GBP: Stormy outlook as dark clouds gather over Westminster

We think the stormy political clouds over Westminster will remain in place until at least October – and are thus confined to pencilling in a 1.27 to 1.28 trough for the pound against the dollar in the third quarter (EUR/GBP at 0.92). This accounts for a significant degree of political uncertainty – in spite of the Bank of England raising rates in August

Source: Shutterstock

Summary: Short-term GBP downside risks as politics outweighs economics

All the drivers for the pound have turned on their head – with a strong dollar (weak global economy), domestic political uncertainty and a muted UK economic cycle all weighing on the pound. We think the stormy political clouds over Westminster will remain in place until at least October – and are thus confined to pencilling in a 1.27-1.28 trough for GBP/USD at some point in 3Q18 (EUR/GBP at 0.92). This compares to our previous third-quarter forecast of 1.34-1.35 for GBP/USD and 0.88 for EUR/GBP.

This near-term downgrade accounts for a significant degree of political uncertainty – in spite of the Bank of England raising rates in August. While we could be positively surprised

by the Brexit progress, we feel the balance of risks suggests that further uncertainty is more likely between now and October – so long as the UK government's Brexit strategy remains one that is seemingly trying to fit a square peg into a round hole.

Politics to outweigh economics for GBP in the short-term... despite an Aug BoE rate hike

The price of GBP continues to reflect an enigma of uncertainties: a fragile UK government, uncertainty over the Brexit end-state and economic and monetary policy uncertainty.

GBP is cheap both on a short-term (Bank of England and UK economy) and long-term (soft or status quo Brexit) basis. But the political chaos in Westminster makes it a good reason to trade at a discount. A benign scenario would be an easing of short-term political headwinds that sees GBP/USD moving back to 1.35 (EUR/GBP to 0.87).

Yet, the difficulty with this is that we don't see the stormy political clouds over Westminster lifting any time before October – at the least until the Tory Party conference and the October EU leaders' summit. Both domestic and Brexit political uncertainties may remain high until then.

Despite the Bank of England raising rates in August, we believe the politics will continue to outweigh the economics for GBP in the short-term – especially if the Brexit strategy of the UK government remains one that is seemingly trying to fit a square peg in a round hole.

Only a concrete resolution between UK and EU officials over the Irish backstop dispute – which would effectively finalise the Withdrawal Agreement and significantly reduce the odds of a 'No Deal' Brexit – would trigger a material move higher in GBP over the coming months.

In the absence of this, we are confined to pencilling in a 1.27-1.28 trough for GBP/USD in 3Q18 – amid heightened short-term political risks and a dovish BoE rate hike. The Bank's policy reaction function goes beyond economics – and officials have explicitly conditioned their policy outlook on the assumption of a 'smooth Brexit adjustment'. We feel that markets are unlikely to price in an extensive BoE normalisation cycle until further clarity on overall Brexit risks; indeed, the recent history suggests investors tend to adjust to BoE policy on a meeting-by-meeting basis – and that means a likely dovish August rate hike is unlikely to lead to sustained GBP upside.

Perceived odds of 'No Deal' Brexit high but low actual odds points Cable at 1.40 in 2019

The perceived odds of a 'No Deal' Brexit have increased – and this is likely to keep GBP under wraps in the near-term. There are signs that GBP markets are pricing in some degree of political uncertainty (reduced sensitivity to macro data surprises and relative interest rates, and a pick-up in short GBP positioning).

But we still feel the actual odds are significantly lower – with economic logic to triumph over political ideology in the end. Our base case continues to look for GBP/USD to move to 1.35 on the easing of short-term political risks in October/November, setting Cable on a path towards 1.40 by year-end – conditional on reduced structural Brexit risks (a steer towards a soft or status quo

Brexit) and a weaker USD. The former poses the bigger threat to our outlook at present - and we shall present our alternative GBP Brexit paths in a forthcoming note.

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