

Mayday! Mayday! Politics are haunting the pound

Will she stay or will she go? With Theresa May's leadership in question, here's our ultimate sterling guide

GBP Scenario Analysis:

Implied odds from UK betting markets (%)		What will affect GBP in the near-term?				
		BoE November rate hike odds	UK 2-year swap rates	Political risk premium		
1	PM May stays on Nothing to see as PM looks to provide 'calm leadership'	35% Odds PM May is replaced this year	80% (+) Fading political risks helps ease for Nov hike	+15bp BoE signals more than withdrawal of stimulus cycle	Relief rally Financial model has a 1-2% risk premium priced	GBP/USD 1.3300 EUR/GBP 0.8850
2	May swiftly replaced A 'continuity' candidate takes over and steadies the ship	Next Tory leader odds (all approx.)* Johnson 20% Davis 15% Rees-Mogg 12% Rudd 10% Hammond 8% Davidson 5%	65% (+) Doubts creep into markets; we still expect a hike	+5bp Curve moves back towards end Sept. levels	1-2% risk premium Some near-term political noise	GBP/USD 1.3150 EUR/GBP 0.8900
3	Drawn out Tory leadership contest No easy transition as several candidates up for the job		45% (+) Ongoing political risks may see odds fall to 50:50	-15bp Markets ease up on overall BoE hiking optimism	2-3% risk premium Need clarity for discount to fade	GBP/USD 1.2700 EUR/GBP 0.9000
4	General Election? Slim chances given that Fixed-term Parliaments Act requires a 2/3 vote in Commons	≈5% Odds we have a general election in 2017	~0% (+) BoE won't hike if election risks loom	-30bp Any BoE hiking sentiment gets priced out	4-5% risk premium Historic premium for prior UK GE's	GBP/USD 1.2500 EUR/GBP 0.9400

Spot reference for scenarios 1.3050 (£/\$), 0.8950 (€/£)

Source: Source: ING, OddsChecker

The risks to sterling

Two channels of political uncertainty have arisen from the UK's governing Conservative Party conference:

(1) greater questions over PM May's leadership – where we note that odds of the Prime Minister leaving by year-end have risen in betting market to around 30%; and

(2) confusion over the government's Brexit transition deal strategy – with reports that some senior Tory ministers want it to last for more than two years, while Boris Johnson's more stringent 'red lines' suggest a more complex transition period than just the 'status quo' extension.

It will be the first channel that is likely to command GBP's attention in the near-term and our scenario analysis provides some guidance for what to expect. Our short-term financial fair value model estimates show a 1-2% risk premium currently priced into GBP, which suggests that there is a potential for a GBP relief rally if questions over PM May's leadership credentials abate.

PM May stays on

- We would expect GBP to recover its latest conference-related losses should May cling on and domestic political risks meaningfully ease. The narrative will shift back to the Bank of England story, with risks of the UK curve steepening further if Carney & Co support a rate hike with a constructive outlook for the UK economy at the November BoE meeting.
- Should the Foreign Secretary Boris Johnson leave the Cabinet, markets may see this as drawing a line, albeit temporarily, under the current split within government which many believe is all too apparent. That would be a catalyst for a symbolic relief rally in the pound, taking GBP/USD back to 1.33 (EUR/GBP: 0.88).

2 May swiftly replaced

- While certainly not our base case, a scenario of PM May stepping down – and a Tory Party leadership contest in the near-term – could see the pound getting quickly dumped (with short speculative positions being rebuilt after the recent neutralisation). • First and foremost it would pose major doubts over a November BoE rate hike – which markets are all but pricing in at this stage (75% probability), while it could dampen some of the recent cyclical upside seen in the UK data – especially the forward-looking indicators.
- A dovish BoE re-pricing on its own could see GBP/USD tumble below 1.30, while a sustained increase in GBP's political risk premium could fuel the move lower to 1.26-1.27 (EUR/GBP to 0.93).

3 Drawn out leadership contest

Were PM May to be swiftly replaced – and in particular by a 'continuity' candidate (ie, David Davis or Amber Rudd) – then we would expect GBP's pain via the short-term political risk channel to ease. But the damage may already be done in highlighting the stark divergence of views on key Brexit issues within the Conservative Party and this week has provided a reality check on GBP's potential to benefit from a Brexit transition deal.

4 Another general election

We see trivial risks of a General Election being called in 2017 given that the Fixed Term Parliaments Act (and requirement of a two-thirds majority in the House of Commons). But our economists note that there have been 4-5 by-elections each year on average since 2010 and a series of Tory losses could hypothetically stoke up election risks.