

Sterling: The perennial ‘comeback kid’

It's clear that both UK and EU officials are implicitly pursuing an economically rational Brexit. The undervalued pound will continue to drift higher



Source: Shutterstock

GBP: ‘Comeback Kid’ has more upside in it as UK economy regains its swagger

The agreement of a Brexit transition deal yesterday was a genuine positive surprise for GBP markets – not least as investors had broadly scaled back their expectations of any progress being achieved as early as this week. While we do believe that it is the second-round effects of an agreed transition deal that will determine the future path of UK asset prices and sterling ([see here](#)), it is worth pointing out two key learning points for investors when it comes to pricing in short-term risks around Brexit:

1. Despite all the huffing and puffing in the run-up to crunch talks, it is clear that both UK and EU officials are implicitly pursuing an economically-rational Brexit – one that looks to safeguard their respective domestic economies ahead of any political agenda (we note both parties have ended up compromising on previously stipulated red lines in the divorce and transition deals)
2. Given the complexities of Brexit, GBP markets remain structurally pessimistic over future

progress – which lends itself to asymmetric risks (greater upside in the event of a positive outcome, limited downside bar the absence of a complete breakdown in UK-EU talks).

Both points mean that **an undervalued pound will continue to be the ‘comeback kid’ in FX markets** – with a natural tendency to drift higher. In the near-term, we expect the focus to shift back to UK economic fundamentals. A Brexit transition deal is one element of GBP’s bullish trifecta this week; if all the cards were to fall perfectly into place – and we also see a status quo hawkish Bank of England policy message and constructive UK inflation data – then we wouldn’t rule out a further move up in GBP/USD towards the year-to-date highs around 1.4250-1.4300. Today’s UK CPI data is set to show inflation remaining sticky above-target – which supports the BoE’s renewed inflation concerns and the case for a near-term rate hike.

USD: Trump protectionism and Fed tightening fears point to nervous markets

A quiet day ahead of tomorrow’s FOMC meeting – though there will be some focus on the G20 communique expected later today ([see here for more details](#)). Expect nervous markets to remain sensitive to Trump trade headline risks.

EUR: Nascent ECB rate hike talk is unambiguously positive for the currency

The euro found some support yesterday following a [Reuters report](#) stating that ECB officials have conceded that QE purchases will likely end later this year and are now shifting the debate internally to the future path of rate increases. The report also noted that policymakers are content with market expectations for the first ECB depo rate hike in mid-2019. It’s somewhat ironic that the unnamed sources talking about rate hikes stressed concerns over markets – in particular, the euro – front-running any ECB policy normalisation; the fact that short-term Eurozone rates and the currency nudged higher following this report suggests that this may have been a bit of an ‘own goal’ by the ECB sources. Still, we see ECB rate hike talk as unambiguously Euro positive – especially in a market that is heavily distorted and underestimating the central bank’s next policy steps. One simply needs to look at the short-term three-year forward Eurozone OIS rate- which remains circa 40bps below when the ECB first started easing policy in mid-2014- to see why the risks are asymmetrically skewed to the upside when it comes the Euro and ECB policy. Look for EUR/USD to remain supported in the 1.23-1.24 area today.