NAVIGATING CURRENCY VOLATILITY IN

Q1 2024

Insights for CFOs

LUMON
CORPORATE

NAVIGATING CURRENCY VOLATILITY IN Q1 2024 - INSIGHTS FOR CFOs

Despite an upturn in fortune for the pound in the wake of a turbulent 2022, volatility persisted in 2023 as the battle to bring inflation under control raged on - forcing central banks to double down on the main weapon in their armoury: monetary policy tightening.

For **businesses with FX exposure**, these sudden market movements have made it almost impossible to plan with conviction – bringing a more proactive and systematic approach to FX risk management into sharp focus for CFOs.

The US Federal Reserve and the European Central Bank (ECB) hiked interest rates at their fastest pace in 40 and 30 years respectively; while the Bank of England (BoE) delivered a 15-year peak - contributing to large swings in the value of the pound throughout 2023:

These market movements contributed to a 13% average variance in the price of the GBP to USD dollar exchange rate over the last five years – vast fluctuations that have made it difficult to achieve stability in financial planning.

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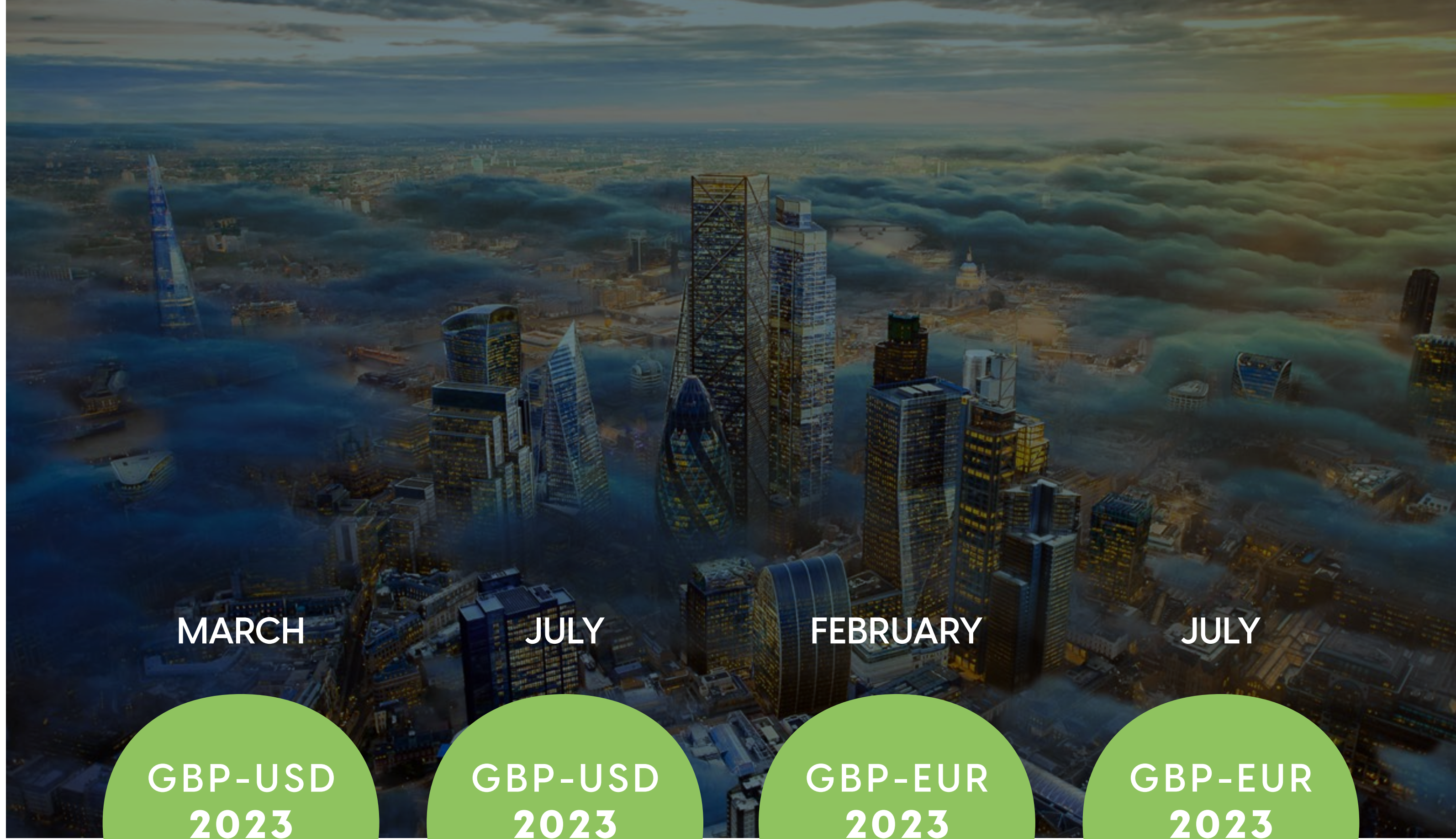


MARCH

GBP-USD 2023 LOW

In **March**, interest rate rhetoric from central bankers on both sides of the Atlantic dragged the pound down almost **2%** to **1.18** against the dollar.

JULY

GBP-USD 2023 HIGH

In **July**, easing US inflation and strong data bolstered UK rate hike expectations, propelling the pound to a 15-month high above **1.31** against the dollar.

FEBRUARY

GBP-EUR 2023 LOW

In **February**, the pound slumped to **1.11** - a four-month low against the euro - after the BoE signalled that it may soon pause its policy tightening cycle.

JULY

GBP-EUR 2023 HIGH

In **July**, the pound surged to **1.17** against the euro after red-hot UK wage growth boosted market expectations of further rate hikes from the BoE.

These market movements contributed to a 13% average variance in the price of the GBP to USD dollar exchange rate over the last five years – vast fluctuations that have made it difficult to achieve stability in financial planning.

Against this turbulent backdrop in the macroeconomic landscape, uncertainty was an overarching theme in currency markets in 2023. These conditions are set to be perpetuated by volatility-inducing variables in 2024 that could dent the pound's appeal - from interest rate announcements to elections.

Q1 2024 – ECONOMIC BACKDROP AND LOOKING AHEAD

So, what does 2024 have in store for currency markets following such a volatile period in currency markets?

With FX market uncertainty set to be a continuing theme in 2024, the resulting volatility will make pricing, forecasting and budgeting difficult for CFOs. These headwinds will be created by a raft of political and economic forces:

UNWINDING OF MONETARY POLICY: POUND COULD FEEL THE WEIGHT OF RATE CUTS

The BoE voted to hold the base interest rate at 5.25% in November for the second time in a row following 14 consecutive rate hikes to cool red-hot inflation - but borrowing costs remain historically high. So, will they fall in 2024?

Inflation has been plummeting in the past year. In October 2022 the CPI measure of inflation climbed to 11.1% - a 41-year high - and 12 months later fell to 4.6%. But is that enough to see rates cut in the immediate term? It depends on who you listen to.

Speaking in November, BoE governor Andrew Bailey didn't think so: "I have pushed back of late against assumptions that we're talking about cutting interest rates or we will be cutting interest in anything like the foreseeable future because it's too soon to have that discussion,"

However, the markets are on the other side of the fence, with analysts forecasting rates to start falling as early as next year and be down to 4.5% by 2025 – just above the BoE's 2% target.

Broadly speaking, the pound strengthens when the domestic rate is raised and weakens when it is cut - but it's not set in stone. The pound can also be impacted by the rhetoric surrounding interest rates, economic data and expectations about the direction of rates, as well as many other factors.

ONGOING GEOPOLITICAL CONFLICT: VOLATILITY SET TO BE PERPETUATED BY TENSIONS IN UKRAINE AND MIDDLE EAST

An increasingly fraught geopolitical backdrop and greater divergence across key regions – particularly Ukraine and the Middle East – is set to compound uncertainty and market volatility in 2024.

This is reflected by a survey by Natixis SA, which found geopolitical flash points pose the biggest risk to the global economy and markets in 2024. According to the poll of 500 institutional investors from around the world, "The biggest macroeconomic risk for 2024 is geopolitical bad actors who with one action can upset economic and market assumptions globally," That is considered more of a threat than risks related to declining consumer spending, central bank monetary policy, and a slowing Chinese economy.

RECESSIONS: GLOOMY FORECASTS FOR UK ECONOMY

In October, the Institute for Fiscal Studies (IFS) cautioned that Britain will slide into a "moderate" recession in the first half of 2024 as borrowing costs remain elevated – compounding sticky inflation. It's safe to say recession is bad news for the pound. When the COVID-induced recession bit in March 2020, the UK currency slumped to its lowest level against the dollar since 1985.

During the 'Great Recession' in early 2009, it plummeted 35% against the US currency as the global financial crisis swept through economies.

Meanwhile, the US economy's resilience has stoked a growing consensus amongst economists that the Federal Reserve will achieve its desired "soft landing," slowing inflation without pushing the economy into recession. This sanguine view is underscored by forecasts from the International Monetary Fund, which expects US GDP growth to remain among the strongest developed market performers at 2.1% in 2023 and 1.5% in 2024 – despite over 500 basis points of interest rate hikes since March 2022.

UK GENERAL ELECTION: POUND TO BE EXPOSED TO THE POLLS

The maximum term for Parliament is five years. The current Parliament first convened on 17 December 2019, meaning it will be automatically dissolved on 17 December 2024.

A general election would follow after 25 working days, meaning the last possible date for it to take place is 28 January 2025.

King Charles could dissolve Parliament at any time before this date at the prime minister's request. A scenario that's gaining traction is for Rishi Sunak to call a general election in October, giving him time to help ease the cost-of-living crisis before inviting the British public to vote.

A Labour election win would be the best result for the pound, according to a recent Bloomberg survey that shows the incumbent Conservative government has failed to win back the faith of global investors more than a year since Liz Truss's disastrous mini-budget.

US PRESIDENTIAL ELECTION: TRUMP VS BIDEN REMATCH VERY LIKELY

When US citizens head to the polls on 5 November, they will face a likely choice between incumbent President Joe Biden and his predecessor, Republican Donald Trump. Both face primary challengers but are expected to emerge as their party's candidates in 2024.

Trump edged ahead of Biden in the polls in December – with a Wall Street Journal survey showing him leading his rival by four points, 47% to 43%. If he were to win and become only the second former president to come back after being defeated for re-election to win a second non-consecutive term, it could pile pressure on the dollar. Not least due to his determination to devalue the dollar in a bid to boost the domestic economy during his first term in office.

INFLATION AND ECONOMIC ACTIVITY

Moving into 2024, the market is reverting from a "higher for longer" approach to interest rates. However, we are still transitioning from a period where it wasn't a case of if policy will be tightened but by how much to when will interest rate policy loosen and how quickly.

Key to this will be how the various central banks view two main factors: inflation and economic activity.

INFLATION: PRICES EXPECTED TO FALL AT SLOWER RATE THAN INITIALLY FORECAST

Inflation has been falling of late and in November 2023 was at:

- UK 4.6% ↓
- ECB 4.5% ↓
- US 3.1% ↓

With many central banks targeting 2%, this is a vast improvement on the double-digit readings seen in 2023.

The Office for Budget Responsibility's (OBR) Autumn Statement response is still fresh in the memory. The **independent budget watchdog revised its initial Spring Budget forecast** for UK inflation to drop to 0.9% in 2024. Now it does not expect it to fall back to the BoE's 2% target until 2025, with interest rates remaining high for some time as a result - an outlook that's reflected by the BoE with concerns over internal factors such as salary inflation.

In the meantime, inflation is falling back towards comfort levels for the FOMC and the ECB, which is a key factor in mounting predictions for rates to be cut as early as March.

The main factor markets will be focusing on in Q1 is: will inflation fall back to or below target for both the FOMC and ECB whilst remaining sticky for the BoE? The Governor for the BoE, along with his fellow BoE members, has signposted that this could be the case.

ECONOMIC ACTIVITY: BRITAN AT RISK OF RECESSION IN 2024

According to the OBR, the prolonged squeeze on consumer spending power amid high inflation and borrowing costs is expected to stifle economic growth in the medium term. In 2024, **growth is only expected to be 0.7%** - compared to 1.8% forecast by the watchdog in March. And in 2025, growth is forecast to be 1.4%, having slashed its previous 2.5% projection.

Whilst the UK economy sidestepped the start of a recession in Q3, despite flatlining, the outlook is gloomy. This was underscored by the Organisation for Economic Co-operation and Development (OECD), which warned that unabated tough action by central banks to tackle obstinate inflation risks tipping Britain into recession in 2024.

Similar concerns remain for the Eurozone. **In Q3 the economy contracted 0.1%** and the flash Composite Purchasing Managers' Index (PMI) for November indicated the 20-country single currency union is on track to do so again in Q4.

Positive macro data towards the end of 2023 has strengthened investors' hopes that the US economy will avoid a recession altogether, but several economists are suggesting a **50% probability in 2024** for the world's largest economy.

INTEREST RATE CUT **PROBABILITY**

Following the monetary policy meetings for the BoE, ECB and FOMC in December 2023, the market reassessed its estimates on the interest rate outlook and the projected timing of rate cut cycles for 2024.

These are the projections for the three key central banks as of 15 December 2023:

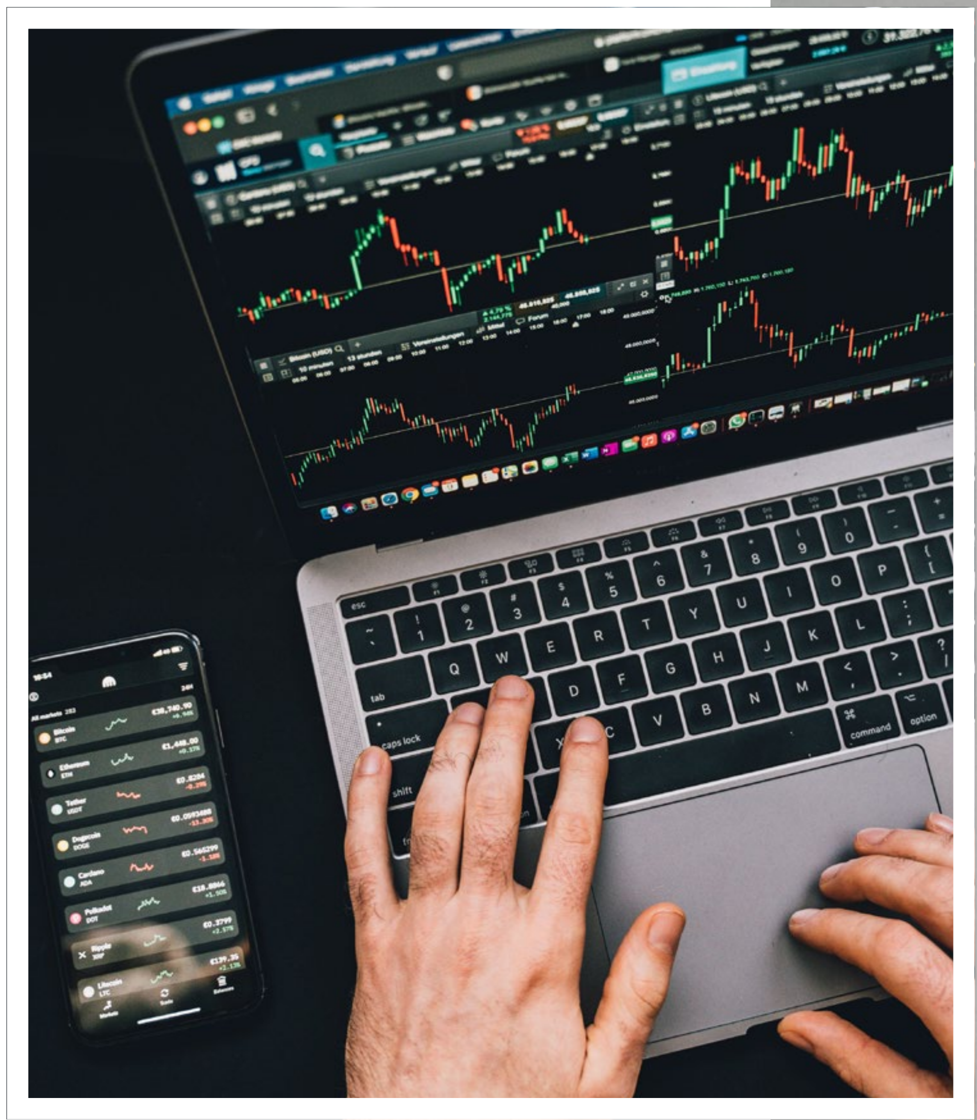
However, if it's sticky above their target, loosening interest rate policy will fail to address inflation, whilst raising may hinder activity further.

	Year 2023 End	Likely month of cutting cycle beginning	Implied basis point cuts during 2024	Implied Dec 24 Interest rate
BoE	5.25%	May 24	-109.44	4.09%
ECB	4.00%	April 24	-151.57	2.37%
FOMC	5.25-5.50%	March 24	-148.3	3.85%

Given the current backdrop, the probability of a rate cut will be based on growth and inflation levels. Central banks' mandate on monetary policy is to control inflation whilst promoting growth.

If inflation is moving back toward a central bank's target and economic activity is sliding, it will provide them with the opportunity to loosen interest rate policy to promote growth. However, if it's sticky above their target, loosening interest rate policy will fail to address inflation, whilst raising may hinder activity further.

Q1 data will be scrutinised to articulate what the interest rate curve will look like in 2024, when the cutting cycle might begin, and what pace will this be.



FX FORECAST FOR Q1 2024

While nobody has a crystal ball, we can see where the consensus is in the market by extracting the monthly FX POLLS from Eikon.

This only highlights that opinion is divided, with large variances between the high and low forecasts. The data below is extracted from the FX Polls posted on 07 December 2023 forecasting the FX rate for 29 February 2024.

GBPUSD		GBPEUR		EURUSD	
N.A.B	1.2967	Citigroup	1.1905	Bank of NZ	1.1200
BNP Paribas	1.2900	Credit Agricole	1.1765	Societe Generale	1.1000
Mizuho	1.2700	Barclays	1.1583	Citigroup	1.0900
Mean	1.2456	Mean	1.1442	Mean	1.0813
Nordea	1.2400	Deutsche Bank	1.1346	JP Morgan	1.0450
Danske	1.2400	Commerzbank	1.1152	Goldman Sachs	1.0400
Standard Chartered	1.1767	Commonwealth Bank	1.1052	Julius Baer	1.04

The data is extracted from the FX Polls posted on 07 December 2023 forecasting the FX rate for 29 February 2024.

KEY EVENTS AND DATA

With the market keeping an eagle eye on interest rate policy, it will inevitably focus on the central bank meetings, inflation data and GDP data. This doesn't mean that other releases won't be key, but it is more likely that currency volatility pick up around these scheduled events.

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CENTRAL BANK INTEREST RATE MEETING	Jan '24	Feb '24	Mar '24
Bank of England	N/A	1st	21st
European Central Bank	25th	N/A	7th
Federal Open Market Committee	N/A	31/1 - 01/02	21/3 - 22/3

CONSUMER PRICE INDEX	Jan '24	Feb '24	Mar '24
UK	17th	14th	13th
Eurozone	5th	1st	1st
US	11th	3rd	12th

FIRST RELEASE OF GDP	Jan '24	Feb '24	Mar '24
UK	7th		
Eurozone	30th		
US	25th		

WHAT APPROACHES CAN BE TAKEN?

Don't fall into the trap of overcomplicating your hedging strategy amid a mountain of available products and strategies. This cluttered approach creates an unclear view of FX risk management that will leave you susceptible to more risk than you started with.

To achieve transparency and stability you must implement a proactive strategy that empowers you to manage FX risk with certainty by replacing emotion-led choices with informed decisions that are underpinned by data and best practices.

Lumon recognises there's no "one size fits all" approach to protecting profit margins from FX risk. To tailor your strategy, our dealers work in partnership with you to understand your unique risks and requirements – and help you harness proactive solutions that secure exchange rates for future transactions.

This relationship-led approach to FX risk management allows us to work together to safeguard your finances against currency volatility now and in the future.

WE SUPPORT CLIENTS TO HELP THEM UNDERSTAND:

1. When to hedge?
2. How much to hedge?
3. How far forward to hedge?

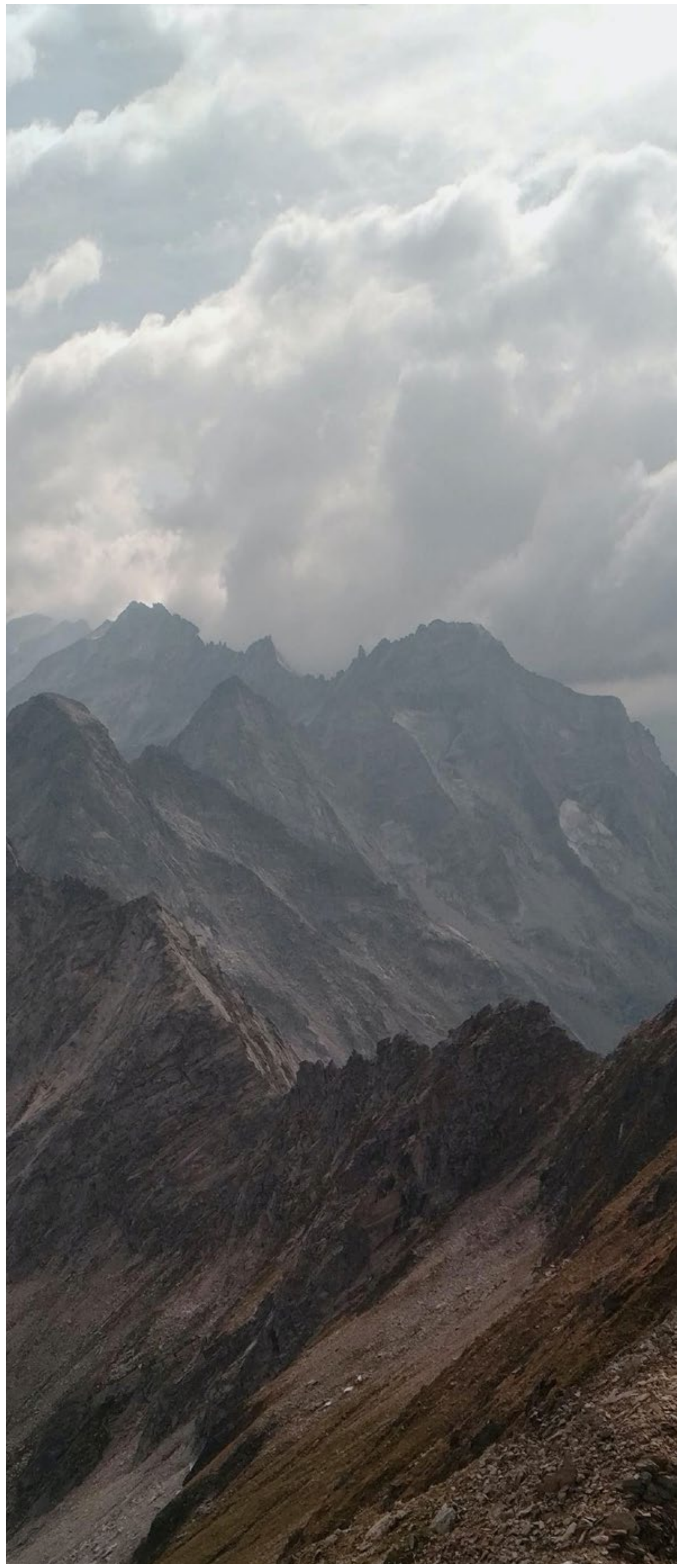
HOW FAR FORWARD AND HOW MUCH SHOULD BUSINESSES HEDGE?

When developing an FX strategy, it is important to consider how far into the future the business is looking to hedge and what percentage of the forecasted cash flows need to be hedged - as this will dictate what solutions form the foundation of the strategy. This will ultimately be determined by how forecastable the specific exposures are and the underlying risk appetite of the business.

ANSWERING SEVERAL KEY QUESTIONS WILL ENSURE THE RESULTING CURRENCY STRATEGY IS FIT FOR PURPOSE:

- Could the forecasted exposures dramatically change at any point in the future?
- What tolerance does the business have concerning foreign exchange variance?
- How secure is the underlying business from which the currency exposure is derived?
- How much cash flow stability is the business looking for?
- Will FX movements affect your end-user pricing?

Every business is unique, so their underlying approach to FX risk management should be too. The solution we work in partnership with businesses to implement helps them recognise that a hedging policy must not be dictated by opinion of how the market might perform - because it is impossible to know.



CFOs STEP-BY-STEP GUIDE TO WORKING WITH A SPECIALIST

1

Data-led, People Centric Partnership
Lumon augments its technical currency market know-how with a relationship-led service, so we can gain a deep understanding of the company's exposures, pain points, risk appetite, and any other variables that influence its objectives.

2

Tailored Risk Mitigation Strategies
Using this knowledge and empathy, we help to develop a tailored strategy that aligns with the level of risk they're exposed to and seeking protection from. The solutions that underpin this allow them to secure a specific exchange rate for future transactions, providing certainty and stability in financial planning.

3

Precision Execution and Risk Mitigation
We support the implementation of the strategy, ensuring trades are executed in line with the predetermined parameters and rules - removing risky emotion-led decisions from the equation.

4

Continuous Support and Market Analysis
Our job does not finish when the strategy is implemented, it starts. We provide in-depth analysis and real-time market insights throughout the life of the hedge - allowing them to gain certainty in their financial operations.

5

Dynamic Strategy Evolution and Performance Monitoring
Our dealers analyse and regularly report on the performance of the strategy, allowing it to evolve with the dynamic business and economic environment.

YOUR TRUSTED CURRENCY PARTNER

Lumon's multi-faceted approach to FX risk management blends empathy, experience, and technical knowledge to provide stability amid uncertainty, allowing you to prioritise growth and profitability with confidence.

If you have a perspective you'd like to share with us or would like to explore our range of FX solutions, please get in touch:

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GET IN TOUCH

We are always ready to help you with your currency needs.
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