GBP: Bad Brexit vibes return... but this time may be different

The UK government will outline its Brexit vision in a series of speeches ahead of the 22-23 March EU leaders' summit. This could hit the pound but the potential downside is likely to be limited. Here are four reasons why

Road to Brexit: May's Cabinet to unveil Brexit vision with six speeches

Brexit-headline risks for GBP are likely to increase in the near-term after the EU's chief Brexit negotiator Michel Barnier stated last week that a transition period is 'not a given'. It seems the sticking points are the usual divisions between the UK and EU over the freedom of movement principle and understanding the UK's position on access to the customs union and single market during the transition period.

Be it luck or chance, Prime Minister Theresa May is set to outline her vision on the UK's future relationship with the EU in a series of speeches over the next few weeks – which, in principle, should deliver some of the clarity that her negotiating counterparts desire. There are reported to be a series of six speeches – two from the PM herself (with the first one on Saturday 17 Feb), while we will also hear from Foreign Secretary Boris Johnson (Wednesday 14 February), Brexit Secretary David Davis (tbc), Trade Secretary Liam Fox (tbc) and de facto Deputy David Lidington (tbc).

More importantly for markets, these speeches will shed light on the prospects of a Brexit transition deal being agreed by the end of March 2018 – which a recent CBI survey shows is when the majority of large UK businesses would look to implement 'cliff edge' Brexit contingency plans if there were no transitional arrangements tabled.

Noisy speeches may see GBP trade with a Brexit risk premium

It may be wishful thinking to expect the next few weeks to go smoothly for GBP as the UK government unveils its Brexit vision over the coming weeks. Indeed, the key risk is that prominent Brexiteers could muddle the landscape – reducing the perceived odds of a Brexit transition deal being agreed by end-March. Such uncertainty would likely command a modest Brexit risk premium priced into GBP in the near-term.

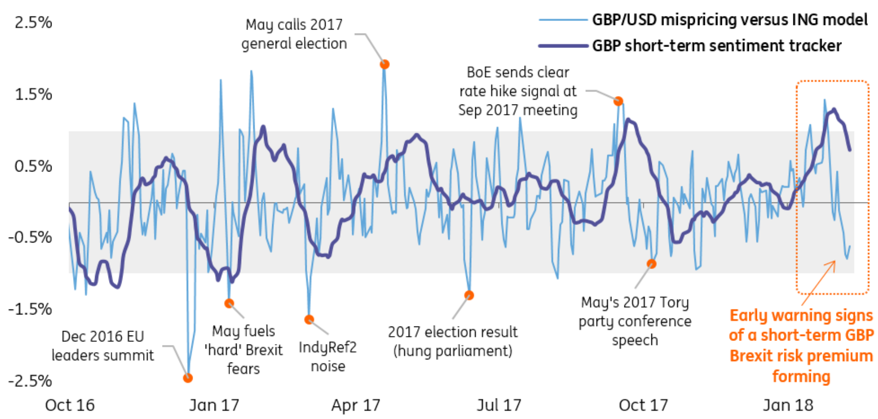
Historically – and since the Brexit referendum – we've seen some pretty sizable short-term risk premium's being priced into GBP during 'noisy' Brexit episodes. As the chart below shows, GBP/USD has at times traded around 1.5-2.0% below it's expected short-term fair value model estimate – although we note the biggest discrepancies were seen mainly during the first 6-12 months after the Brexit vote (so up until 1H17).

Of late, however, we've rarely seen GBP/USD trade with any meaningful discount – a potential sign of Brexit fatigue and evidence that there is now a high bar to sell the currency on the back of Brexit or domestic UK politics. In fact, more recently we have seen GBP/USD trade at a sizable premium relative to its fair value estimate, though we chalk this down to a structurally and politically weak USD (see our note outlining the four misconceptions for GBP/USD right now).

Should noise levels around Brexit increase over the coming weeks, we would expect GBP/USD at best to trade with a 0.5%-1.0% risk premium. We would expect a similar – albeit slightly bigger – risk premium to be priced into EUR/GBP. In terms of levels – and assuming the conservative assumption of no change in our fair value estimates – heightened Brexit noise could see GBP/USD trade in the 1.3720-1.3950, with EUR/GBP bouncing around the 0.88-0.90 region.

Large Brexit risk premiums in GBP may be a thing of the past

GBP/USD deviation from ING's financial model estimate (+ve = overreaction; -ve = underreaction)



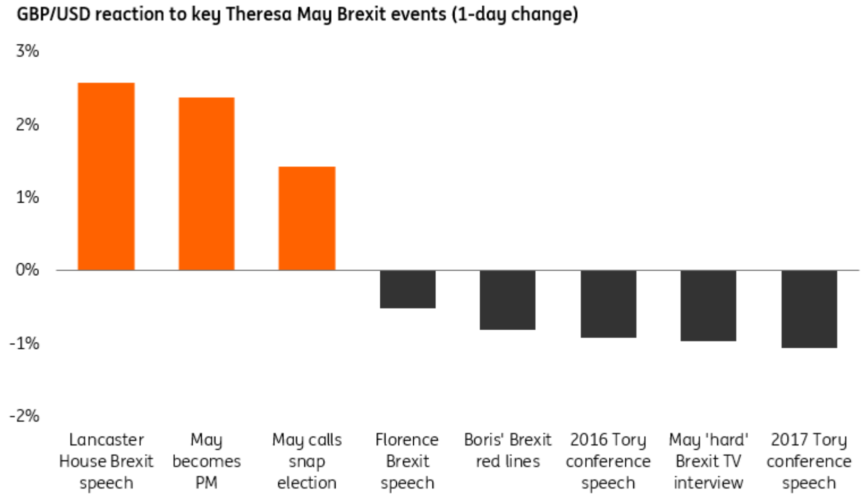
Source: ING estimates, Bloomberg

Watch out for a sharp GBP bounce back in the event of a positive outcome

Despite the potential for negative Brexit-headline risks for GBP over the coming weeks, it would be remiss to ignore the potential for a sharp bounce back. Indeed, given that GBP has been typically subdued around 'noisy Brexit' episodes – in particular, prior Brexit speeches by PM May - the short-term risks around key Brexit events have tended to be asymmetric, with a particular propensity for GBP to sharply rebound.

In the current environment, we would expect the same risk-reward dynamics – with a favourable outcome, in this case, visible progression towards an agreed Brexit transition deal, leading to sharp snapback in GBP/USD to above 1.40 (our 1-month target is 1.43). In a similar vein, EUR/GBP would fall back towards the lower-end of the broad 0.85-0.90 trading range.

Asymmetric GBP reaction to May's previous speeches



Source: ING estimates, Bloomberg

Four reasons why risk-reward still favours GBP upside despite Brexit risks

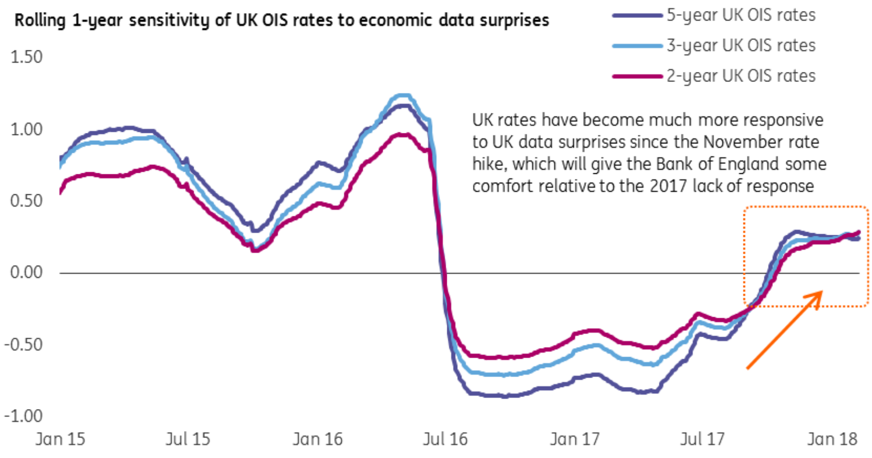
We cite four reasons for why (a) we expect any Brexit risk premium dynamics to be smaller than previously seen and (b) the risk-reward continues to favour GBP upside ahead of the 22-23 March EU leaders summit:

- **Signs that markets are becoming less Brexit-focused** and more responsive to UK macro data (see chart below). This means that a continuation of solid UK economic data would offset any Brexit-specific risks. Such a trading environment was non-existent in 2017, where markets were largely taking their cue solely from Brexit progress.
- **The Bank of England's Brexit-contingent hawkish signal** may reduce the inclination for any speculative short GBP plays on Brexit noise, thereby warranting a smaller risk premium (or a less persistent GBP disconnect from fundamentals). Equally, based on the reaction following the Bank of England's hawkish signal at the September 2017 BoE meeting - which teed up a November rate hike - we estimate that GBP should

currently be trading circa 1% higher (and closer to 1.40). We would expect to see the deferred GBP upside potential realised (in full) in the event of a positive outcome over a Brexit transition deal;

- **Brexit Divorce Deal precedent for a last minute solution** means that investors may be reluctant to reassess odds of a Brexit transition deal right up until the 22-23 March EU leaders summit. This would imply that price action follows a more 'trade the Brexit facts' path – rather than seeing speculators taking a punt on the outcome of Brexit transition negotiations.
- **Real money investors are yet to be 'Brexit believers'.** While the latest CFTC data shows that net long GBP/USD positioning stands at 14% (slightly below the five-year high of 22%), we note there remains a large discrepancy between leveraged funds and asset managers/institutional investors. In particular, we note the latter group of investors remain net short GBP/USD (13% of open interest) - which suggests that the market still remains structurally short. While the CFTC data only captures a fraction of the market - we do think there is scope for more Brexit good news and lower UK economic uncertainty brought about by a transition deal to see a further deleveraging of short GBP/USD positions. This story alone should help GBP/USD consolidate in the 1.40s - with the UK macro and fundamental story determining which side of 1.45 we sit.

Markets have become more sensitive to UK macro data surprises



Source: ING estimates, Bloomberg, Macrobond

Bottom line

Despite the potential for negative Brexit-headline risks for GBP over the coming weeks, it would be remiss to ignore the potential for a sharp bounce back in the event of a favourable outcome - in this case, visible progression towards an agreed Brexit transition deal. We would look for GBP/USD to move sharply above 1.40 (our 1-month target is 1.43), while in a similar vein, EUR/GBP could fall back towards the lower-end of the broad 0.85-0.90 trading range.

Author

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com