

GBP: Summer is over, brace for the reality check

The Brexit heat is back on and sterling is, in our view, unprepared. We estimate that there is no risk premia priced into the currency, while speculative positioning is neutral. Both should facilitate GBP's downside this month as negative headline news likely gains traction. We target EUR/GBP 0.9100



Prime Minister Boris Johnson

Source: Shutterstock

Sterling has started to feel the heat of Brexit uncertainty yet again. After a calm summer, which was scant on material Brexit-related news, and general US dollar weakness, which helped all G10 currencies, including the pound, the uncertainty is back following reports that Prime Minister Boris Johnson is ready to walk away from a deal and introduce the internal market bill to override the withdrawal agreement (see the box below for details). GBP, in our view, is unprepared.

Political uncertainty is back

The UK press is awash with reports that the government is prepared to walk away from EU trade negotiations this autumn. None of this is particularly surprising - the theatrics surrounding talks were always going to increase as the de-facto October deadline

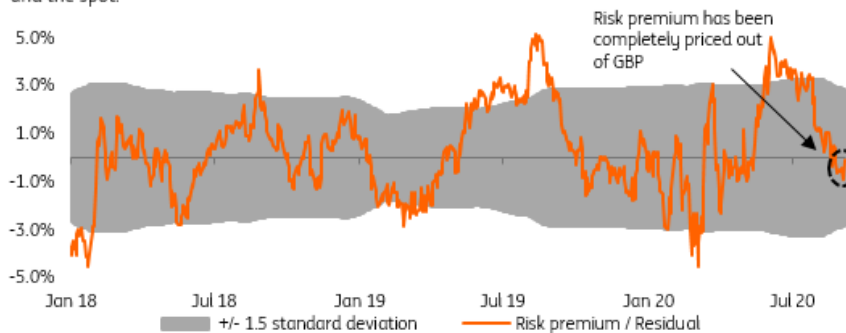
approached, and threats of ‘walking away’ were always a possibility. But [a story in the FT](#), suggesting the UK is prepared to override parts of the Northern Ireland protocol agreed last year - notably on the areas covering state aid and customs - has caught the Brexit-watching community off-guard. Before rushing to conclusions on what this all means, we need to wait and see what actually appears in the text of the internal market bill, due later this week. But if reports are correct, it’s not immediately clear what the UK strategy might be.

One possibility is that the UK government has decided it would be better to progress without a trade deal. This would probably be motivated by a wish to have greater state aid control. And in that case, it would probably want more room to manoeuvre with state support in Northern Ireland than would otherwise be possible under the terms of the withdrawal agreement. But this would, of course, involve breaking the terms of an international agreement, and many are highlighting that this could hamper efforts to negotiate trade deals with other countries in future.

Perhaps then, we should view this story as part of a wider strategy to apply maximum pressure on the EU. After all, we saw similar fireworks this time last year, only for a deal to materialise weeks later. The move may also be designed to ease concern among Conservative backbench MPs. Whatever the case, there’s little doubt that talks are in a precarious position. We suspect a deal is more likely than not, although the probability is now not much higher than 50:50.

Figure 1: No risk premium priced into sterling

The estimate of the EUR/GBP risk premium. Residual between EUR/GBP short-term financial fair value and the spot.



Source: ING

No risk premia priced into GBP

Following the pro-risk summer lull, we estimate that all Brexit-related risk premium has been priced out of GBP, with EUR/GBP now trading at around its short-term fair value (Figure 1). This is in stark contrast to August last year or June this year, when a roughly 5% risk premia was priced into sterling at the peak of Brexit uncertainty and concern about the outlook for UK-EU trade negotiations. While we still see an above 50% probability of a deal (albeit any deal is likely to be of a limited nature – see our [Economic Monthly](#)), the lack of risk premia priced into sterling suggests further downside to the currency in coming weeks, particularly if little progress is made

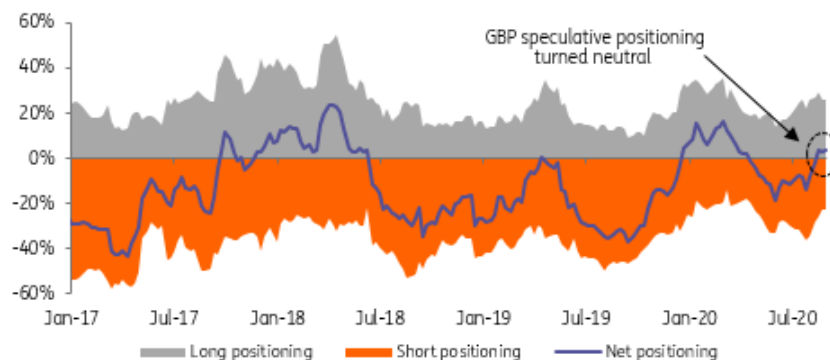
ahead of the 15 October deadline (now seemingly self-imposed by Johnson) .

As we argued in the latest [FX Talking](#), the current market pricing looks complacent to us and we see EUR/GBP moving to 0.91 this month. The lack of risk premia evident in GBP should allow for such a move higher in the cross. Should there be no deal, we expect EUR/GBP to break above this year’s high of 0.95 and potentially test parity.

Indeed, even with a limited deal in place, the change in UK-EU trade terms would leave the UK at risk of a slower recovery vs its peers, taming the potential medium-term upside to both GBP spot and its fair value. In the case of no deal, such a trend would gain even more traction and, coupled with the likely response and more easing from the Bank of England (with negative rates being a clear possibility in such a scenario), the outlook for sterling would clearly deteriorate and the currency would come under further pressure.

Figure 2: GBP speculative positioning is neutral

GBP/USD speculative positioning, as % of open interest (as of 1st August 2020). Negative number means the speculative community is net short GBP vs USD

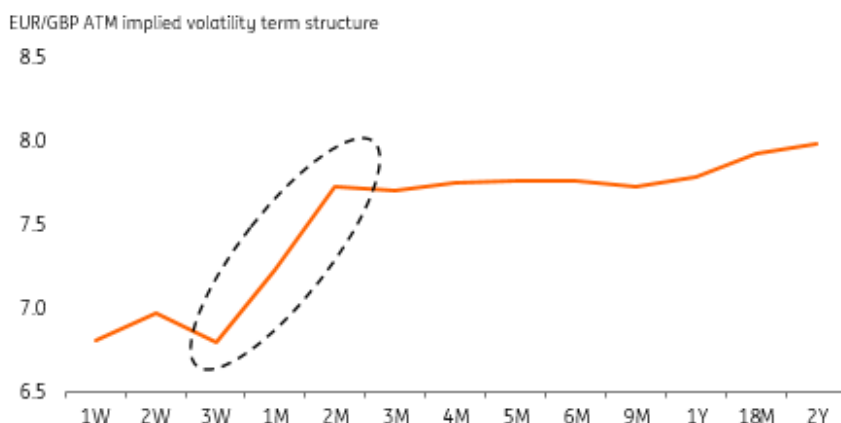


Source: ING, CFTC

Positioning to facilitate near-term GBP downside

Not only is there not enough risk premia priced into GBP, but the speculative positioning in GBP/USD remains fairly neutral. This is evident in Figure 2, which shows that net GBP/USD speculative shorts were heavily trimmed (also due in part to broad-based USD weakness observed in past months). Positioning, like the lack of risk premia, should therefore not act as a hurdle for near-term GBP weakness and should in fact facilitate it. We thus target GBP/USD at/below 1.31 this month.

Figure 3: Modest kink present in the GBP volatility term structure



Source: ING, Bloomberg

Option market not as complacent but it may get worse

Unlike the spot market, the option market partly accounts for the UK-EU trade negotiations risk, with the EUR/GBP implied volatility term structure showing a kink between the 3w and 2m tenors (as per Figure 3). This covers the 15 October deadline date, as well as other risk events such as the November BoE meeting. Nonetheless, should the risk of no deal increase further, the GBP implied volatility (particularly the front-end of the term structure) is likely to rise more.

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