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FX Focus: Sterling's underperformance against EUR could continue

FIGURE 1: FX Forecasts

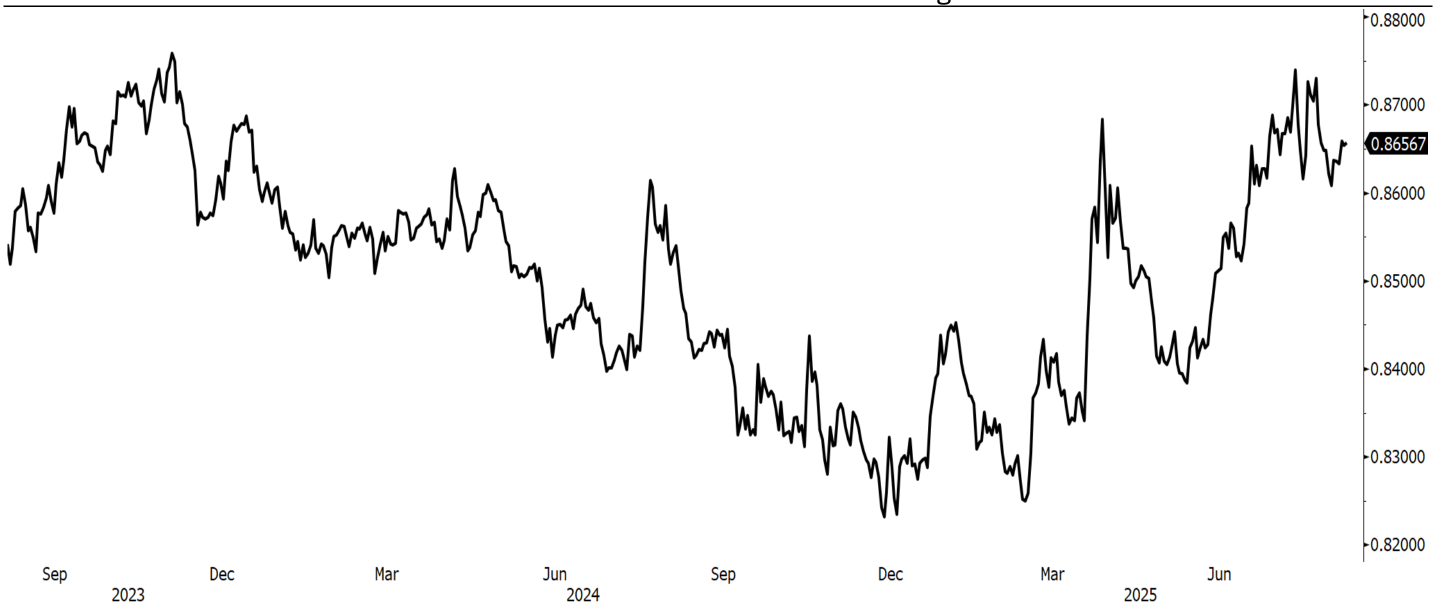
Forecast (July 2025)	Spot	0-3m	6-12m	Long-term
EURGBP	0.8650	0.8800	0.8700	0.8400

Source: Citi Research as of August 2025

The United Kingdom appears to have a better trade deal outcome with the US than the euro area currently based on the tariff figure alone. But the sterling has still underperformed the euro since the start of this year as stagflationary headwinds and policy constraints dominate the UK landscape. This might continue and could see sterling underperformance against euro extend to year end, leading the EURGBP cross to head higher towards the 0.8800 – 0.8900 level later this year or in early 2026.

- The US has levied a baseline tariff of 10% on UK goods with a carve-out for automobiles and automobile parts, and aluminum. In contrast, the euro area has been hit with an all-inclusive tariff of 15% that also includes automobile/ automobile parts. This may also apply to pharmaceuticals and semiconductors in the future.
- This, at face value, should be supportive for sterling versus the euro. But GBP has underperformed euro since the beginning of the year. This may continue over the medium term for the following reasons:
    - UK's seemingly steady drift towards stagflation amid weaker consumer demand, a softer labor market and sticky inflation. The Bank of England's (BoE) stagflationary forecasts in August point to rising UK unemployment and inflation this year. The preliminary UK PMI data for August also shows businesses reducing headcount and an uptick in price pressures. The overshoot in UK's August CPI, the fourth in a row, comes amid reflation risks highlighted by the BoE's August monetary policy report.
    - The UK economy's reliance on government spending to boost growth at a time of looming fiscal tightening in the second half of the year may lead to contraction later in the year. With the UK budget announcement scheduled for Q4, government spending is likely to weaken further, and potentially higher taxes are likely to weigh on household consumption and business investment. This speaks to the BoE's wider set of stagflationary forecasts. It now expects UK unemployment to rise to 4.8% in Q3 from 4.6% in the May forecasts while adding 1.1ppt to UK's Q3 inflation forecast.
    - The question facing sterling investors is whether the BoE's near 50bp in rate cuts currently discounted by UK rates markets to mid-2026 will be enough to offset looming UK fiscal tightening in the second half of the year. Failure to boost UK growth via fiscal stimulus due to the tight spending disciple employed by the UK chancellor via her "fiscal rule" and reluctance of the BoE to make deeper rate cuts could tighten UK financial conditions. This is likely to be medium term bearish for the sterling especially against the euro.
- The euro area too faces disinflationary headwinds from the 15% US tariff. But unlike the UK, markets believe the disinflationary headwinds in the euro area may prove temporary given the fiscal measures outlined by the euro area and Germany in early March to boost infrastructure and defense spending. Markets have embraced these measures as a sign of Germany's resurgence from years of fiscal conservatism to mitigate the disinflationary headwinds from US tariffs from 2026 onward.
- Relative growth differentials in favor of the euro area potentially sets a challenging backdrop for sterling against the euro over the medium term with targets to the 0.8800 – 0.8900 level (February 2025 high) and perhaps even higher on the EURGBP cross looking achievable by year-end or in early 2026.

FIGURE 2: The EURGBP cross bottomed in December 2024 and has been rising since the start of 2025



Source: Bloomberg, August 22, 2025. **Past performance is no guarantee of future results.** Real results may vary.

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