Stop! Hammond time

An economically rational Brexit, as championed by UK Chancellor Philip Hammond, is good news for sterling.

Talk of a Brexit transitional arrangement easing cliff-edge risks

The growing consensus within Theresa May's cabinet over a post-Article 50 transitional arrangement with the EU is certainly good news for sterling. A two or three-year "implementation phase" starting in April 2019, would avoid the immediate risk of a cliff-edge Brexit - that is trade between the UK and EU defaulting to World Trade Organisation rules, which is arguably one of the biggest uncertainties clouding GBP markets.

In an ideal scenario, one could see a transition deal - and the lifting of this cliff-edge cloud - reducing business uncertainty and restoring confidence in the UK investment environment. That could, in turn, spark a rebound in corporate activity. A reduction in economic uncertainty would also give the Bank of England greater confidence to begin normalising monetary policy.

It's still too early for GBP markets to price this in

The question for us, however, is whether it is too soon for GBP markets to begin pricing in such a scenario. In our view, yes; while the wind may be blowing in the direction of a transition deal, last week's Brexit negotiations highlighted the number of divorce stumbling blocks that need to be overcome before any transitional arrangement is likely signed, sealed and delivered.

Moreover, the specifics of any transition deal matter; only a continuation of the status quo over the agreed period - that is free movement of trade, capital and labour - would have the greatest positive effect on GBP.

GBP short-term risks lie to the downside

Until we get clarity over any transitional arrangement, we think GBP will continue to trade with a negative bias in the short-term. This week's second quarter UK GDP data is likely to confirm a weak period of activity; our economists are looking for 0.3% QoQ. That should dent hopes of a 2017 BoE rate hike. A recovery in dollar sentiment should see GBP/USD move back below 1.30, while a consolidation in the euro may keep EUR/GBP range-bound around the 0.89 level.