

GBP and UK election: Asymmetric sterling reaction

GBP price action after the election will be asymmetric; less pronounced gains on a market-friendly outcome vs more meaningful losses on a non-market friendly outcome. A Conservative party majority should send EUR/GBP to 0.82/0.83 within a day. A hung parliament should lead to EUR/GBP spiking to 0.87. The asymmetry applies to spillovers into other G10 FX



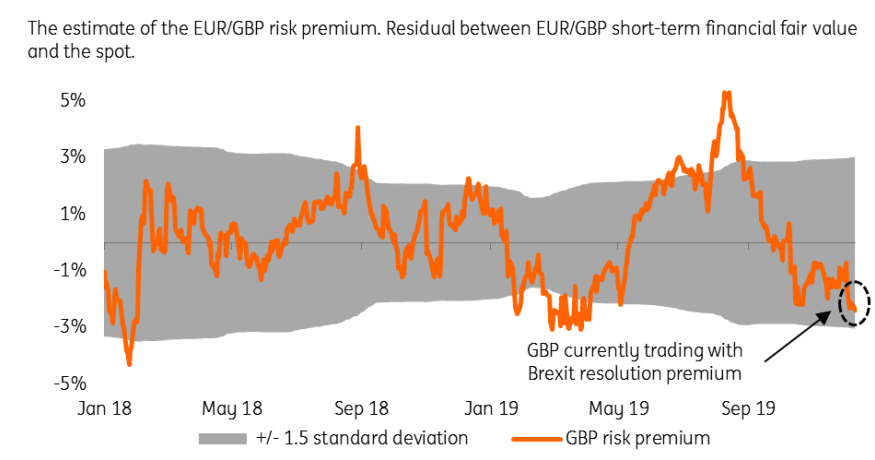
Market-friendly outcome partly priced in...

Investors are awaiting the outcome of the UK general election (this Thursday) and the market is currently partly pricing a Conservative party victory. EUR/GBP is trading below 0.8500 (closing below this level for the first time since May 2017) and our short-term financial fair value model suggests a more than 2% positive Brexit resolution premium currently priced into GBP (Fig 1). The short GBP speculative position has been trimmed (currently 13% of open interest vs close to 40% in mid-September – Fig 2).

The EUR/GBP implied volatility term structure shows a heavily inverted curve, reflecting the anticipated two-way price action after the vote – either non-negligible appreciation or a

meaningful depreciation. Indeed, EUR/GBP and GBP/USD break-evens point to a non-negligible and rather volatile post-election sterling reaction, at 140pips and 190pips, respectively.

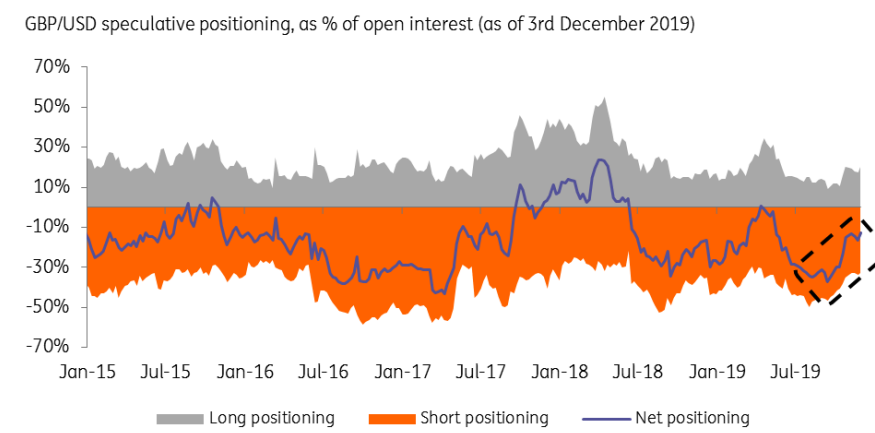
Figure 1: GBP trading with positive Brexit resolution premium



... pointing to asymmetric GBP reaction

Given the anticipated market-friendly outcome, the GBP price action is likely to be asymmetric (skewed towards more meaningful sterling weakness vs strength, as the non-market friendly outcome doesn't appear to be investors' base case). The theme of asymmetry is present in the scenario analysis in Figure 3 (larger GBP downside on a non-market friendly outcome vs a less pronounced upside on a market friendly outcome). This is why the EUR/GBP implied volatility smile is skewed towards EUR/GBP calls (vs puts), as evident in Figure 4.

Figure 2: GBP speculative shorts reduced since mid-September



Scenario analysis - bigger potential move on non-market friendly outcome

In Figure 3, we present an updated scenario analysis (initial GBP reaction over one to three days), reflecting the latest spot levels, market expectations as well as the parties manifestos (which were

not known when we published our previous scenario analysis).

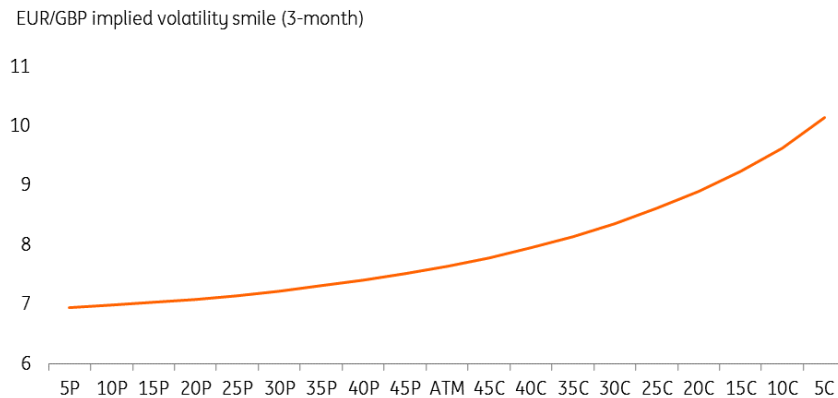
Figure 3: Scenario analysis for GBP post election price action

Immediate/short-term reaction	
Large Conservative majority	Main driver: Hope of a ratified deal EUR/GBP: 0.82 GBP/USD: 1.35
Thin Conservative majority	Main driver: Hope of a ratified deal EUR/GBP: 0.83 GBP/USD: 1.33
Hung Parliament	Main driver: Brexit impasse to continue EUR/GBP: 0.87 GBP/USD: 1.26
Labour-led minority government	Main driver: Economic policy concerns EUR/GBP: 0.89 GBP/USD: 1.24

Source: ING

1. **A large Conservative party majority** would be perceived as an expected market-friendly outcome and lead to additional sterling gains. A Conservative Party majority of say 30-40 plus would be more positive as it would reduce potential uncertainty around a possible extent of the transition period. EUR/GBP to reach 0.82 and GBP/USD 1.35.
2. **A smaller Conservative majority** would initially lead to GBP gains, too (to 0.83), yet the scale of GBP strength is likely to be marginally more limited. While the Withdrawal Agreement would very likely be passed by the end-January 2020, the question of a hard Brexit might return around mid-year if eurosceptics in the European Research Group oppose an extension to the transition period beyond the end of 2020 (which would, in turn, suggest there is no Conservative Party majority for an extension). Still, as this is an issue for 2020, it is unlikely to prevent initial GBP gains.
3. **A hung parliament** would lead to a full pricing out of the GBP Brexit resolution premium (which is currently worth more than 2% based on our estimates), a rebuilding of sterling speculative shorts and GBP/USD likely dropping to 1.26 (and EUR/GBP rising 0.8700 this week).
4. **A fragile Labour-led minority government** would, in our view, be the most negative of the most probable election outcomes. This reflects (a) the market not pricing such a scenario; (b) initial market concerns about nationalisation and fiscal concerns (i.e. a material rise in borrowing needs as implied by the Labour manifesto). While the prospects of a second referendum could eventually help to stabilise GBP (as well as lower the probability that Labour policies would be introduced in full under a minority Labour-led government) the initial reaction would likely be GBP negative.

Figure 4: EUR/GBP volatility smile asymmetrically skewed to calls

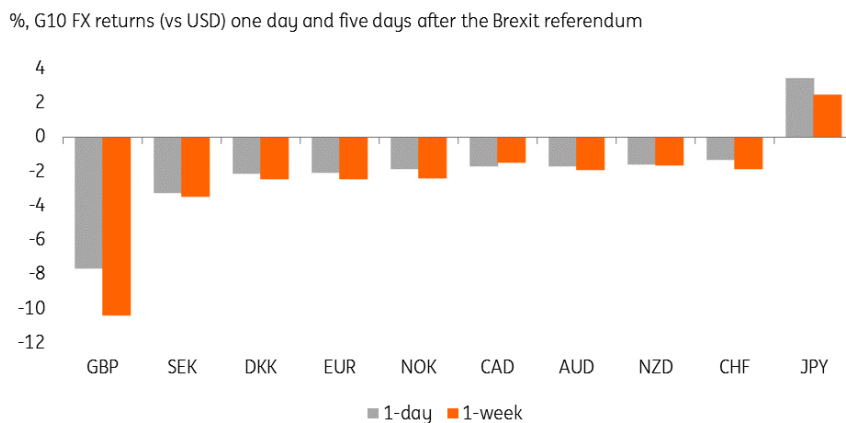


Source: ING, Bloomberg

Spillover into other G10 FX: Also asymmetric but unlikely to last long

In terms of spillover into the global FX space, there are two things to note. First, it is unlikely to be long-lasting as Brexit is seen as a largely domestic event. Second, it's likely to be asymmetric as well, with a muted reaction on a market-friendly outcome (as this is expected) and a more pronounced reaction if the Conservative Party fails to achieve a majority or the election results in a hung parliament (as this would come a surprise based on the latest polls and market pricing).

Figure 5: Meaningful reaction the negative Brexit referendum surprise ...

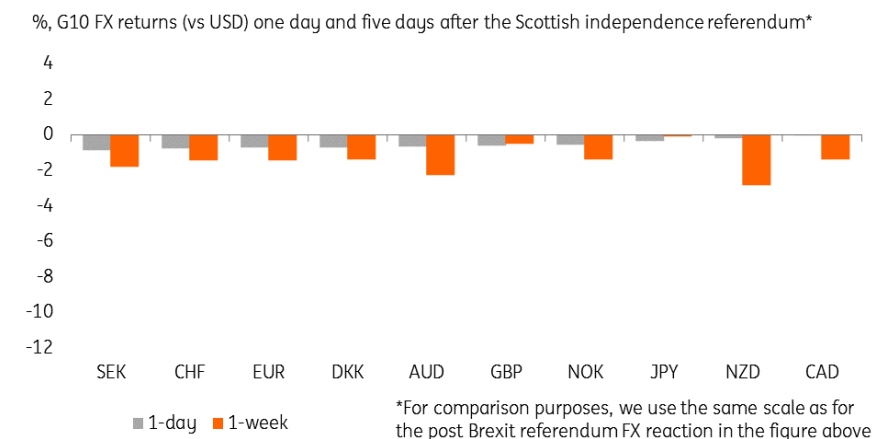


Source: ING

Figure 5 shows the G10 FX reaction vs the US dollar after the 2016 Brexit referendum (the result was unexpected back then and not seen as market friendly). The Japanese yen and US dollar outperformed, with the European FX segment coming under pressure. Of course, GBP was the prime casualty. As the same Figure 5 shows, the bulk of the reaction came on the day (of the

referendum result) with one-week price action not dissimilar to the one-day price action. In contrast, after the 2014 Scottish referendum (when the outcome was in line with expectations and market friendly) the reaction was far more muted (Figure 6).

Figure 6: ... as opposed to more muted reaction after the Scottish referendum



Source: ING, Bloomberg

Large majorities (usually) welcomed by GBP

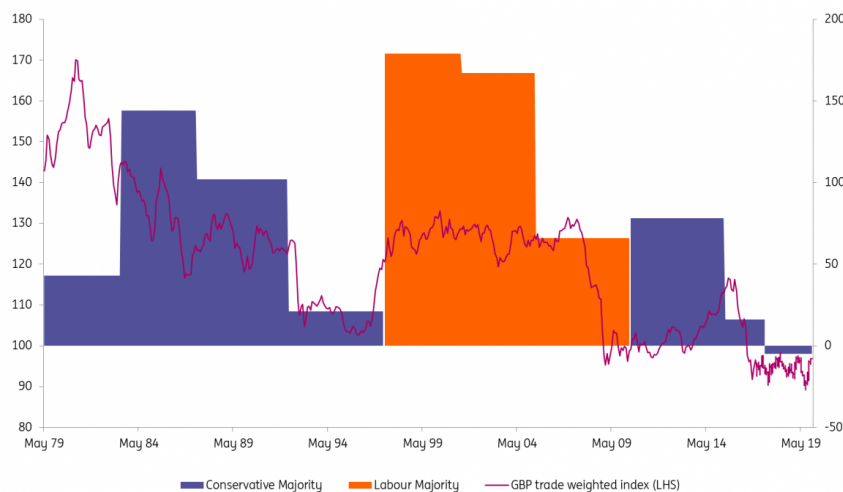
It's been a while since the UK was led by a government backed by a working majority. The last time we experienced this in the UK was the Conservative-Lib Dem coalition government of 2010-2015. Ever since Theresa May's ill-fated general election in June 2017, the government majority and GBP have been sinking (Figure 7).

Typically, governments backed by small majorities have seen GBP underperform over the last 40 years. Weak majorities mean louder voices for the backbenchers and limited room for manoeuvre - e.g. for the governments of John Major and David Cameron. Large majorities, including those for Tony Blair's two terms, have been welcomed by GBP.

Certainly GBP seems to be enjoying a 'buy the rumour' rally on an expected Conservative majority at Thursday's election. GBP could rally further if the Conservatives somehow deliver a 50+ seat majority.

We suspect the market would be less enamoured with a (however unlikely) sizable Labour majority this time around. Corbyn's policy are diametrically opposed to those of the Blair government, where Chancellor Gordon Brown gave the Bank of England independence. Corbyn's plans for massive redistributive tax changes and greater control of the private sector would likely see GBP hit hard should Labour enjoy a big win.

Figure 7: government majorities and GBP: size matters



Source: Bloomberg, ING

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.