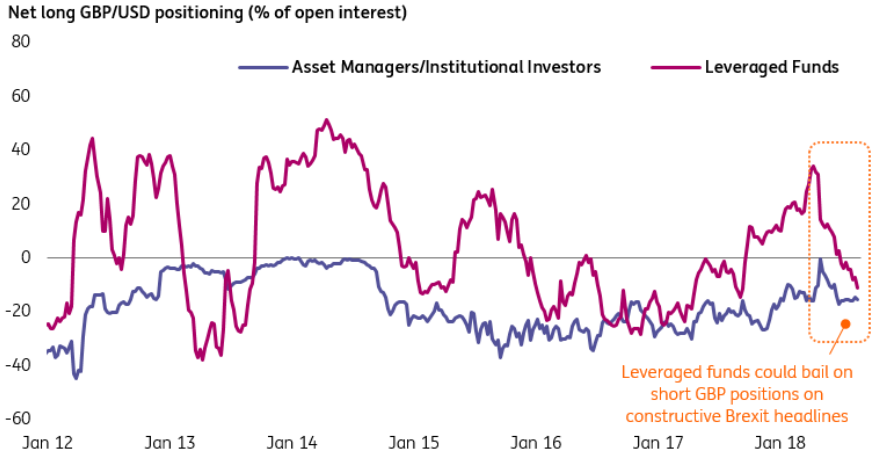
GBP: Barnier's Brexit Boost

GBP markets were caught off guard as the EU's Brexit negotiator Michel Barnier said they were "ready to propose a partnership the likes of which has not existed before with any third country". This is something that most hadn't thought was possible and may see a partial reassessment of no deal Brexit risks that lends support to a politically-infested pound

Source: istock

Leveraged funds that are short GBP could bail on more positive Brexit headlines



Source: ING, Macrobond, CFTC. Note: Positioning data as of 21 Aug 2018

Summary: Chasing GBP lower on no deal Brexit risks becoming highly unattractive

While the politically-infested pound has been living on a prayer in recent weeks, we think that a lot of bad news is now priced in – such that risk-reward no longer favours chasing the marginal pricing in of no deal Brexit fears. The pound's sharp 0.7-0.8% rally in response to Barnier's somewhat constructive comments (albeit the rest of the rhetoric towing the usual EU party line) reflects this risk-reward trade-off. Given the extent to which leveraged funds have turned short GBP in recent months (see chart above), we feel that GBP will now be more sensitive to constructive Brexit headlines – versus being vulnerable to negative (or status quo no deal Brexit) noise. More positive Brexit headlines could see leveraged funds further bail on their short GBP positions; a neutralisation of GBP positioning would see GBP/USD moving back to the 1.31-1.32 area (EUR/GBP back to 0.88-0.89).

Indeed, when it comes to Brexit and the currency, talks between the UK and the EU are not necessarily the primary short-term risk. In fact, some investors may have found comfort from the UK-EU talks – especially as it was clear that the EU isn't actively looking to push the UK off any Brexit cliff edge (which makes sense given that a no deal Brexit would be somewhat damaging to both economies).

The inherent willingness of both sides to find a Withdrawal Deal solution should serve as a bit of a backstop to the degree of no-deal Brexit risks priced into the currency. But when it comes to GBP and political risks, it is far too early to signal the all clear; the biggest test for the pound will be the return of a divided UK parliament from their summer recess and the upcoming Party Conference Season. A murky UK political backdrop may continue to put a dampener on GBP upside in the near-term – but we do think that a good chunk of Brexit negativity is priced in and look for a stable, albeit Brexit-headline-sensitive, GBP.

Below we reiterate some of our short-term and medium-term views – as well as our Brexit scenario analysis matrix.

Short-term outlook: UK politics is the biggest stumbling block for the pound

We believe the politics will continue to outweigh the economics for GBP in the short-term – especially if the Brexit strategy of UK government remains one that is seemingly trying to fit a square peg in a round hole. Only a concrete resolution between UK and EU officials over the Irish backstop dispute – which would effectively finalise the Withdrawal Agreement and significantly reduce the odds of 'No Deal' Brexit – would trigger a material move higher in GBP over the coming months.

There are two probabilities for GBP investors to consider: (1) the **perceived** odds of a no-deal and (2) the **actual** odds of a sudden regime shift in the UK-EU trading relationship:

1. **The perceived odds of a no-deal Brexit have materially increased – and this is likely to keep GBP under pressure in the near-term as politicians take Brexit towards the brink of a cliff-edge.** There are signs that GBP markets are already pricing in a large degree of political uncertainty (GBP's reduced sensitivity to macro data surprises and relative interest rates; a pick-up in short GBP positioning; the breakdown in high-frequency correlation between EUR/USD and GBP/USD).
2. **But we still feel the actual odds of a cliff-edge Brexit are significantly lower – with economic logic to triumph over political ideology in the end.** The odds of a sudden economic regime shift – and a sudden switch to WTO trading rules between the UK and EU is a highly improbable scenario in our view. We still believe that this outcome will be avoided at all costs by politicians – and if this is the case, then we do not subscribe to the idea of another sharp Brexit-related GBP depreciation over the coming months (not least given that we're already at weak levels).

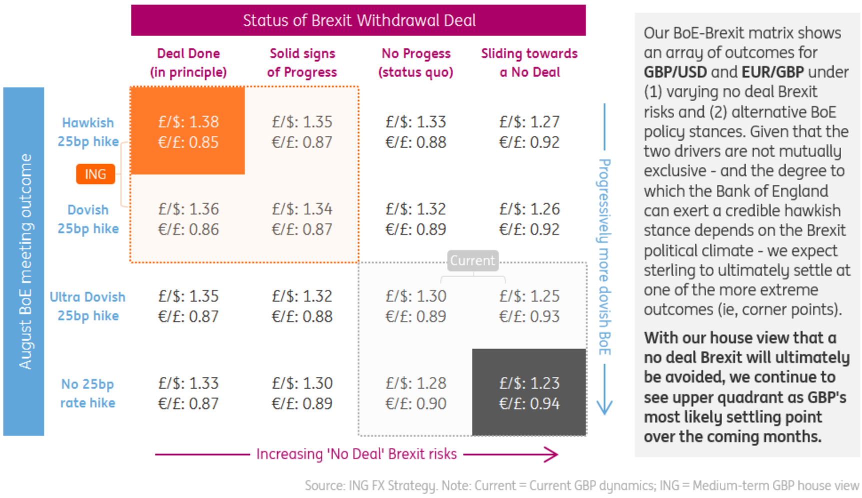
Medium-term outlook: Look for GBP to move sharply higher once structural Brexit risks fully fade

While we are short-term GBP bears, we remain constructive on the medium-term prospects for GBP – given our house-view that a politically acceptable withdrawal deal will be struck between the UK and EU.

Based on the BOE's latest r* estimates, we note that the term structure of UK interest rates is around 75-100 basis points too low right now. Long-term UK interest rate expectations will remain distorted by Brexit no-deal risks in the immediate future – and any sustained shift higher in the UK curve won't transpire until some of these Brexit tail risks have been concretely taken off the table. Indeed, throw into the mix the unique Brexit uncertainties surrounding the UK economy – and this renders r* an almost redundant factor for UK rate markets right now. Indeed, when we think about the conceptual factors that drive r* – demographics, productivity, fiscal policy, savings-investment imbalances, demand for safe assets – one could argue that these would look inherently different in a 'soft' versus 'hard' Brexit world.

We'll also need to see actual signs of a UK economic recovery – and positive UK data surprises over coming months could also lift short-term domestic rates and the pound. Our medium-term bullish GBP view – which sees GBP/USD at 1.40 (EUR/GBP 0.85) at the turn of the year – is partly based on this structural re-pricing UK interest rates driven by a fading Brexit risk premium.

ING's GBP Brexit scenario analysis matrix



Source: ING FX Strategy