Four reasons why EUR/GBP won't reach parity

As the pound gets an economic and Brexit reality check, we explain why the 'Great British sell-off' in currency markets isn't here to stay

GBP forecast update: Short-term pressure, gentler recovery

The pound has been an easy target for currency markets as the combination of a post-Brexit economic reality check and ongoing political anxiety has made the UK economy an outlier relative to its faster growing European peers. We believe this economic divergence story has largely run its course. In fact, GBP is beginning to show signs of idiosyncratic selling, similar to previous periods when domestic political risks have flared up.

We make two points here. First, this tends to be a short-run phenomenon, with GBP's material undervaluation acting as a limiting factor for sustained weakness. Second, and more importantly, we would need to see an additional layer of bad news to fuel any further politically-induced GBP selling. This seems unlikely in the absence of a Brexit disaster situation unfolding - that is a complete breakdown in UK-EU negotiations and renewed cliff-edge risks. Political will from both sides suggests the worst-case scenario will be avoided.

So while EUR/GBP has overshot our 0.90 forecast for 3Q17 - and admittedly quicker than we had anticipated - we cite four reasons for why we think a move towards parity looks unlikely at this stage. Our revised forecasts acknowledge GBP could remain under pressure ahead of key domestic and Brexit political risk events in October. But we view this as an overshoot of more fundamentally-justified levels, rather than a sustained trend in EUR/GBP towards parity.

ING's GBP forecast update as of 24 Aug 2017

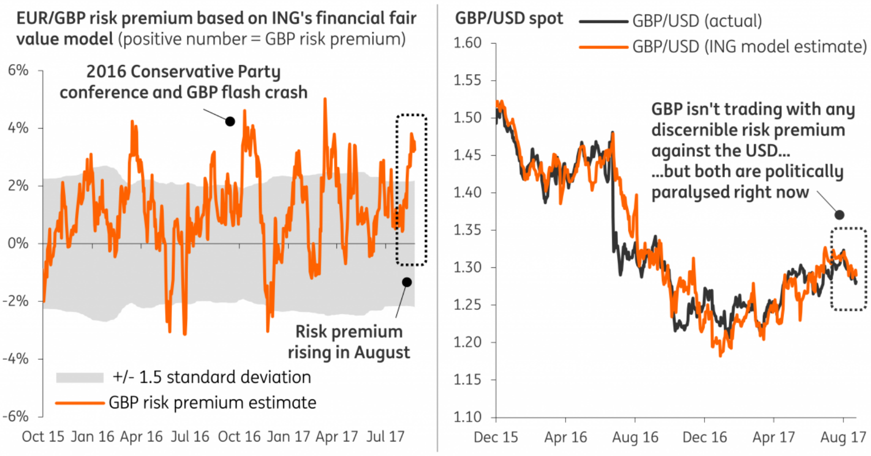
		Spot ref	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
EUR/GBP	Latest	0.9205	0.94	0.90	0.88	0.88	0.88	0.85
	Prior		0.90	0.85	0.83	0.85	0.83	0.80

Source: Source: ING

1 The euro has become a 'political haven' for currency markets

We had earmarked October as being a pivotal month for GBP regarding political risk events. The Tory Party Conference (1-4 Oct), the final round of opening Brexit talks (9 Oct) and EU summit (19-20 Oct) will give markets an opportunity to assess the progress made when it comes to the UK's exit from the EU. These event risks mean that it is understandable to see GBP markets trading with some apprehension. We have been warning of a potential 'sell on (PM) May and go away' type of behaviour emerging ahead of October.

However, the extent of GBP's recent weakness - and deviation from short-term fundamentals - is now starting to look excessive relative to the near-term political risks at stake. This is certainly the case for EUR/GBP, which based on our estimates is trading around 4% above its short-term financial fair value. In contrast, GBP/USD is showing no visible signs of a UK-specific risk premium. We rationalise this as both UK and US political uncertainty offsetting each other in the near-term, making the euro the go-to 'political haven' in currency markets. How times have changed.



Source: Source: ING model estimates, Bloomberg

2 Political will suggests a Brexit disaster can be avoided

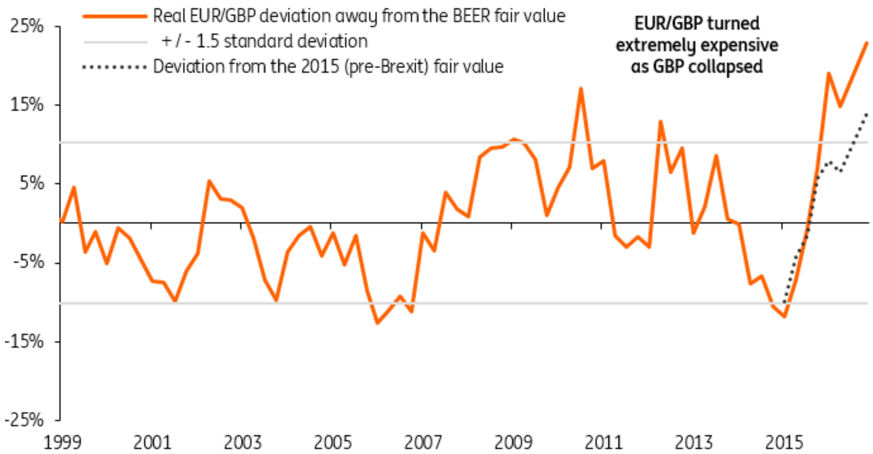
For GBP's politically-driven weakness to persist and extend all the way towards parity against the EUR, we would argue that 'hard Brexit' risks would need to notch up another gear. In reality, the only way this could occur over the next six months is if we get a nightmare Brexit scenario in October - that is a complete breakdown of UK-EU negotiations.

Instead, while we have previously acknowledged it is too early for GBP markets to price in any Brexit transitional deal hopes, we do think the growing consensus within Theresa May's cabinet over a transitional arrangement means that the tail risks of a cliff-edge Brexit are diminishing. The lack of clarity by the UK government on any preferred transition length - and rumours of only a 12 or 18-month arrangement being sought - may be seen as a near-term disappointment.

Progress on securing a transition deal - with both sides providing strong assurances - should help to ease any significant GBP downside bias. However, for this to serve as a catalyst for a rebound in the currency, we would need to see evidence that a reduction in economic uncertainty is in fact spurring a rebound in investment activity. This is what would give the Bank of England (BoE) greater confidence to begin normalising monetary policy - which would undoubtedly be a positive GBP development.

3 GBP is cheap, very cheap

We see GBP as extremely undervalued, with the very stretched valuation likely putting a limit on the scale of further downside. EUR/GBP is rich by a staggering 20% based on our medium-term Behavioural Equilibrium Exchange Rate (BEER) valuation framework. Even if we control for the post 2015 rise in GBP fair value due to improving UK terms of trade and declining UK government consumption, EUR/GBP would still be overvalued by 14%. When the medium-term valuation reaches such extreme levels, it tends to be difficult for the currency to weaken materially given the limits imposed by the underlying fundamentals.

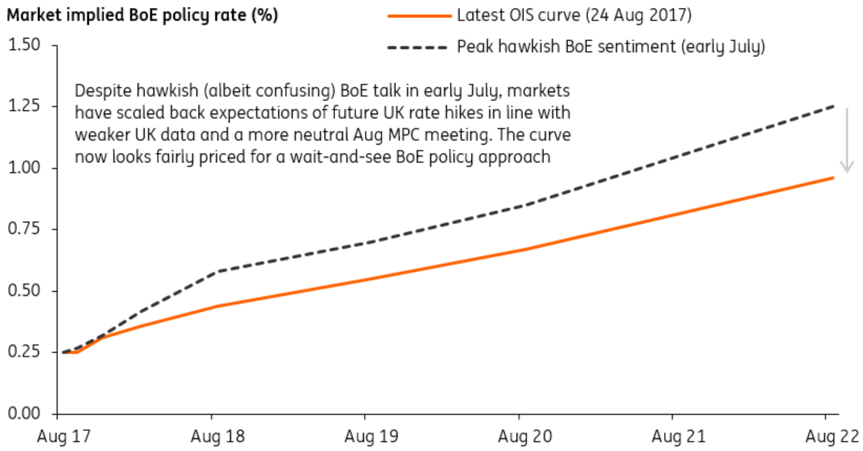


Source: Source: ING estimates, Bloomberg

4 Markets have adjusted to a wait-and-see BoE stance

The latest round of key UK economic data has put talks of a BoE rate hike on the back burner, with the breakdown of 2Q GDP highlighting the current weakness of the UK consumer. However, markets have now adjusted to a wait-and-see BoE policy stance and see limited risks of a flatter UK rate curve. For short-term domestic rates to move lower, we would need to see evidence of weak consumer activity turning into a hard-landing for the UK economy. Our economists see this as highly unlikely and are not expecting the economy to take a significant turn for the worst.

We also believe EUR/GBP parity may not be in the economic interests of the BoE given the implications that further GBP weakness has for imported inflation and the squeeze in real household incomes story. Equally, one could argue it is not in the economic interests of the ECB for financial markets to get ahead of themselves when it comes to pricing in the end of the central bank's quantitative easing programme. With implicit opposition from both sides, it's difficult to fundamentally justify any EUR/GBP move towards parity - certainly over the next three to six months.



Source: Source: Bloomberg

And why would we be wrong about EUR/GBP parity…

Apart from one (or more) of our four assumptions turning out to be wrong, currency markets can sometimes be an untamed beast. Just because GBP is undervalued doesn't mean it should rally. There needs to be some positive catalysts for GBP to manifest, not least signs of a stabilisation in a slowing UK economy and greater progress towards a Brexit transition deal (even if not fully agreed). But certainly, the very negative psychology needs to be broken, such that GBP is not such a clear sell on rallies. Indeed we – and the BoE – are on the look-out for a 'sell UK' mentality developing, where GBP, gilts and equities all sell-off at the same time. This, however, has not been the case so far.

If that mood was to develop, with GBP weakness proving more trouble for the inflation trajectory, the IMF might recommend sharp rate hikes to break the vicious cycle. Typically that has been the prescription for significant 20% falls for the likes of the Russian ruble, Turkish lira and Brazilian real. Of course, the UK has had some painful experiences in using rate hikes to defend the pound (think 1992), and we very much doubt that the BoE would do that to support the currency. Yet, we believe, the bearish psychology on GBP still needs to be broken.

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