

GBP: The sterling meltdown

We see more GBP weakness to come. The current sterling meltdown is in line with our view that [GBP risks are heavily skewed to the downside](#) given the Brexit uncertainty and rising odds of an early election (our base case). The latter suggests EUR/GBP will head towards the 0.95 level with GBP/USD falling to 1.18



The British pound started weakening sharply today, with the market awaking to the reality of a new UK government, its rather combative stance on the current EU-UK Brexit deal and its open remarks on the rising probability of a no deal Brexit (Michael Gove's comments that "no deal is now a very real prospect" over the weekend). Politics should remain the key negative for sterling in the months to come. There is more scope for risk premia to be built into the pound while the Bank of England is unlikely to offer much help to the battered currency.

Politics: It will get worse

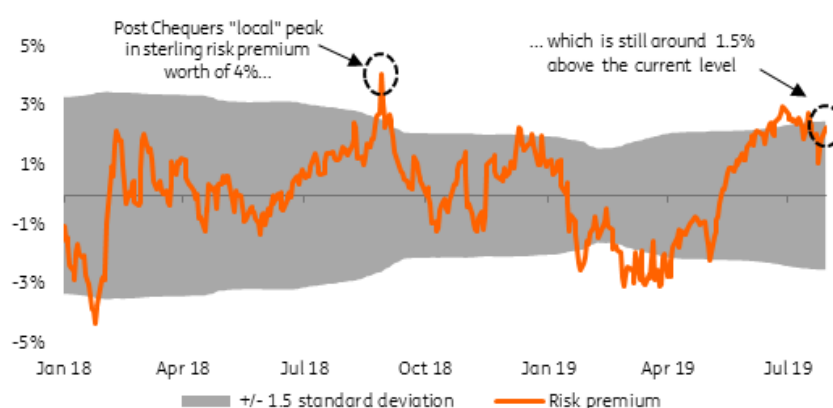
While the new UK government's rhetoric on a no deal Brexit is firming - by extension raising the odds of a hard Brexit - we continue to view early elections as most probable. As our economists point out (see [Brexit and the next 100 days in five charts](#)), if Boris Johnson's government presses for a no deal Brexit, the most likely outcome will be a no confidence vote in Parliament. This could, in turn, translate into an early general election (which would most likely be accompanied by an Article 50 extension).

We view early elections as negative for GBP as the Conservative party under Johnson is very likely to run on a ticket of a divisive Brexit stance vs the EU. The election may even partly resemble the Brexit referendum. With the Conservatives currently leading in the polls, this is unlikely to be seen as positive by the markets. Based on the latest polls, the Conservative party would be in a good position to win (under the current hard Brexit agenda). This may be perceived as another victory of the pro-Brexit camp and further justify a hard Brexit stance after the election – in turn increasing the odds of 'no deal'.

On the other hand, the possible alternative outcome of a Labour victory (under Jeremy Corbyn's leadership) may not be seen as overly positive for GBP either given the market's scepticism about Labour policies.

Figure 1: Still more scope for GBP risk premium to rise

The estimate of EUR/GBP risk premium. A residual between EUR/GBP fair value and spot.



Source: ING

BoE: No help coming to sterling either

The Bank of England is unlikely to provide much support to the currency this week (or in coming months) either. We view GBP reaction to the BoE stance as fairly asymmetrical and skewed to the downside both this Thursday and in coming months (see [BoE Preview](#)). This is because the market will likely be more reactive to a dovish change in BoE interest rate guidance (for example if the bank acknowledges the case for cuts, effectively endorsing the market's view), rather than a scenario where the BoE tries to make the case for hikes. The latter is unlikely to be viewed as credible by the market. This is because (a) domestically, the perceived probability of a 'no deal' Brexit as well as early elections has risen; (b) externally, other global central banks are easing policy. None of these make a strong and credible case for tighter monetary policy that could support GBP.

Risk premia: Still more to be priced in

While a fair degree of risk premium is priced into sterling, it is not particularly extreme. Based on our short term financial fair value model, we estimate the risk premium is currently worth around 2.5% in EUR/GBP (Figure 1), which is still not elevated and not outside of the "normal" 1.5 standard deviation band. Moreover, as the same chart shows, the current risk premium is still below the GBP risk premium highs observed in 3Q18 after the Chequers cabinet meeting and subsequent ministers' resignations. At that time, the risk premium was worth 4%, suggesting another 1.5%

decline in GBP could be still on the cards just to match the state of affairs back then – and a possible overshoot is possible should the odds of a hard Brexit increase.

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