GBP: Reaping the vaccine dividend

We upgrade our GBP forecast to 0.85/EUR for end '21 and 0.82 for end '22. With the risk of a 'no deal' Brexit no longer hanging over markets, the persistent GBP undervaluation of recent years should begin to dissipate. The faster pace of UK vaccination and the scope for a stronger 2Q21 recovery should drive GBP higher this year. GBP/USD to rise above 1.50 in 2021

Sterling stars are aligning

We are upgrading our sterling end-2021 forecast from EUR/GBP 0.88 to 0.85. With the risk of a 'no deal' Brexit out of the way, sterling is now free to reap the benefits of a faster vaccination rollout in the UK relative to the eurozone. This argues for: (a) an earlier easing of restrictions and stronger second quarter economic rebound; and (b) reduced need for further dovish steps from the Bank of England. With GBP having suffered persistent Brexit-related undervaluation since 2016, the currency should now start the process of a gradual convergence towards its medium-term fair value.

Our base case suggests EUR/GBP at 0.85 in the second half of this year and 0.82 by the end of 2022.

We also look at two alternative scenarios. In the bearish scenario, the risks associated with the new

Covid variants, and the possible need for fresh restrictions, would make BoE easing more likely and could bring EUR/GBP back to 0.92. In a bullish sterling scenario, we see EUR/GBP reaching 0.75 next year under the assumption of renewed European political jitters and European Central Bank rate cuts.

Below we look at four potentially key macro drivers for sterling and how they could lead to diverging paths for the currency.

Three scenarios for EUR/GBP in 2021

EUR/GBP lower

	Potential EUR/GBP drivers				
	Reopening pace	Recovery strength	ECB vs BoE	Politics	EUR/GBP forecast
1	New variants presses the reset button on UK's faster vaccination programme	Brexit shock larger than expected in short-term. Recovery fund adds Eurozone momentum	BoE opts against neg. rates in Feb but changes mind later in 2021 on longer lockdowns. 20bp rate cut delivered.	Odds of Scottish Independence referendum pre-2024 election weigh on sterling	2Q21: **0.92** 4Q21: **0.90** 2Q22: **0.90**
2 ING base	UK's early advantage allows slightly earlier reopening. But this is unlikely to forge a lasting divergence in recovery pace	After weakness in 2020, UK plays a bit of catch-up. But Brexit and rising unemployment weigh on outlook	Neither the BoE nor ECB lower rates further. ECB more likely to maintain QE purchase pace into 2022	UK-EU relationship characterised by ongoing uncertainty, but political turbulence set to die-down in 2021	2Q21: 0.86 4Q21: 0.85 2Q22: 0.83
3	Eurozone continues to be plagued by lower supplies. New variants don't effect existing vaccines. UK reopens quickly	Faster reopening coupled with rapid fall in UK unemployment, helped by extended wage subsidies	ECB cuts rates on euro strength and/or later this year, BoE starts hinting at modest tightening from mid/late 2022	European politics flare up. Fresh disagreements over recovery spending and/or Italian elections planned	2Q21: **0.82** 4Q21: **0.80** 2Q22: **0.75**

Source: ING

1 Factor 1: The reopening process

The UK has undoubtedly had a smoother start to the vaccination programme than the eurozone. Temporary supply reductions and logistical difficulties have generated relatively slow, albeit varying, rollout speeds.

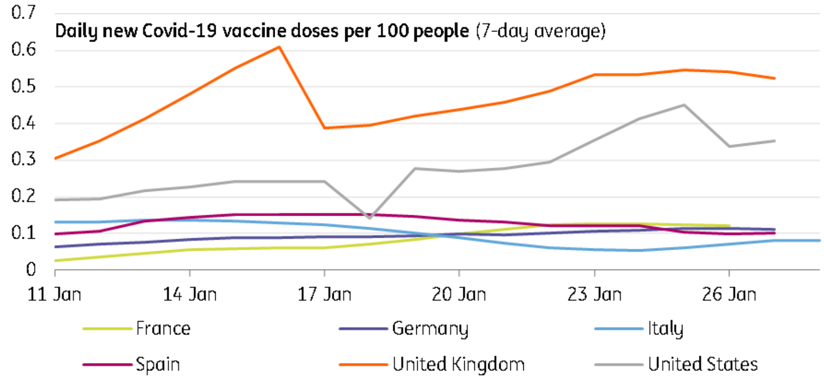
By contrast, around 14% of the UK population has so far received their first dose, and it is likely that the government will hit its target to reach all over 70s by mid-February, and all over-50s by Easter. Reaching this latter milestone is key for reducing hospital admissions, given two-thirds of Covid ICU patients have been below the age of 70.

It's also not totally inconceivable that the majority of adults will have been offered their first dose by the end of the second quarter, particularly if other vaccines (e.g Johnson & Johnson) arrive in the UK earlier than currently planned.

All of this potentially means the UK will achieve a slightly earlier reopening - though this will undoubtedly be a gradual process. And in reality, we may only be talking a couple of months, in which case it's unlikely to make a lasting difference to the recovery paths. Some of the vaccine supply constraints will likely ease after the first quarter as a wider pool of manufacturers get approved.

The obvious risk to all of this comes from the new strains. The key question here is whether the current batch of vaccines still prevent serious illness if overall efficacy is lower. If they don't, then clearly this is a bigger near-term downside for the UK given the more advanced stage it is at in the vaccination programme.

Figure 1: Daily vaccine doses have been much higher in the UK so far



Source: Macrobond/Our World in Data

2 Factor 2: Relative UK and eurozone recoveries

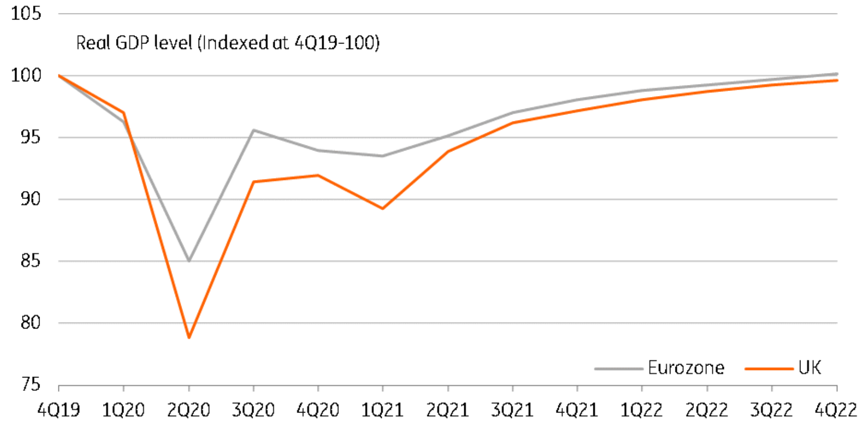
Having underperformed the eurozone through 2020, it won't come as much of a surprise that the UK is likely to record higher growth rates this year - but we should also see some catch-up in level-terms as well.

There are admittedly some slightly quirky reasons for this. Part of the UK's underperformance during 2020 is explained by the way public services output - education and healthcare - are accounted for in GDP. Both components have seen comparatively large falls in the UK relative to the eurozone. Equally, certain 'locked down' services also represent a comparatively higher share of UK spending (transport is a good example).

Still, there's little doubt that new UK-EU trade ties are dampening the prospect of a fast British recovery. The rise in costs for businesses, reduced attractiveness of UK exports, and uncertainty surrounding the future of the deal, will all constrain investment - and in time that will hit productivity. One consequence could be that unemployment rises more quickly/remains stubbornly elevated during the post-Covid recovery, relative to Europe.

Another factor is government stimulus. The UK government's furlough scheme is currently slated to end in April, while those in Europe generally look set to be offered for longer. A lot depends on how the UK scheme is phased out (and whether it's extended), but the result is likely to be higher unemployment at a time where it is more stable in Europe. Remember too, that the eurozone has the recovery fund this year - Spain and Italy stand to gain about 1.75% and 1.25% of 2019 GDP, respectively this year.

Figure 2: The UK is likely to 'catch up' with the eurozone to some extent



Source: ING forecasts

3 Factor 3: Bank of England vs ECB

For 2021, the question is which central bank is more likely to cut interest rates.

In the case of the Bank of England, the appetite appears to be fading. Policymakers will unveil the results of a survey of banks on negative rates, and we think the conclusion is likely to be that there are challenges but that the sector could generally withstand them. Even so, there appears to be limited willingness on the committee to take rates below zero at this stage. Some members are not convinced of the benefits, and the vaccine rollout has taken the pressure off the Bank to do more.

The ECB also isn't ruling out another rate cut this year, with even some hawkish Governing Council members floating the idea as public concerns about euro strength build. However for the time being, this isn't our base case.

So with neither central bank imminently poised to add stimulus, the question is, what happens regards tightening in 2022? Out of the two, the Bank of England is more likely to stop actively expanding its balance sheet next year - though rate hikes are unlikely on either side before 2023.

4 Factor 4: Politics

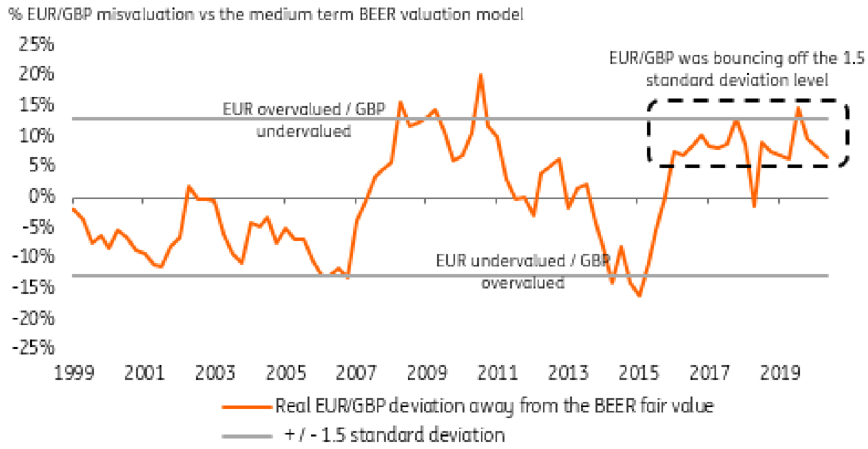
After four years of political turbulence for sterling, 2021 should - in theory - be calmer. It’s a similar story in Europe, where despite recent drama, early Italian elections remain unlikely. Votes in the Netherlands and Germany are also unlikely to be major euro drivers.

However, there are two ways the UK political outlook could become more dramatic. Firstly, will the deal agreed between the EU and UK will stand the test of time? Any signs that the UK may want to diverge on certain level-playing field issues could spark talk of retaliation and tariffs. Equally, the Scottish Independence story is gaining traction, with the pandemic having boosted support for ‘Yes’.

The issue is likely to come into sharper focus ahead of Scottish Parliamentary elections slated for

May. In principle the UK government is likely to reject permission for a second independence vote, though there is some debate over whether the leadership in Scotland could hold some form of referendum earlier on a unilateral basis.

Figure 3: GBP persistent medium term undervaluation to fade



Source: ING, Macrobond

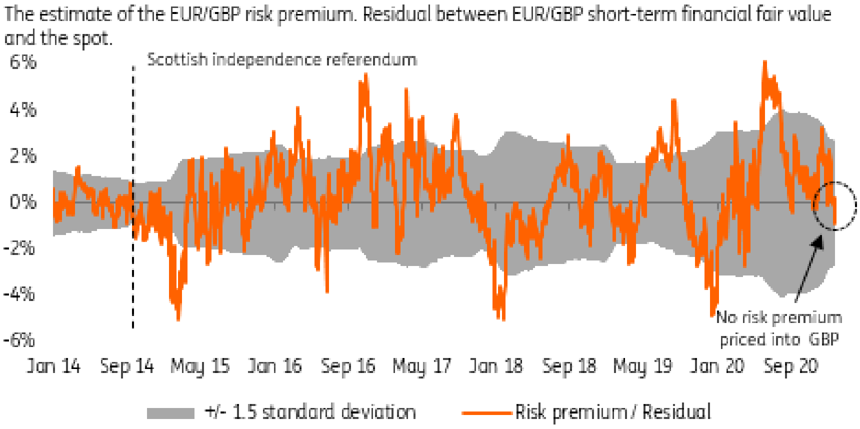
GBP to start gradually converging towards its medium-term fair value

We estimate EUR/GBP is currently trading 7% above its medium-term BEER fair value (a model which estimates the currency's fair value based on medium-term fundamental factors such as labour productivity, the current account and government consumption). As Figure 3 above shows, EUR/GBP has been persistently overvalued since 2016 (the overvaluation started to emerge around six months ahead of the Brexit referendum in June 2016) with the cross continuously bouncing off the 1.5 standard deviation upper band (which constitutes the level of extreme overvaluation) which has acted as a soft ceiling on the cross.

With the risk of a hard Brexit out of the way and the UK set to benefit from faster vaccination vs. the eurozone, we expect EUR/GBP to start gradually converging towards its medium-term BEER fair value. Still, a full and fast convergence is unlikely this year, in our view, given the uncertainty stemming from the possible negative headline news around the Scottish independence referendum during the Scottish Parliamentary election campaign (though we don't see a second referendum as imminent) and the ongoing risk of tariffs should the UK government choose to deviate from the EU's labour laws.

Still, with UK politics taking a less prominent role this year in contrast to past years, the case for persistent EUR/GBP overvaluation is not there and the cross should gradually converge towards its medium-term fair value of 0.82.

Figure 4: No risk premia priced into GBP ahead of the Scottish independence referendum in 2014



Source: ING, Refinitiv

Brexit risk premium fully priced out, further GBP gains to be gradual

Although the Scottish election may bring back negative headline news about another Scottish independence referendum, we don't think this should have an overly negative impact on GBP in 2Q. This is because (a) a referendum could be years away rather than months; (b) as we observed with the Brexit referendum, the risk premium started to be built into GBP only six months ahead of the event; and (c) the first Scottish referendum in 2014 did not translate into a material build up of GBP risk premium, as evident in Figure 4.

The same Figure 4 also shows no meaningful current short-term mis-valuation in the EUR/GBP (as measured by our short term financial fair value model). This means that further GBP gains should be gradual rather than abrupt as the prior Brexit-related risk premium has already been fully priced out. With GBP exerting positive beta to risk (vs EUR) further gains in the global stock market this year should also be a modest positive for GBP.

In Figure 5, we show various EUR/GBP outcomes based on the varying directions of the relative ECB-BoE policy rate spread and global risk sentiment. On the former, should the BoE eventually inch towards an earlier normalisation of the policy rate vs. the ECB, this is likely to benefit GBP vs. EUR and skew the risk for EUR/GBP towards the bottom part of the table (i.e. towards lower EUR/GBP) - though this should be more of a story for 2022 rather than this year.

Figure 5: EUR/GBP outcomes based on relative ECB-BoE policy rate spreads and global risk sentiment

Global risk channel (% change in global equity markets)

Relative monetary policy channel (change in relative policy rate: ECB vs BoE spread, in %)	-15%	-10%	-5%	0%	5%	10%	15%
0.75	6.6%	5.7%	4.9%	4.2%	3.5%	2.8%	2.2%
0.50	5.1%	4.3%	3.5%	2.8%	2.1%	1.4%	0.8%
0.25	3.7%	2.9%	2.1%	1.4%	0.7%	0.1%	-0.6%
0.00	2.3%	1.5%	0.7%	0.88	-0.7%	-1.3%	-1.9%
-0.25	0.9%	0.1%	-0.7%	-1.4%	-2.0%	-2.7%	-3.2%
-0.50	-0.5%	-1.3%	-2.0%	-2.7%	-3.4%	-4.0%	-4.6%
-0.75	-1.9%	-2.6%	-3.4%	-4.0%	-4.7%	-5.3%	-5.9%

*Projected change in EUR/GBP based on changes in relative monetary policy and risk appetite. Example: Interpret the number at the bottom right corner as a 5.9% decline in EUR/GBP in response to (a) 15% rise in global equity markets; and (b) 0.75% decline in relative ECB-BoE policy spread (ie BoE rising rates by 75bp and ECB staying on hold)

Source: ING

Brighter future ahead

The prospects for sterling have improved dramatically and the undervalued currency should benefit from the mix of faster vaccination, stronger rebound in 2Q and a less dovish BoE (vs the ECB). While risks remain in place (the negative headline news around the Scottish independence referendum; the ongoing risk of tariffs should UK government choose to deviate from EU labour laws), these should only slow, rather than reverse, sterling's upside.

Figure 6: ING sterling forecast

	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22
EUR/GBP	0.88	0.86	0.85	0.85	0.84	0.83	0.82	0.82
GBP/USD	1.39	1.45	1.51	1.53	1.55	1.57	1.56	1.52

Source: ING

As per the forecast table above (Figure 6), we target EUR/GBP at 0.85 and 0.82 this year and next, respectively. As for GBP/USD, its gains should be even more pronounced as the pair will also benefit from the rising EUR/USD (we expect EUR/USD to move into the 1.25-1.30 area later this year - see FX Talking). GBP/USD should in turn breach the 1.50 level in 2021. The fact that GBP/USD remains one the least overbought crosses in the G10 space in terms of speculative positioning (as reported by the CFTC) also point to further sterling upside.

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