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 medium-term 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-

weighted terms this year).

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.

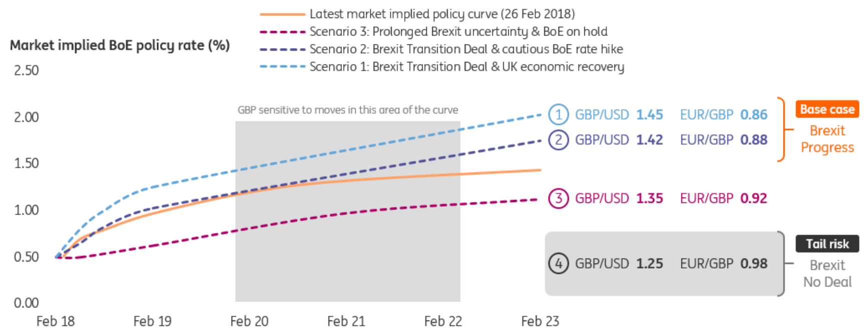
A hawkish Bank of England signal and nascent signs of wage inflation would be an added boost to GBP

- 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%).

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



Source: ING FX Strategy

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-or-break 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.

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