‘Brexit-contingent’ hawkish signal defers GBP upside

The Bank of England is clearly looking to hike rates. But future moves are contingent on a smooth Brexit process, suggesting that meaningful GBP upside may be slightly tempered in the near-term

Source: Source: Bank of England

Carney delivers a 'Brexit-contingent' hawkish signal for GBP bulls

Governor Mark Carney and his colleagues delivered a pretty clear signal that the Bank of England (BoE) is looking for a summer rate hike - with the post-meeting statement noting that "policy would need to be tightened somewhat earlier and by a somewhat greater extent" than anticipated in November. However, the 9-0 vote should be interpreted as a sign that this is largely contingent on the BoE's smooth Brexit assumption remaining intact. In principle, that means a Brexit transition deal being signed, sealed and delivered over the coming months.

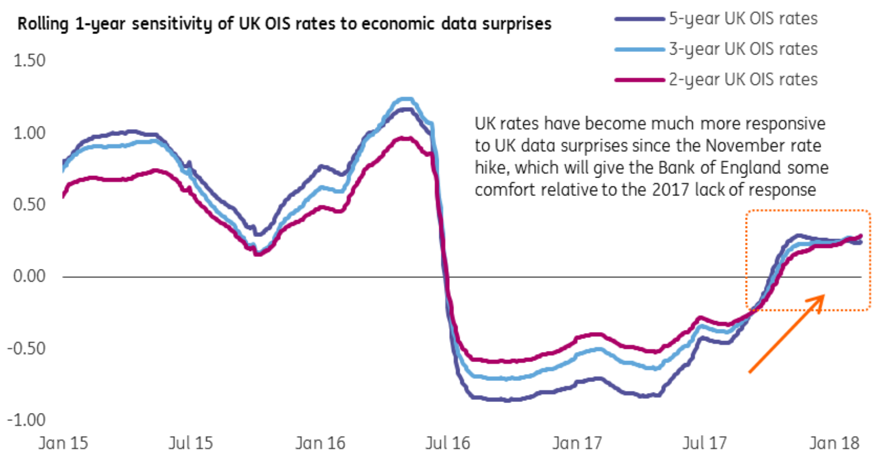
Given that markets will be fully aware of this Brexit-contingent hawkish signal, GBP’s gains in the near-term may be slightly more tempered than one would have typically expected from such forward guidance. While we continue to look for GBP/USD to move up to 1.45 as the UK economy regains some of its cyclical swagger, we do think that patience is required before markets take that bet - not least until there is greater clarity on a UK-EU transition deal (which is likely to materialise over the next four-six weeks ahead of the 22-23 March EU leaders).

Sterling misconceptions

As we point out in our four GBP misconceptions below, we do think there is still a positive UK-specific story to be priced into GBP and cite two non-mutually exclusive catalysts: (1) positive UK data surprises and (2) reduced UK economic uncertainty in the form of an agreed Brexit transition deal.

Indeed, on the former, we note that the UK OIS curve has become much more sensitive to UK data (see chart below) - which will give the Bank some relative comfort. One could argue that today's hawkish message was in part to ensure this relationship held and that markets would not revert back to their Brexit-focused mindset (ie, neglecting resilient UK data). Should the investment side of the UK economy positively surprise to the upside in 2018 (via the theoretical lens of reduced Brexit uncertainty), there is the potential for the UK rate curve to steepen further - and help lift the pound. Therefore, the Bank's upward revision to 2018 UK GDP (from 1.6% to 1.8%) isn't necessarily a top.

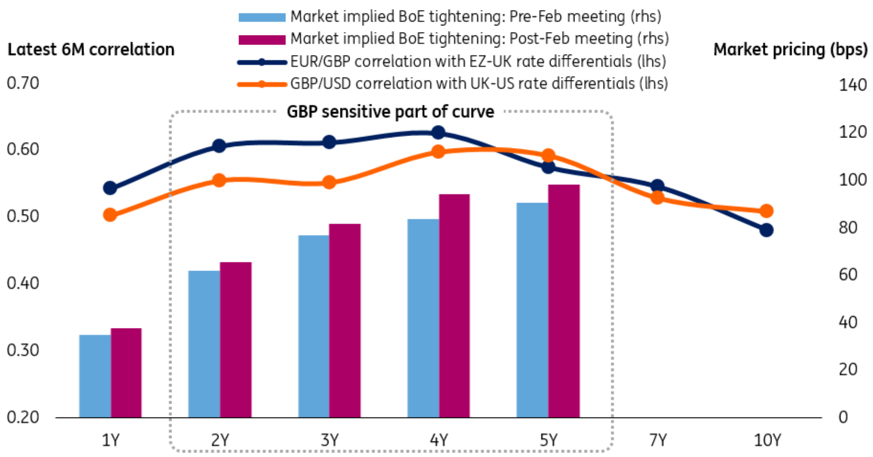
We continue to see deferred gains for the pound - and reaffirm our 1.45 target for GBP/USD. Given the looming Italian elections and the prospect of some more cautious ECB currency talk, we look for a EUR /GBP move to 0.86 in 1Q18.



Source: ING estimates, Bloomberg, Macrobond

1 Misconception 1: GBP requires a May BoE rate hike to move higher

Not necessarily. For currencies, we continue to believe that it is the overall level of policy tightening priced into markets that will matter more in 2018 and this is certainly true for GBP crosses – which exhibit the greatest sensitivity to relative interest rate differentials across the two-five year part of the curve (see chart below). This means that positive surprises in the UK economic cycle and Brexit progress – both of which will affect the size and extent of the BoE's normalisation cycle – matter more for GBP than the actual timing of Bank rate hikes over the coming months. We see the ~75 bps (three hikes) worth of implied BoE tightening priced into the two-year part of the UK rate curve as being conservative and think that there is scope for some further upside in the event of any 'good' UK news (data of Brexit transition) over the coming months.

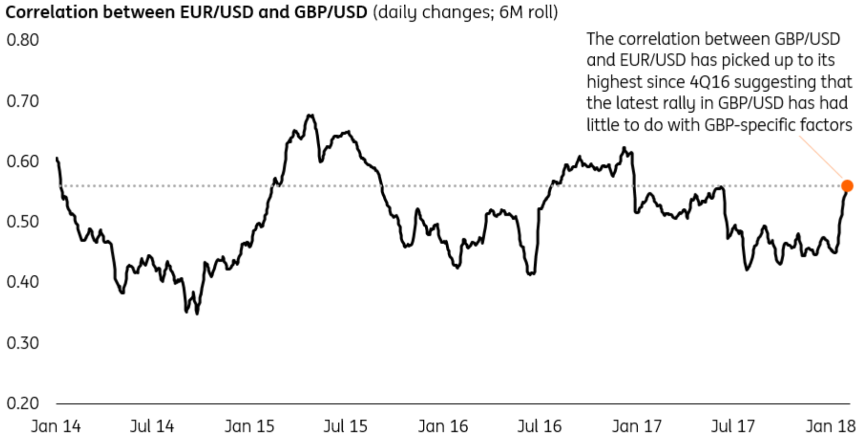


Source: ING estimates, Bloomberg. Note: 31-Jan (Pre Feb BoE meeting) and 08-Feb (Post Feb BoE meeting)

2 Misconception 2: GBP's rally is reflecting optimism over a 'soft' Brexit

Sure, while we agree that there has been a positive re-assessment of the Brexit tail risks since last December's Divorce Deal (see our GBP Prisoner's Dilemma note) – we shouldn't get carried away at overstating this effect on recent currency moves. GBP/USD's rally above 1.40 earlier this year had little to do with anything GBP-specific; we point to the fact that the six-month correlation between GBP/USD and EUR/USD picking up to its highest since the Brexit referendum (~0.55) – which suggests that this has predominantly been a weak USD story (and therefore little evidence to cite GBP's rally as being Brexit or UK-specific). If anything, the reduction in Brexit tail risks has merely allowed GBP to participate in the upside amid a weakening USD environment.

Correlation between EUR/USD and GBP/USD (daily changes; 6M roll)

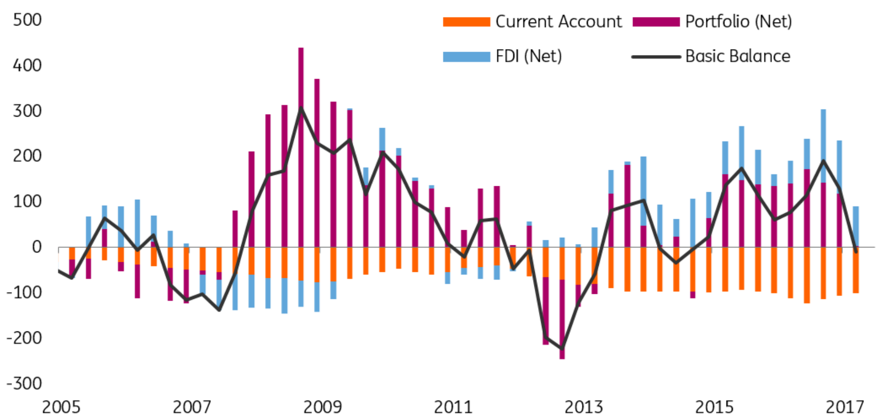


Source: ING estimates, Bloomberg

3 Misconception 3: Markets are extremely long GBP and so the scope for further upside is limited

The latest CFTC speculative positioning data puts GBP/USD net long positioning at 14% (of open interest) – which is the highest since 3Q14. Yet, seeing a similar pattern for EUR/USD suggests that this may not necessarily be GBP-specific. Looking more broadly, and taking into account real money flows, we point to the UK's basic balance – and decline in the financial account (namely portfolio investment inflows) as evidence of slowing demand for GBP-assets over 2017. One would expect this to reverse in 2018 should the UK economy stay resilient and an orderly Brexit transpire. Therefore we believe the broader market remains structurally short GBP – but to get any meaningful shift to more neutral positioning levels, investors will need to see a fundamental UK economic story emerge.

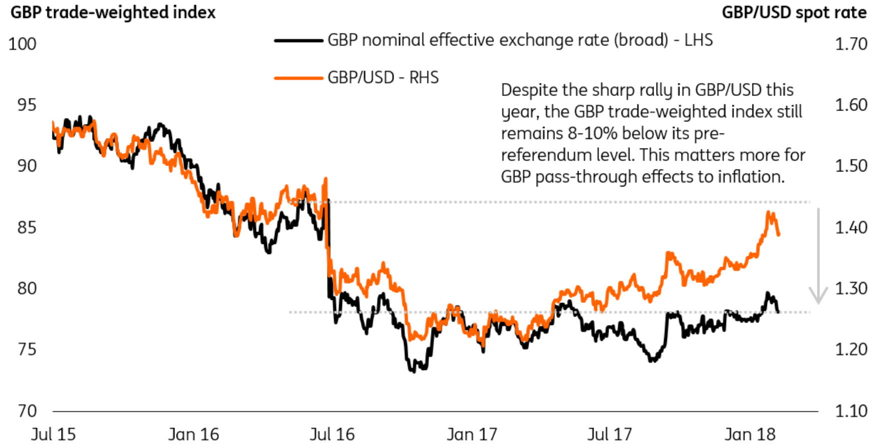
UK basic balance (£ billions, 4Q sum)



Source: ING, ONS

4 Misconception 4: GBP strength would weigh on the BoE's propensity for additional hikes

The inflationary damage is already done from GBP's sharp post-referendum depreciation. Moreover, on a trade-weighted basis, GBP still remains 8-10% below its pre-referendum levels. Given the size of the shock – and ongoing uncertainty – it may end up being that the pass-through effects of GBP's post-Brexit depreciation turn out to be less transitory – and more persistent – than originally thought. Given the Bank's growth-inflation trade-off, a gradual normalisation cycle and slightly stronger GBP is unlikely to derail UK economic growth (especially if the domestic side remains resilient) – but will help to keep price pressures in check. We saw evidence of this shifting trade-off at today's BoE policy meeting.



Source: ING, Bloomberg, Bank of England