

GBP: A Florentine renaissance

PM May's speech has signalled a shift towards an 'economically rational' Brexit. This can only be good news for a significantly undervalued currency



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Economically rational Brexit

Theresa May's speech in Florence has signalled a shift in the UK's position towards an 'economically rational' Brexit – one that seeks to reduce some of the medium-term UK economic uncertainty clouding sterling markets. This can only be good news for a significantly undervalued currency – though any upside potential may be less imminent and obvious at this stage.

While prospects of a two-year transitional period pose upside risks to our year-end GBP/USD and EUR/GBP forecasts of 1.33 and 0.90 respectively, we are reluctant to revise these until we see greater strides towards a deal. Michel Barnier's response to the speech suggests this could be one of the focal points of Brexit talks over the coming weeks and months – and therefore we still retain a constructive GBP outlook in the near-term.

PM May's speech fails to give mini-boost to GBP

The knee-jerk move lower in GBP suggests investors may have been hoping for a clearer and more succinct speech from the Prime Minister, rather than the one they got. In effect, it takes us to the

same destination: the UK will be looking for a two-year status-quo transition deal with EU once the Article 50 period transpires in April 2019.

An agreed transitional period, in principle, could unlock further upside potential in the pound, but [our economists](#) wary that getting to that stage may not be a straightforward path. The response from the EU's chief Brexit negotiator, Michel Barnier was fairly amicable, but he noted a transition deal is subject to "the wishes" of the EU. While they have previously supported the idea of a status-quo transitional arrangement, the finer details – such as the exact budgetary and judiciary conditions of any transition period – still need to be ironed out.

[Does May's speech put Brexit back on track?](#)

But a swiftly agreed transition could unlock GBP upside potential

If this two-year transition deal can be signed, sealed and delivered swiftly – then we see three channels which could make the GBP move higher:

- (1) reinforced BoE policy tightening sentiment and a steeper UK rate curve
- (2) a recovery in domestic investment prompting upside risks to the UK's growth outlook
- (3) a reduction in GBP downside tail risks stemming from cliff-edge Brexit risks being pushed further down the road

Final word

A combination of these factors would inject some modest upside to pound over the coming months, with GBP/USD potentially moving up to 1.38-1.40 by year-end. Equally, we could see EUR/GBP trade in a slightly lower range of 0.85-0.87 on the basis of a swift transition deal.