Sterling's high stakes game of snakes and ladders

GBP is well bid as the 31 October 'no-deal' Brexit risk is (largely) taken off the table. Speculators are still short GBP and progress on Brexit legislation could see GBP/$ rally to 1.32/34. However, if new amendments head the way of a customs union, UK prime minister Boris Johnson's fragile coalition and the GBP rally could fall apart

Source: iStock

Earlier part of the week may be better for GBP

After surging last week, GBP opened the new week holding onto its gains. Saturday's vote on the amendment to the Withdrawal Agreement Bill (WAB) is seen as delaying rather than de-railing prime minister Boris Johnson's bid for an orderly Brexit.

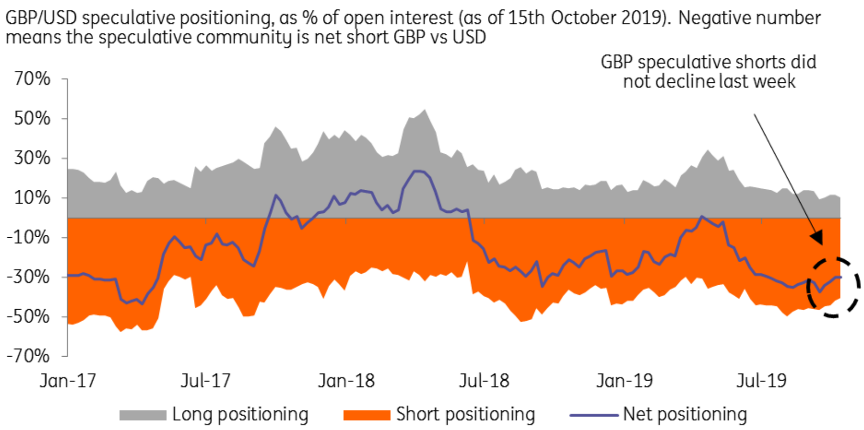
As our UK economist, James Smith discusses here, the path ahead this week is a rocky one. Of the five big hurdles this week, the best chance of a GBP rally may come earlier in the week – were the government to find support for the second reading of its WAB. Here signs that parliament could finally agree on a Brexit deal would see Boris Johnson go one step further than Theresa May and should be enough to drive EUR/GBP under 0.8500 – i.e. into a new trading range. GBP/$ could see 1.32/34.

However, the biggest threat GBP faces this week could be the committee stage discussions of the legislation. This may well start on Wednesday and see a variety of amendments introduced. We doubt amendments calling for a second referendum will have the numbers, but the desire to remain in a customs union could prove much closer.

Were a majority in parliament to back an amendment forcing the government into negotiating customs union access as part of the trade talks, the European Research Group's support for the whole WAB could easily fall away as would the government's fragile coalition for a deal – and GBP could hand back a decent part of recent gains. Given the market is still substantially short GBP, that might only see Cable come back to 1.2700 area – and the softer dollar environment may also limit the size of Cable's correction here.

Five big Brexit hurdles facing Boris Johnson this week

Despite Cable's rally to 1.28, speculative GBP shorts were not reduced



Source: Bloomberg, ING

Could Cable hit 1.40 before year-end?

The FX options market currently assigns just a 10% probability to GBP/$ hitting the 1.40 level before the end of the year. We can see why that is the case.

The revised Brexit deal currently envisages the transition period ending in just over a year in December 2020. While that is likely to be extended, the current state of play means there is still a risk of the UK (outside of NI) abruptly exiting the single market and customs union. That will keep businesses in the dark, and in turn, keep investment subdued. While Bank of England policymakers have attempted to reignite talks about possible policy tightening over recent days, we think this is unlikely to be forthcoming in the short-term.

As above, we see a Cable move to 1.40 being too much of a stretch this year - and if it were to happen it would probably involve us and the market massively under-estimating the size of the squeeze in short UK positions - those positions including equities, where fund managers have been underweight UK equities since 2014.

But at this point, the above factors are predominantly stories for next year, with the near term GBP price action evolving around: (a) the potential positive passage of the deal; and (b) possible amendments that can subsequently change the voting dynamics.

Spillovers into the European FX

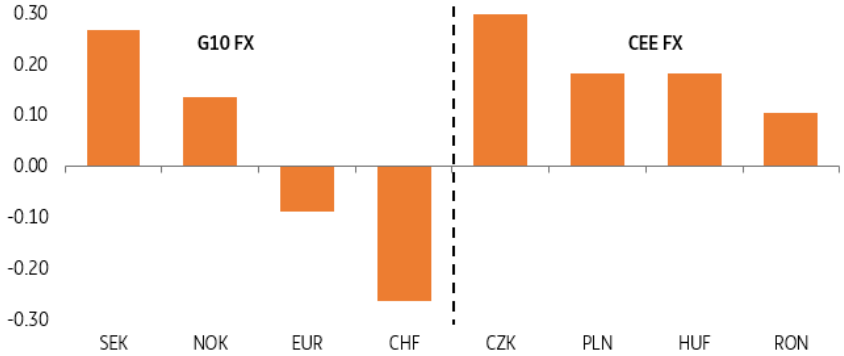
In the European FX arena, we see SEK in the G10 FX space and CZK in the CEE space as the biggest beneficiaries from the possible successful WAB vote this week.

As the figure below shows, both currencies show that highest correlation with GBP and the price action since the 10 October (when the PM Johnson government changed the stance towards negotiations with the EU) provides the case in point.

SEK has been the second-best performing G10 currency, after GBP, while what is perceived as the low beta CZK delivered gains on par with PLN and HUF. Should the WAB be approved and legislation make progress in UK Parliament this week, SEK and CEE FX are set for further gains.

European crosses correlation with GBP. The GBP rally sends EUR/SEK and EUR/CZK lower

European FX (G10 and EM) correlation with GBP – 3 month correlation



Source: Bloomberg, ING

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com