Stalling GBP gains and implications for European FX

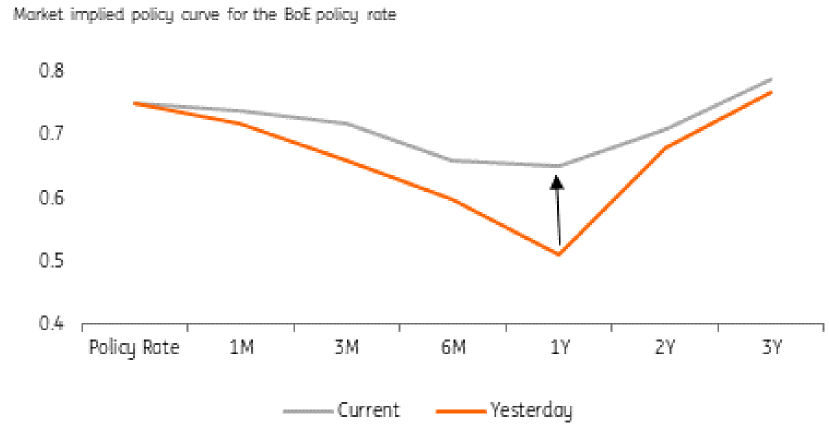
GBP gains have stalled as the market was partly positioned for Conservative party victory. We estimate that the market-friendly election outcome had an overall 4% positive impact on GBP. With GBP not cheap, further gains should be muted. European FX benefiting but US-China partial trade deal to have a bigger and longer-lasting impact than UK election

Source: Shutterstock

GBP gains stalling

Following the initial overnight GBP rally, sterling gains stalled. This in part reflects the fact that ahead of the election, the FX market had been partly pricing in a Conservative party victory. As discussed in GBP and UK election: Asymmetric sterling reaction, we estimated that around 2% Brexit resolution premium was priced into GBP ahead of the election (that's why we looked for GBP gains to reach EUR/GBP 0.82/0.83 level, but not much beyond that).

Figure 1: Modest re-pricing of market BoE outlook helped GBP



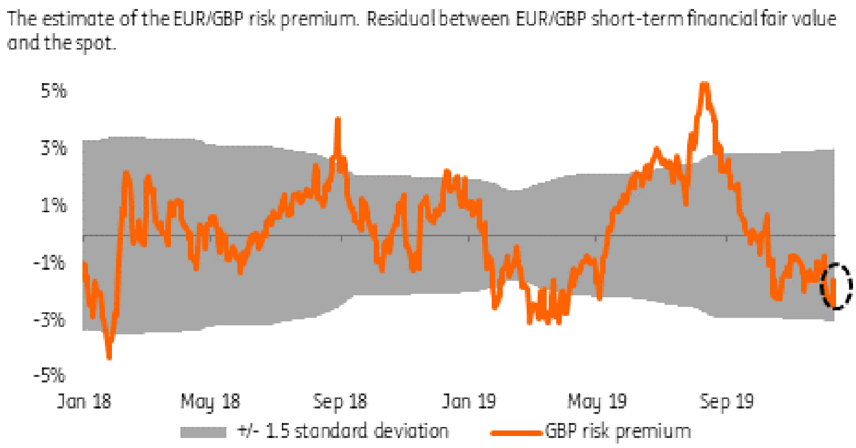
Source: ING, Bloomberg

Market friendly election outcome worth around 4% of GBP gains

Coupled with the close to 2% GBP gains vs EUR overnight, this means the market-friendly election outcome was worth around 4% in sterling (note that the GBP rally in October was more about pricing out a GBP risk premium – with early elections not being announced in time). We also note that the short term GBP fair value increased modestly overnight (largely caused by the hawkish re-pricing of the markets BoE outlook – Fig 1).

Hence, and despite the GBP rally overnight, EUR/GBP mis-valuation remains within the tolerable 1.5 standard deviation band, as is evident in Figure 2.

Figure 2: EUR/GBP mis-valuation remains within the tolerable area



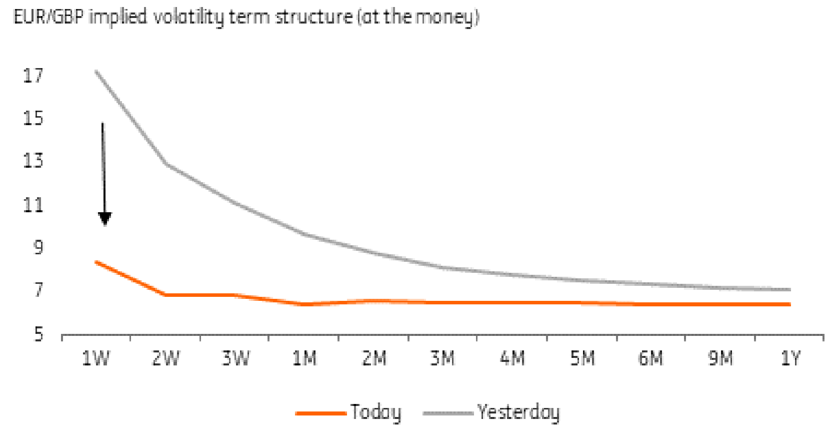
Source: ING

Option market pricing out uncertainty

Given the mix of the market-friendly election outcome and the fading uncertainty, we have naturally observed a big adjustment in the option market.

The front-end GBP volatility collapsed with the implied volatility curve no longer as extremely inverted as was the case before the election (Fig 3). Also, we observe a non-negligible adjustment in the GBP volatility smile, with the shape of the smile now less skewed toward EUR/GBP calls vs the pre-election state of affairs (Fig 4). Yet, again, this reflects the fading risk of the worst-case scenario.

Figure 3: GBP volatility curve no longer extremey inverted

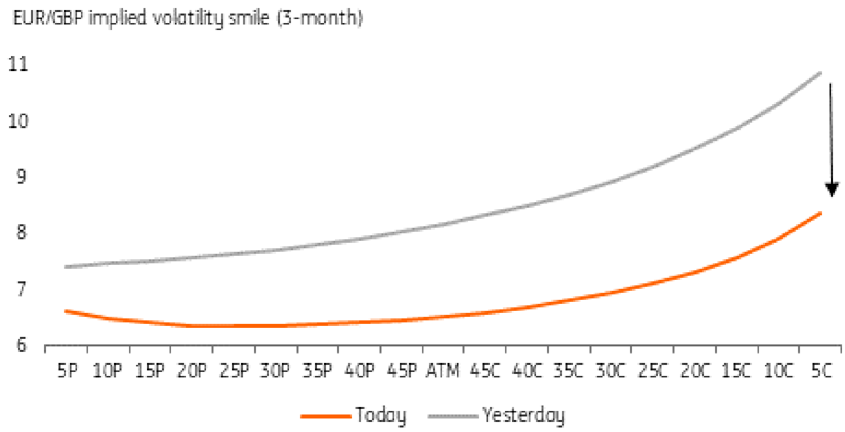


Source: ING, Bloomberg

Good outcome but stay realistic

Big Conservative party majority at this point seems the best possible near-term outcome for GBP. Sterling may see further gains, but one should be realistic in terms of expectations. As per GBP: Winning here Don't look for fireworks (particularly when medium-term GBP fair value declined significantly over the past three years – by around 8-9% vs the euro, see 2020 FX Outlook – and GBP is not cheap in medium-term basis).

Figure 4: Shape of the option smile now less skewed towards EUR/GBP calls



Source: ING, Bloomberg

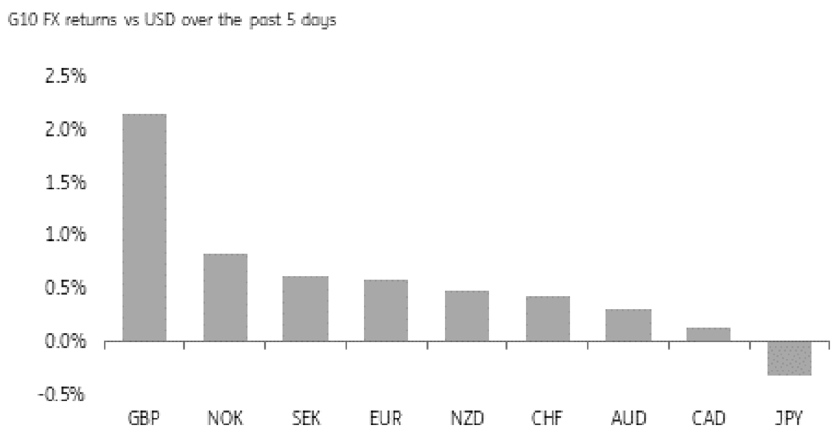
Spillovers – European FX benefiting for now

European FX naturally outperformed overnight, benefiting from the market-friendly election outcome (Fig 5).

The rise in EUR/USD has been the key contributor to the European FX gains. While positive at this point, the spillover into other currencies should not be long-lasting and be generally muted. This was the case after the previous market-friendly UK election outcomes. What is likely to be more supportive of pro-cyclical European currencies (both Scandies and CEE FX) is the US-China phase one trade deal. The subsequent stabilisation in global risk appetite (via the improved global growth and trade channels) is good news for these currencies. Within the CEE space, we underscore our preference for CZK and among Scandies, we prefer NOK to SEK.

Yet, the lack of long-lasting upside and generally low yielding nature of these currencies (bar NOK) vs their global peers mean that the dollar block higher-yielding FX should do better. We like CAD and NZD in the G10 FX space and the likes of BRL, RUB or KRW in the EM FX space.

Figure 5: European FX feeling the postive spillover



Source: ING, Bloomberg