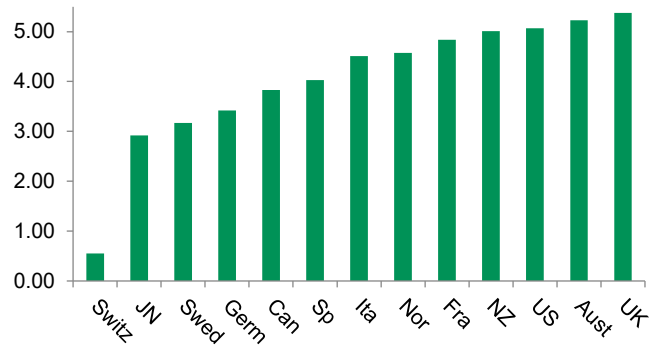


Source: Crédit Agricole CIB, Bloomberg

BoE to hike but rate expectations are excessively hawkish

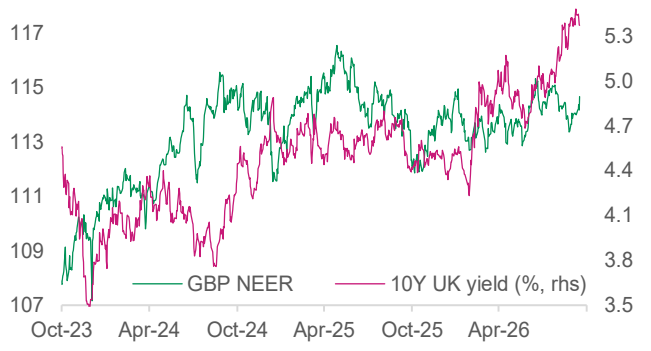
The GBP further draws support from the fact that UK markets expect four rate hikes in the coming months, making the BoE one of the most hawkish central banks and the GBP one of the most attractive high-yielders in G10 (Figure 4). We doubt that the MPC would meet these hawkish expectations, however, and note that recent speakers have been reluctant to validate the market views.

Fig 4. 10Y bond yields' ranking in G10



Source: Crédit Agricole CIB, Bloomberg

Fig 5. GBP NEER vs 10Y gilt yield



Source: Crédit Agricole CIB, Bloomberg

We further worry that the correlation between the GBP and gilt yields could turn negative once again if tighter financial conditions make the BoE more dovish in the coming months (Figure 5). Moreover, higher gilt yields could raise borrowing costs and thus complicate the UK fiscal outlook ahead of the Autumn statement and the

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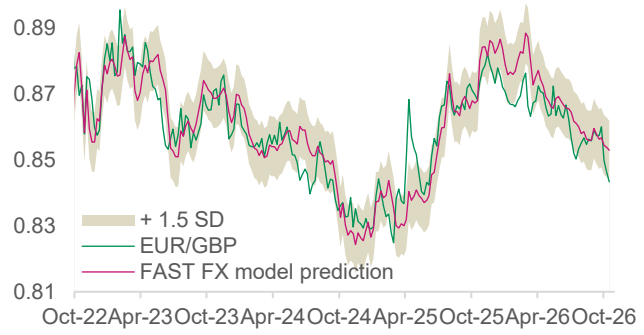
Budget and Spending review in March 2027. GBP investors could thus worry about any further rise of state borrowing and/or the negative economic impact of any fiscal austerity measures needed to mitigate it.

The GBP as a safe-haven proxy for the EUR

In recent weeks, the GBP has emerged as an attractive safe-haven proxy for the beleaguered EUR. Indeed, the fiscal challenges and the political risks in France continue to contrast with the 'prudence' and the apparent stability of the Burnham government. Our FX valuation analysis of EUR/GBP that incorporates both the spike of sovereign credit risks in the Eurozone and the relative EUR-GBP rate spread suggests, however, that the GBP's appreciation vs the EUR may have run its course. As a result, EUR/GBP is starting to look undervalued (Figure 6).

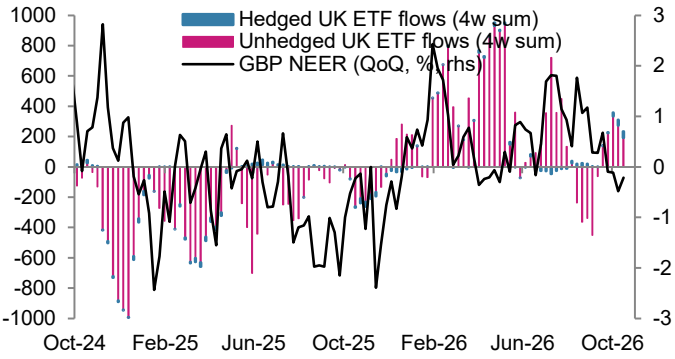
Furthermore, we note that the mining-heavy UK stock market has recently attracted international investors looking to reduce their exposure to Eurozone stocks (and US equities). Our ETF-flow tracker signals that the UK stock markets have attracted their largest inflows in more than three years, in a boost to the GBP (Figure 7). All these positives could linger for now, but a renewed UK growth underperformance could rekindle fiscal risks and undermine the appeal of GBP-denominated assets.

Fig 6. EUR/GBP vs short-term fair value model



Source: Crédit Agricole CIB, Bloomberg

Fig 7. GBP NEER vs net flows into UK stock market ETFs



Source: Crédit Agricole CIB, Bloomberg

Two key events to shape the near-term GBP outlook

Autumn statement

Ahead of the Autumn statement on 28 October, we expect Chancellor John Healey to focus on measures to meet some immediate fiscal demands and boost the government's fiscal headroom, which has been eroded recently by higher borrowing costs and weaker property market. According to our estimates, the shortfall could amount to c.GBP10bn and include outlays related to cost-of-living support, the funding shortfall in the Defence investment plan and the policy package announced by PM Andy Burnham after assuming office, among others. We believe that the funding gap could be filled with both higher taxes and some increase in net borrowing.

The Chancellor may thus delay tackling the UK's long-term fiscal challenges to the March 2027 budget. Among these would be government outlays related to Burnham's policy agenda as well as measures to deliver the planned real spending squeeze and boost its defence budget to 3% of GDP, announced by the previous government. These possible policy choices are estimated to cost the government more than GBP60bn by 2029-30. Given the scale of the public spending plans, gilt and GBP investors should remain wary about any further rise of state borrowing and any fiscal austerity measures needed to mitigate it.

BoE not riding to the rescue

Ahead of November BoE policy meeting, we and the markets are expecting the MPC to support a 25bp hike but to further remain largely noncommittal about future tightening. We believe that policymakers would be encouraged by the fact that the UK economy has performed more strongly than expected but would continue to worry about the growth outlook considering the impact of the softening labour

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market and the erosion of real purchasing power on UK domestic demand from here.

To the extent that the Autumn statement leaves many questions about the longer-term fiscal outlook unresolved, the MPC could also continue to expect additional economic headwinds from fiscal austerity measures ahead. Partly due to that uncertainty, gilt market conditions could remain challenging and continue to add to government and private borrowing costs, thus tightening UK financial conditions. We thus expect the BoE to deliver what could be called a 'dovish hike' that could fail to validate the very aggressive rate hike expectations. This could hurt the relative rate appeal of the GBP vs the EUR and USD.

Conclusion

We remain ready to adjust our near-term GBP forecasts in response to the recent FX market moves. We are sceptical, however, that any notable upgrade of our longer-term outlook for the GBP vs the USD and the EUR is needed. Indeed, we already expect GBP/USD to move closer to 1.39 and EUR/GBP to trade around 0.84 in the next six to twelve months (Figure 1).

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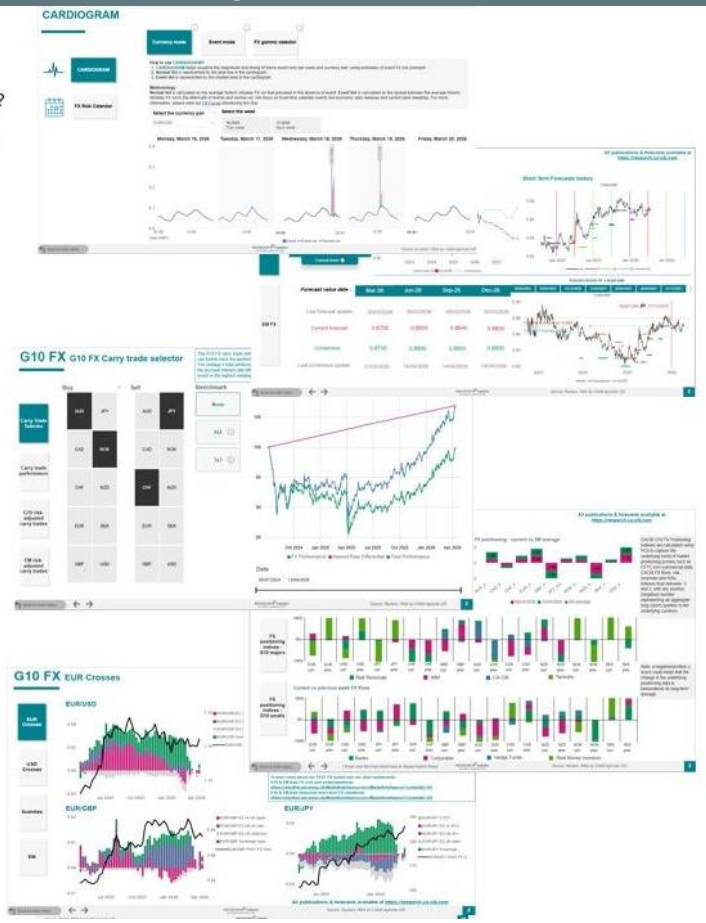
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