

Article | 19 March 2018

### Brexit transition: Bullish for sterling

EU leaders have agreed to a Brexit transition deal, which we think will help alleviate uncertainty surrounding the UK economy. News on wages and a Bank of England meeting this week will now determine where the pound goes from here

## EU and UK officials agree Brexit transition... one of GBP's bullish trifecta achieved this week

- EU and UK officials have agreed to the terms of a Brexit transition deal and while (at the time of writing) details of the agreement are still being announced– we suspect today's outcome will go some way to alleviating the short- to mediumterm uncertainties surrounding the UK economy. The pound has moved higher against both the US dollar and euro (around +0.5%) given that today's reported agreement is a positive surprise for investors who had broadly scaled back their expectations for any Brexit progress being achieved this week.
- We believe that GBP's re-pricing of Brexit transition optimism is now complete and revert our attention back to UK economic fundamentals to determine the scope and extent of any GBP appreciation over the coming weeks. A Brexit transition agreement is one element of GBP's bullish trifecta this week; if all the cards were to fall perfectly into place and we also see a status quo hawkish Bank of England policy message and constructive UK wage inflation data then we would not rule out a sharp move in GBP/USD up towards the year-to-date highs around 1.4250-1.4300 (+2.0% approx).
- Our base case remains for GBP/USD to move up to 1.45 as the UK economy regains some of its cyclical swagger but we do think that patience may be required before investors look to take that bet. We had previously cited two non-mutually exclusive catalysts for this to happen: (1) positive UK data surprises and (2) reduced UK economic uncertainty in the form of an agreed Brexit transition deal. Today's news means that the latter condition has been ticked and gives us greater conviction over our 1.45 target.
- Indeed with the UK economy at an inflection point in theory, reduced Brexit uncertainty means the scope for positive UK data surprises over the coming year has increased. Forward-looking indicators (business surveys and PMIs) over the coming weeks and months will be a big test of this and we'll be monitoring these closely to see the responsiveness of UK economic activity to reduced uncertainty brought about by an agreed Brexit transition deal.
- **Bottom line:** Risk-reward suggests that an extremely cheap GBP has greater room for a cyclical recovery over 2018 (we still look for a 3-5% sterling appreciation in trade-

Article | 19 March 2018

#### Brexit transition deal in focus at the March EU leaders summit: Risk-reward suggests greater GBP upside in the event of a positive outcome

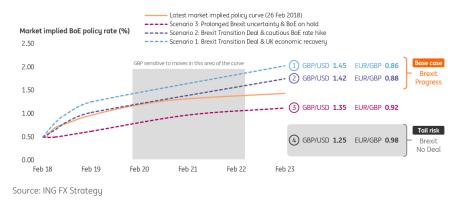
- The immediate focus for investors at the upcoming 22-23 March EU leaders summit is
  whether both sides can formally agree on a Brexit transition deal which, if successfully
  achieved, would go some way to reducing the long-run risks surrounding the UK economy.
  While it appears the UK government has conceded to the transition period ending in
  December 2020 and potentially EU citizens' rights the major sticking point remains over
  the Irish border.
- In principle, if a deal can be finalised, we would expect GBP to see a sharp knee-jerk move higher noting that this would be a positive surprise given that investors have downgraded their expectations for a transition being agreed at this summit, while more neutral GBP positioning and a small Brexit risk premium in the currency (our model estimates suggest GBP/USD should be trading in region of 1.39-1.41) also lends support to a move higher.

## A hawkish Bank of England signal and nascent signs of wage inflation would be an added boost to GBP

- One of the channels through which we expect GBP strength to materialise in the event of a positive transition deal outcome is reaffirmed sentiment over BoE policy tightening. Not only would we see greater market conviction over a May rate hike (currently 70% priced in), but the potential for a re-invigorated UK economy in the near-term could also spur talk of a second BoE rate hike in 2018.
- The case for a steeper UK rate curve this week would find additional support from:
- 1. A Brexit-contingent hawkish signal at the March BoE policy meeting (Thu)
- 2. A series of constructive UK economic data releases namely core CPI inflation remaining sticky at 2.6% YoY (Tue) and headline wage inflation also showing signs of moving higher (Wed). Feb UK retail sales (Thu) is expected to come in a tad softer though markets may look through this given the largely weather-related disruptions.
- If all the cards were to fall perfectly into place for GBP this week that is the combination of Brexit progress, a status quo BoE message and constructive UK economic data we could see a bullish breakout in GBP (especially against a weak USD), and would not rule out a sharp move up towards the year-to-date highs around 1.4250-1.4300 (approx +2.0%).

Article | 19 March 2018

# Road to a Brexit transition deal: Four scenarios in play for GBP over 2Q18



# Only signs of complete gridlock between UK-EU officials would break the pound

- On the flipside, while it may be tempting to paint the EU leaders summit as a make-orbreak moment for GBP, we would not see the failure of a transition agreement being reached this week as a reason to sell the currency.
- Investors should focus on the tone of Brexit talks where we think only signs of complete deadlock and a lack of appetite from either the UK or EU to concede on key sticking points would see GBP's recent resilience come majorly unstuck. We think downside risks for GBP/USD this week may be contained to 1.3750-1.3800 (approx -1.5%).

#### ING's outlook for GBP: Medium-term bulls

- With BoE policy tightening and a resilient UK economy acting as a 'put' on the pound amid short-term Brexit risks, we continue to think there is more GBP upside over the coming months. We target GBP/USD at 1.45 in 2Q18.
- Equally, the currency should hold its ground against a strong euro and we look for EUR/GBP to trade within the broad 0.85-0.90 range, with a positive Brexit transition outcome suggesting greater risks of a move to the 0.86-0.87 range in the near-term.

**Author** 

Viraj Patel

Foreign Exchange Strategist +44 20 7767 6405 viraj.patel@ing.com

Article | 19 March 2018