Short-term woes, long-term hopes

What next for the pound? So much depends on the British political mess and how the Brexit talks progress

After the shock election...

With the dust settling after the UK's indecisive election result, the pressure's certainly on for sterling. There are domestic political, as well as Brexit policy, unknowns that will cast a shadow over sterling in the immediate future. We see two sources of uncertainty reflected in GBP at present: a short-term domestic political risk premium and a 'hard' Brexit risk premium. We explain the narrative outlining both sources of 'risk' below but the bottom line is that they could present conflicting signals for GBP in the short- and medium-term. The more neutral GBP positioning – and obvious idiosyncratic political risks generated as a result of the election outcome – means that we could see the pound remain under pressure in the near-term. But downside could be buffered by growing hopes of what we deem a more 'economically rational' Brexit.

Domestic political risk premium: May's election backfire sees political uncertainty increase, not decrease

1.24 GBP/USD to move lower this summer on political uncertainty

UK economy also showing signs of slowing

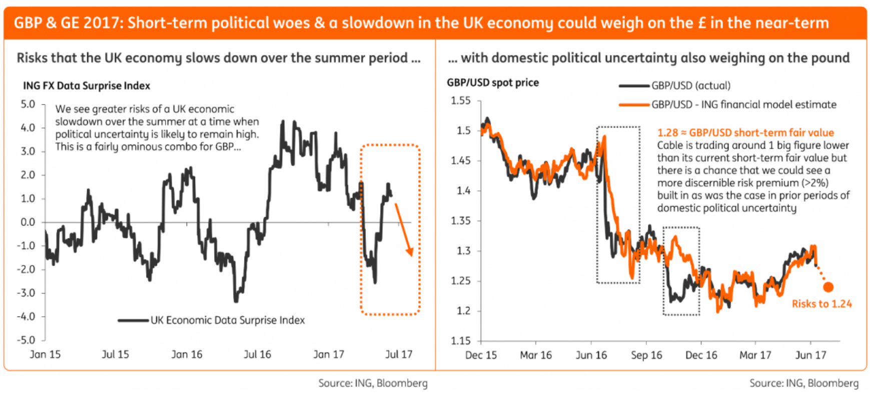
May's election backfire sees political uncertainty increase, not decrease

Theresa May has unequivocally stated her intention to stay on as Prime Minister and while there may be some underlying unrest within the Conservative Party, it seems that a leadership contest at this stage remains highly unlikely – especially as it would likely lead to another election that could risk handing the keys to Downing Street over to Jeremy Corbyn. On that note, the Labour leader hasn't given up on forming a minority government and putting forward an alternative Queen's speech – but again this outcome seems unlikely. Still, we note that any confidence and supply arrangement between the Tories and DUP would be a less stable form of government than the 2010 coalition; it would risk slowing down the legislative process on key policy areas – not least the Budget and Brexit.

Given that the purpose of the General Election was to enhance the political stability of the incumbent Conservative government, these short-term political unknowns will likely keep GBP under pressure over the summer; a modest 1-2% domestic political risk premium – coupled with a more concerning slowdown in the UK economy – could see GBP/USD trade down to 1.24-1.25 and EUR/GBP up above 0.90. Add to this a difficult start to Brexit negotiations, and there is every reason to remain cautious over GBP in the near-term.

'Hard' Brexit risk premium: Too premature to call for a 'soft' Brexit, but an 'economically rational' Brexit has the potential to be a GBP game-changer

How the pound could react



Source: ING, Bloomberg

Still too premature to call for a 'soft' Brexit

Brexit negotiations are set to begin next week and there is now a bigger question mark over the UK's position going into the talks. Certainly the loss of Conservative seats – and rise in Labour foothold – has led to speculation that we could see a shift towards a more 'softer' Brexit approach being adopted by the UK government. There are plenty of additional supporting factors – the DUP's desire to avoid a hard border between Northern Ireland and the Republic of Ireland, the rise in Scottish Conservatives pushing for a more "open Brexit" and reshuffle within Mrs May's Cabinet (and team at Downing Street) all support the fact that we may see an alternative Brexit vision being adopted by the UK government.

We think it may be too early for GBP investors to make a judgement call on a 'soft' Brexit and there is a risk that this term is being loosely brandished about. Indeed, a major shift in the UK's position may seem slightly premature at this stage – especially as (a) Labour have since the election signalled their intent to leave the single market (which on our scale would sit more towards the 'hard' – or difficult – Brexit spectrum) and (b) the early phases of Brexit negotiations will be centred around the Divorce Bill – which in itself could have ramifications for the type of Brexit stance adopted by the UK and EU.

An 'economically rational' Brexit has the potential to be a GBP game-changer

But there is hope. What we do see now is a greater likelihood of an 'economically rational' Brexit approach being adopted – with the dial shifting towards obtaining a deal that is in best interests of the UK's long-run economic prospects. This would mean a greater focus on securing a constructive trade deal that minimises the explicit (ie, tariffs) and implicit (ie, labour) costs for UK businesses operating in Europe. This would be a net positive for an undervalued GBP that is currently trading at around a 15% discount* – which is part reflecting a significantly weaker long-run UK economy. This undervaluation factor was the main reason why we think GBP/USD upside beyond a 6M horizon doesn't look like a bad shout.

However, before any positive fundamental re-pricing could occur, we will need to see visible steps towards a transition deal. In the absence of one, the passage of time remains GBP negative and the risk of the currency falling off the 'cliff-edge' is likely to cap any upside in the next couple of months. Talk of this is what we'll be keeping our eye out for in the early phases of Brexit negotiations.