

FX: Sterling risk premium tracker

We have observed a general reduction in various GBP risk premia measures over the past week, with UK legislation against a no deal Brexit on 31 October helping the battered pound. Still, early elections in late November / early December remain our base case and we retain a negative view on GBP for 4Q19

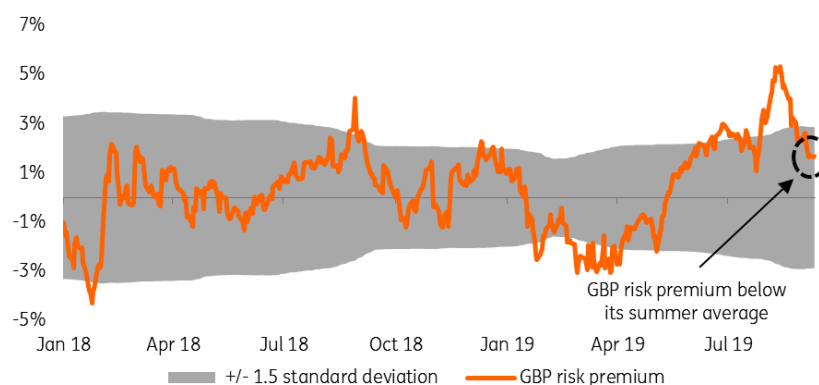


Where we are now?

The pound has strengthened over the past few days amid UK legislation against a no deal Brexit and stretched short GBP positioning. As a result, EUR/GBP risk premium has dropped and is now close to 1.5%. This is well below the summer average of 3% and the risk premium peak of 5.3% last month (Figure 1).

Figure 1: GBP risk premium declined further

The estimate of EUR/GBP risk premium. A residual between EUR/GBP short-term financial fair value and the spot.

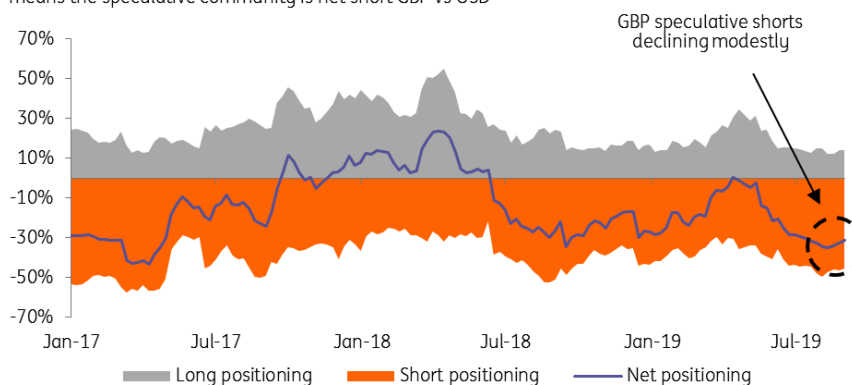


Source: ING

The GBP/USD speculative shorts remain elevated but have been modestly declining over recent weeks (Figure 2). As the data is reported with a lag, we suspect the speculative shorts are currently lower than the latest available data suggests (i.e. below 30% of open interest vs the last figure of 31%).

Figure 2: Speculative positioning lower but still elevated

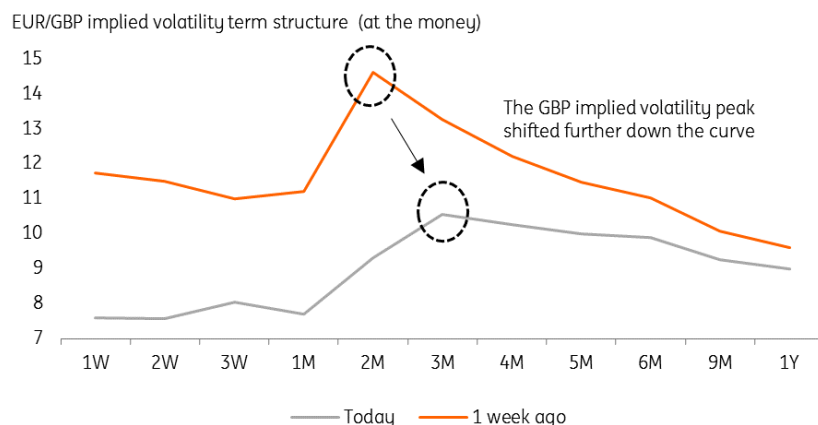
GBP/USD speculative positioning, as % of open interest (as of 3rd September 2019). Negative number means the speculative community is net short GBP vs USD



Source: ING, CFTC

The reduction in immediate risk of a no deal Brexit is very apparent in the options market. Not only has sterling implied volatility declined across all tenors, but as Figure 3 shows, the peak in volatility has shifted further down the curve from the two-month tenor (expiring shortly after the 31 October "do or die" deadline) to three months (the period when the possible election campaign should escalate / elections could take place). The options pricing, albeit currently less extreme, directly ties in with our view that more pressure on GBP is still to come ahead of a general election, which we expect in late November / early December this year.

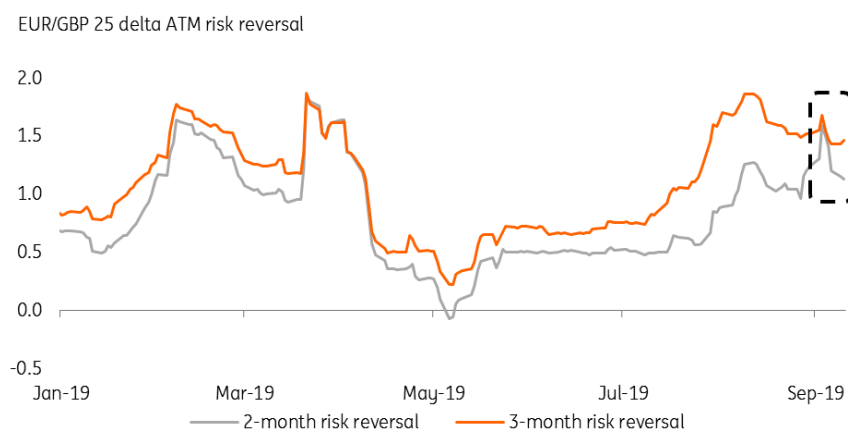
Figure 3: The GBP implied volatility peak shifted further down the curve



Source: ING, Bloomberg

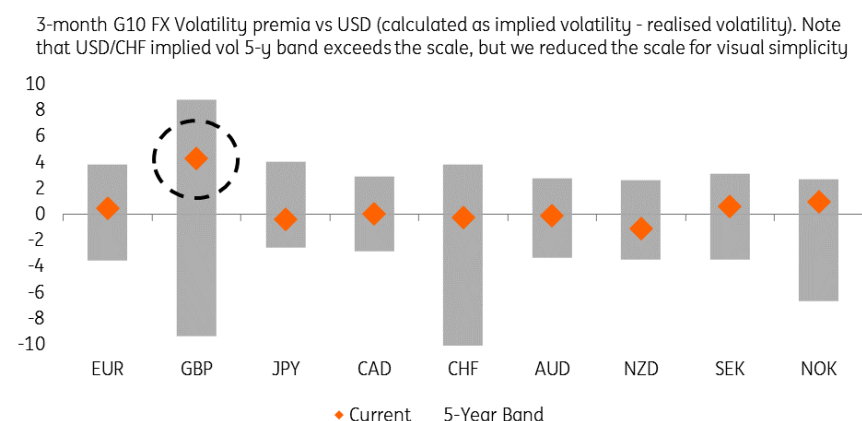
Indeed, the overhang of the early election within the three-month period (but after the 31 October deadline) is the key reason why three-month EUR/GBP risk reversals did not correct as much as the two-month tenor (Figure 4). We expect the sterling volatility risk premium to remain elevated vs its G10 peers (Figure 5), particularly the three-month tenor.

Figure 4: More limited correction in three-month EUR/GBP risk reversals



Source: ING, Bloomberg

Figure 5: Sterling volatility risk premium to remain the highest in the G10 FX space

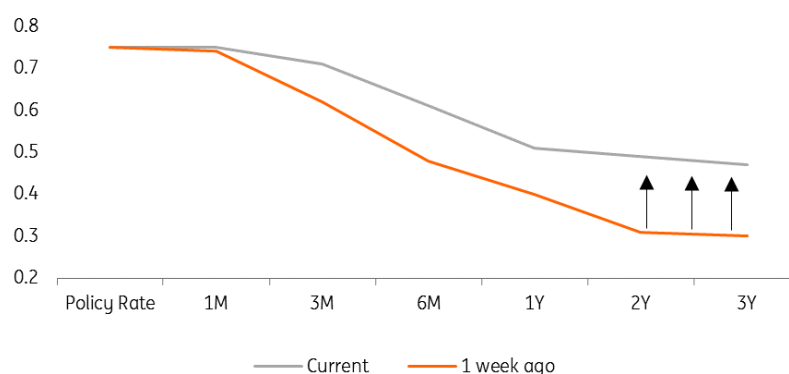


Source: ING, Bloomberg

With the risk of an imminent no deal Brexit declining, the market is now pricing (Figure 6) less aggressive easing from the Bank of England (though some of the hawkish re-pricing has also been caused by the rise in core yields) and sterling has been outperforming its G10 FX peers (Figure 7). As per below, we don't expect GBP gains to be long lasting.

Figure 6: Market pricing less aggressive BoE easing

Market implied policy curve for the BoE policy rate



Source: ING, Bloomberg

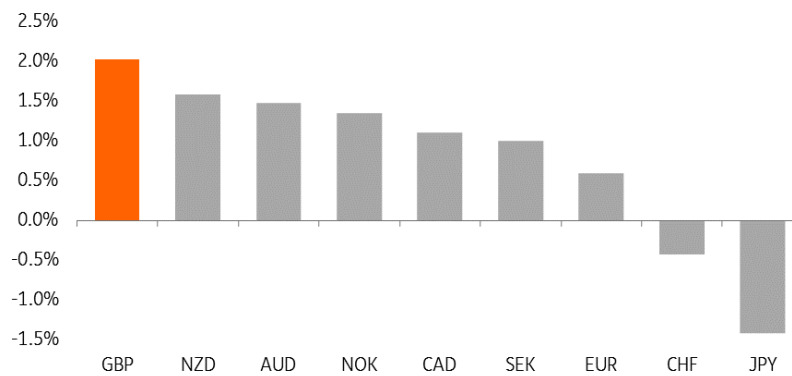
What to look for?

The UK Parliament has now been suspended for the next five weeks, with legislation against a no deal Brexit in place. For now, GBP may enjoy a calmer period with occasional upside caused by the still-stretched positioning. Yet, given our base case for early elections in late November / early December (likely to be triggered by a vote of no confidence) we expect GBP to come back under pressure. Among other things, the possible victory of the Conservative party under the leadership of Boris Johnson would mean an increased likelihood of no deal Brexit should Conservatives achieve a Parliamentary majority.

This suggests that the current subdued risk premium in the pound will increase, in turn weighing on the currency. We expect EUR/GBP to converge towards the 0.95 level and GBP/USD to fall below 1.20 over the next three months.

Figure 7: GBP outperforming as risk premium priced out of sterling

G10 FX returns vs USD over the past 5 days



Source: ING, Bloomberg