GBP: Light at the end of the tunnel

The outlook for the pound all hinges on Brexit

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• With the Conservative Party leading the polls, GBP is likely to gain over the next one to two months as we get more clarity on the Brexit path. EUR/GBP to reach 0.83.
• Even if the Withdrawal Agreement is passed by next January, this isn't the end of the Brexit saga. Uncertainty about extension of the transition period will weigh on GBP in 2Q20.
• If the transition period is extended, GBP should do well in 2H20 but sluggish growth and a valuation which is no longer cheap will tame its upside.

Current pre-election polls suggest GBP strength over the next few months

The GBP outlook for the coming one to three months primarily hinges on the outcome of the 12 December Parliamentary elections and its implications for the Brexit path. As current polls are predicting a non-negligible lead of the Conservative Party (and it achieving a Parliamentary majority) such an outcome should be beneficial for sterling as it would sharply increase the odds of the Withdrawal Agreement being ratified in Parliament and thus reduce the Brexit uncertainty. We expect EUR/GBP to reach 0.83 (and GBP/USD to 1.33) over the next two months.
Transition period uncertainty to tame GBP upside in 2Q20...

Yet, the Withdrawal Agreement being passed in Parliament and the UK leaving the EU early next year (by January – albeit still within the transition period parameters) do not mean GBP firing on all cylinder and a pronounced GBP rally.

First, the market is already partly expecting a GBP positive outcome (as Figure 39 shows, GBP trades with a modest premium vs EUR based on our short-term financial fair value model). So while positive, more Brexit clarity should lead to a less pronounced GBP rally compared to the one observed this October when GBP corrected from stretched (Figure 39) and oversold (Figure 40) levels. As for the speculative positioning, it is now also less stretched than it was prior to the October GBP rally (Figure 40 again).

Second, once the UK withdraws from the EU, the hard work of negotiating trade deals with its international partners begins (including the EU). With the current transition period set to expire by the end of 2020, this means less than a year (assuming the UK leaves by end-January 2020) for the UK to conclude the new (and necessary) trade deals. We see it as highly unlikely for the UK to conclude such complex deals within such a relatively short period of time. Hence, the extension of the transition period beyond 2020 (likely to 2022 as a starting point) will be necessary, in our view. If the transition period is not extended and the new trade deals are not in place, this would be equivalent to a hard Brexit (by end-2020).

...as extension will be necessary but the path towards it won’t be straightforward

The question of the extension and the associated conditions (as the extension won’t come for free) will, in our view, tame GBP upside during a significant part of the second quarter of 2020 (and possibly third quarter if the negotiations about the extension drag on). We expect the EU to be open to prolonging the transition period, but in return it will likely require the UK to contribute to the EU budget (as enjoying the access to the EU single market for little longer would not come for free). The EU budget payments are likely to be fairly unpopular and a contentious issue in the UK Parliament, very likely to be opposed by the pro-Brexit/anti-EU wing of the Conservative Party.
Some degree of uncertainty about the transition period extension therefore should, in our view, lead to some reversal of GBP post-election gains. We also note that a thin Conservative Party majority is likely to lead to a larger reversal of GBP gains in 2Q20 than would be the case under a large Conservative majority outcome as it would increase the risk of the transition period being not (easily) extended - as hard-line pro-Brexit MPs (mainly from the ERG) – would have issues with EU budget payments.

While all the above is heavily scenario-conditional and still some time away (we need to see the election outcome first) the issue of extending the transition period is, in our view, another risk event for GBP and should therefore tame the potential optimism in the case of the Parliament successfully ratifying the Withdrawal Agreement and the UK leaving the EU. That’s why we kink EUR/GBP and GBP/USD profiles, pencilling initial GBP strength (next 1-3 months) and some reversal in 2Q20.

2H20 outlook: Less uncertainty but also less mispricing

Assuming the UK will avoid a hard Brexit and achieves the extension of the transition period by June 2020 (in our view, the EU will want to know by this deadline whether the UK contribute to the budget in order to be able to plan for the new EU budget) or a little later, we expect sterling to settle at stronger (yet not too strong) levels later in 2020. EUR/GBP to reach around 0.82 level and GBP/USD around 1.38 by end 2020.

On the positive side, both the passage of the Withdrawal Agreement and the transition period extension will take away some degree of Brexit uncertainty. With the transition period extended to 2022, this can give some breathing room to the economy and should cause the market to price out the currently pencilled in partial BoE cut (Figure 41 - and even potentially price in a partial hike) if the new government runs loose fiscal policy.

No spectacular economic growth...
On the less positive side, two factors should prevent a meaningful GBP rally. First, the economic growth will remain subdued in 2020. Our economists pencil in growth around 1.2% next year (Figure 42), due in part to the constrained investment as 2020 will still feature plenty of uncertainties (such as the issue of extending the transition period). This should restrict the BoE from delivering actual hikes next year.

...and no spectacular GBP valuation

Second, compared to conventional wisdom, we don’t see GBP as materially undervalued based on our medium-term BEER valuation framework (Figure 43). Not only has GBP rallied recently but also its fair value has declined over recent quarters. The latter should not come as a surprise as Brexit uncertainty has weighed heavily on the UK economy (translating into sub-optimal growth) and translated into a deterioration of GBP fair value vs EUR of 8-9% since 2017. As Figure 44 shows, this was primarily driven by the worsening relative current account position of the UK. Sterling’s fair value decline against the US dollar has been even larger than was the case against the euro as this has been further exaggerated by the drop in EUR/USD fair value.

EUR/GBP at 0.82 would actually bring the cross into modestly undervalued territory (ie, modestly expensive GBP). The lack of a meaningful medium-term undervaluation should limit the scale of GBP upside (compared to early October, when EUR/GBP at 0.93 screened almost 10% overvalued and thus had plenty of potential for a sharp decline).

Better year for sterling ahead, but it won’t be a smooth ride

In short, given our assumptions (Conservative Party election victory, Withdrawal Agreement passed by January 2020, transition period extended), next year should deliver stronger sterling vs 2019. Yet, it won’t be a smooth ride, bumps in the form of question marks about the transition period are ahead and GBP is not as cheap as it was earlier in the year. This suggests contained GBP upside vs EUR, but upside nonetheless. Against USD, sterling should record more gains due, in part, to our modestly higher EUR/USD in 2H20 (at 1.13). This means that GBP should be one the best performing European currencies next year and the best performing low yelder in the G10 FX space in 2020.
This article is part of our 2020 FX Outlook report.

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