

GBP: Market too complacent on transition risk

After being driven by global factors over recent months, GBP is now facing the idiosyncratic risk of the EU transition period failing to be extended. With the end-June deadline looming and the possibility of non-extension rising sharply, GBP looks unprepared for this risk event. No extension is likely to drive EUR/GBP above 0.90 by end-June.



Following its solid recovery after the Covid-19 outbreak hit global FX markets, GBP has started underperforming its G10 peers yet again - being the weakest G10 currency so far this month. With the end-June deadline for the extension of the transition period approaching (this is a deadline written into the withdrawal agreement) and the UK government so far being adamant not to extend, the downside risk to GBP is growing. Our economists now see the non-extension as an above 50% probability event.

Non-extension impact: Economic and monetary channels

Not extending would in our view have a negative impact on GBP as it would increase the odds of:

- (1) a shallower economic recovery, with the UK potentially experiencing a double dip recession and
- (2) more easing from the Bank of England.

The risk of not extending would have meaningful economic implications. With the Covid-19 crisis causing a demand-driven slowdown, a failure to extend the transition period and the imposition of tariffs from 2021 in the case of no deal would likely cause supply disruptions and deliver a second blow to the UK economy. Even if there is some form of a free trade deal on goods reached later in 2H20 (which sets tariffs to zero), it would involve plenty of costs and bureaucracy (and one particular headache for firms might be the so-called rules of origin). And the free-trade agreement covering goods is likely to do very little for services (which account for 80% of UK output). See [Brexit in 2020](#) for details. All this would in turn suggest an economic slowdown / possible contraction in 1Q21 and a possible double-dip recession for the UK economy in the worst-case scenario (vs the U-shaped recovery expected for the UK and the global economy at this point).

A possible second dip in UK growth in a relatively short period of time would likely warrant further BoE easing, likely in the form of more QE (we still think negative rates are a lower probability event). This would be likely more detrimental for the GBP's prospects than the current BoE easing cycle as, at this point, the BoE is just following the global trend of aggressive monetary policy loosening (ie, the Federal Reserve and the European Central Bank are doing the same) and does not stand out. The trend has been a friend for the BoE and GBP so far. However, should the BoE have to respond to idiosyncratic negatives such as no extension of the transition period in an environment where other central banks are no longer in easing mode, the pound would not be judged kindly.

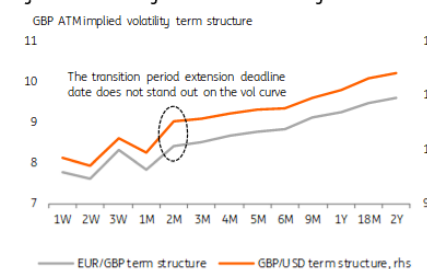
Prospects of a double-dip recession, more BoE easing and the general uncertainty about the relationship with its main trading partner would all pose a downside risk to GBP. Even if some form of a free trade agreement between the EU and the UK is eventually reached, the uncertainty about its form is likely to weigh on GBP. This is not great news for GBP when the UK economy is already facing a larger negative impact on 2Q GDP (vs 1Q GDP) than the eurozone (see [Lockdowns lifted...](#)).

GBP downside seems heavily under-priced

We believe such a downside risk is heavily under-priced by the market as is evident in i) the GBP implied volatility term structure, ii) speculative positioning and iii) the lack of risk premia in the GBP spot market.

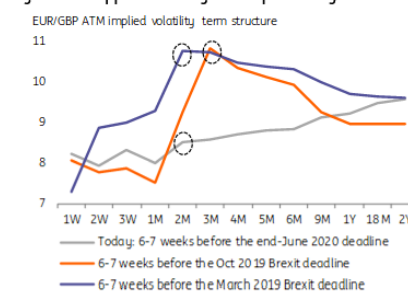
- EUR/GBP and GBP/USD implied volatility curves provide a case in point. As Figure 1 shows, there is virtually no kink in sterling implied volatility curves around the June deadline date. Neither is the case for the year-end volatility levels. This is in contrast with previous occasions of Brexit-related risk, which showed some degree of uncertainty about the key deadline dates (as per Figure 2).

Fig 1 GBP volatility curves don't show any kinks ...



Source: ING, Bloomberg

Fig 2 ... as opposed to large kinks previously

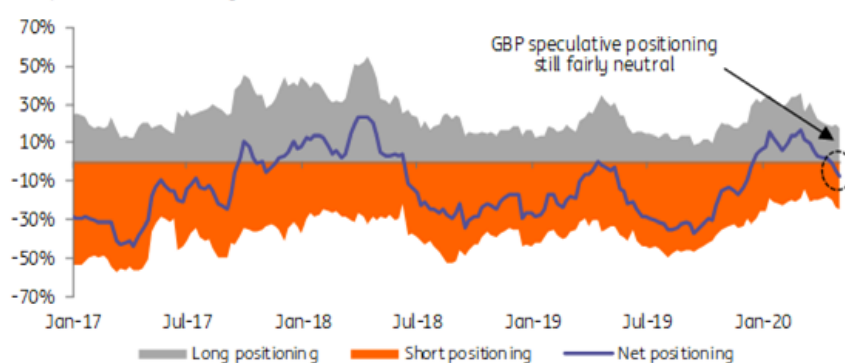


Source: ING, Bloomberg

- Speculative positioning also points to the same conclusion. Although GBP longs have been declining since the start of the Covid-19 crisis (primarily as GBP was hit on the USD funding squeeze in March), speculative positioning remains close to neutral (Figure 3) and has more scope for a decline – as we have observed during the previous Brexit-related events.

Fig 3 GBP speculative positioning is fairly neutral

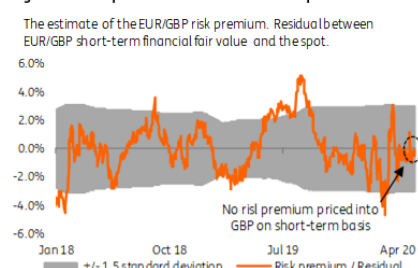
GBP/USD speculative positioning, as % of open interest (as of 5th May 2020). Negative number means the speculative community is net short GBP vs USD



Source: ING, CFTC

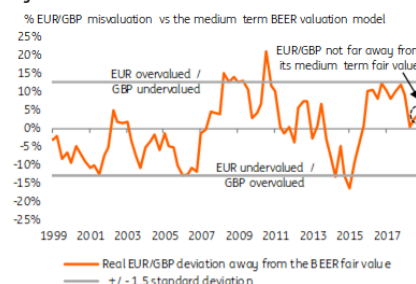
- As the GBP spot market does not exhibit signs of mis-valuation either (as Figures 4 and 5 show, GBP does not exert a meaningful risk premium / under-valuation either within our short-term or medium-term valuation framework) the risk of the transition period not being extended has plenty of potential to weigh on GBP.

Fig 4 No risk premia evident in the GBP spot



Source: ING

Fig 5 Medium-term GBP valuation also not stretched



Source: ING

Therefore, should the UK government fail to ask for an extension, given the complacency evident

in the sterling market, EUR/GBP would likely move above the 0.90 level by end-June and possibly even higher thereafter depending on the newsflow about a potential free trade agreement (the details and depth of which would be uncertain).

EUR: The ECB containing risk premium via the top-up to the PEPP programme

On the EUR side, and despite the German constitutional court ruling, our economists expect the ECB to top up its Pandemic Emergency Purchase Programme at the June ECB meeting. The programme, in its current size, is already running out of money and such a decision would signal that the ECB is dealing with the European Court of Justice but not the national courts. Such action should keep any EUR fiscal risk premia at bay and allow for the GBP driven rise in EUR/GBP.

Forecast: Downside risks to the GBP year-end outlook growing

The extension of the transition period was one of the key assumptions for our constructive EUR/GBP year-end forecast of 0.85. As this is now looking less-and-less likely, we see meaningful upside risks to our year-end forecast (that is towards weaker GBP levels). We will look at a formal revision in our next round of FX forecasts.

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