

FX: Sterling risk premium tracker

With Brexit uncertainty rising, we introduce a sterling risk premium tracker. We look at various measures of sterling stress, gauged by factors such as our short-term financial fair value model, speculative positioning & the options market. We think the risk of no-deal Brexit / early election is underpriced by the market and look for more downside to GBP



Source: iStock

Where we are now?

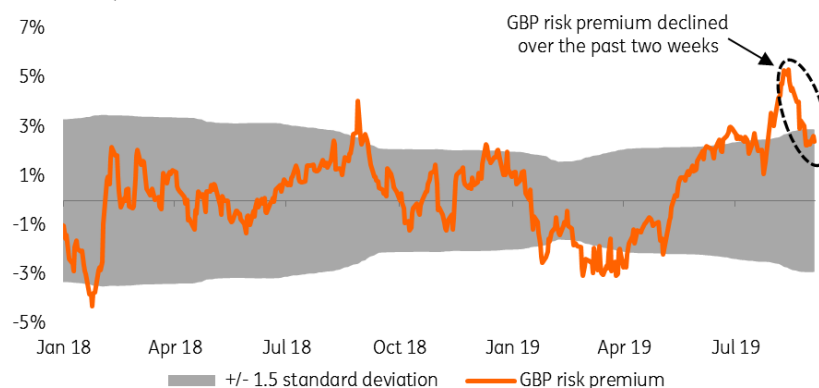
Despite the rebound in the UK pound in the last few weeks, the short term **sterling risk premium isn't extreme**.

We estimate it to be worth around 2.5 % in EUR/GBP (vs 5% this August), with EUR/GBP still within its 1.5 standard deviation band as can be seen in figure 1. This means that more risk premium can be built into sterling. Our financial fair value model is based on short-term drivers of currencies such as rate spreads, yield curves and a gauge for risk appetite.

[Read all about Brexit and the UK government's decision to suspend parliament here](#)

Figure 1: More scope for GBP risk premium to rise

The estimate of EUR/GBP risk premium. A residual between EUR/GBP short-term financial fair value and the spot.

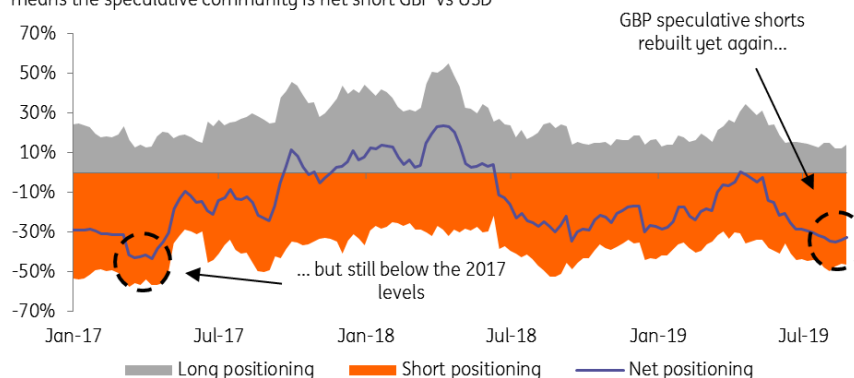


Source: ING

The build-up of **speculative GBP/USD shorts** paused in recent weeks. Although elevated, they are still below the 2017 extremes (33% of open interest currently vs 43% back then – as can be seen in figure 2). In the case of the rising probability of a no-deal Brexit and/or early elections, the shorts can rise further.

Figure 2: Speculative positioning elevated but below the 2017 levels

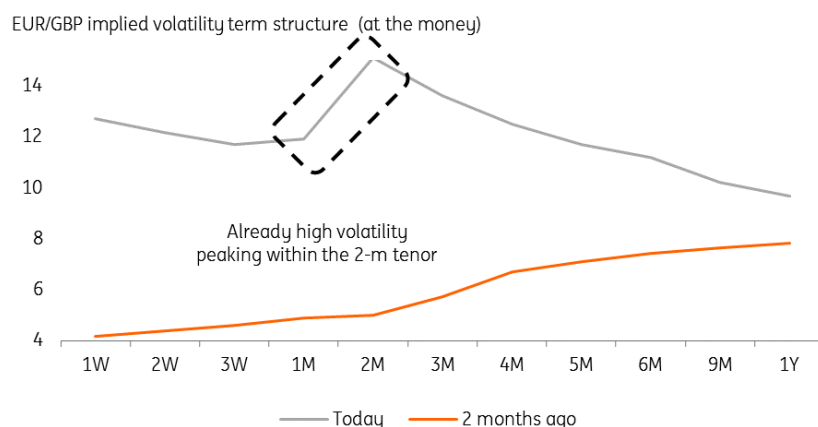
GBP/USD speculative positioning, as % of open interest (as of 27th August 2019). Negative number means the speculative community is net short GBP vs USD



Source: ING

The **options market clearly shows signs of stress**. The EUR/GBP implied volatility curve (the term structure) is kinked around the deadline data as can be seen in figure 3 and GBP volatility premium is the highest in the G10 FX space (figure 4). Still, EUR/GBP risk reversals can rise further (figure 5)

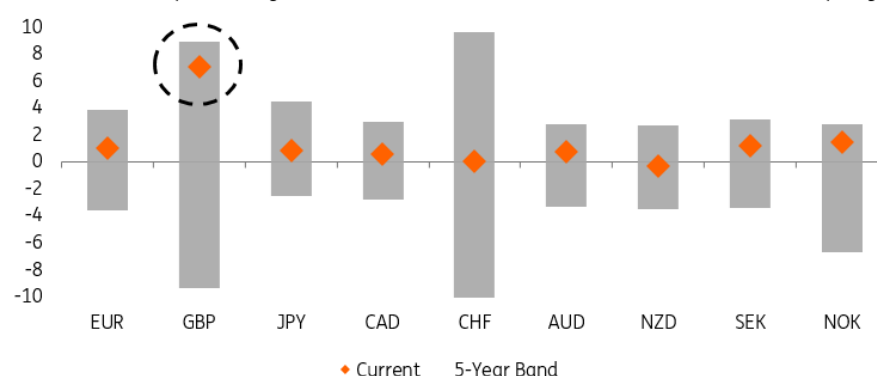
Figure 3: The GBP volatility curve already heavily kinked around the Brexit date



Source: ING, Bloomberg

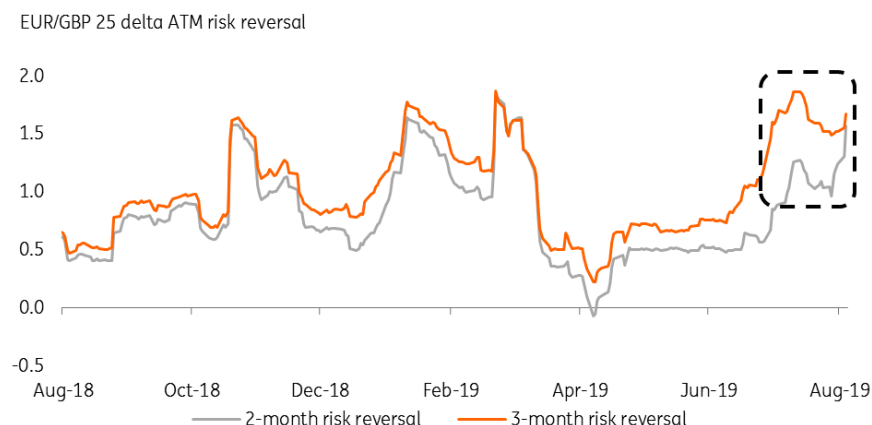
Figure 4: Sterling volatility risk premium remains high

3-month G10 FX Volatility premia vs USD (calculated as implied volatility - realised volatility). Note that USD/CHF implied vol 5-y band exceeds the scale, but we reduced the scale for visual simplicity



Source: ING

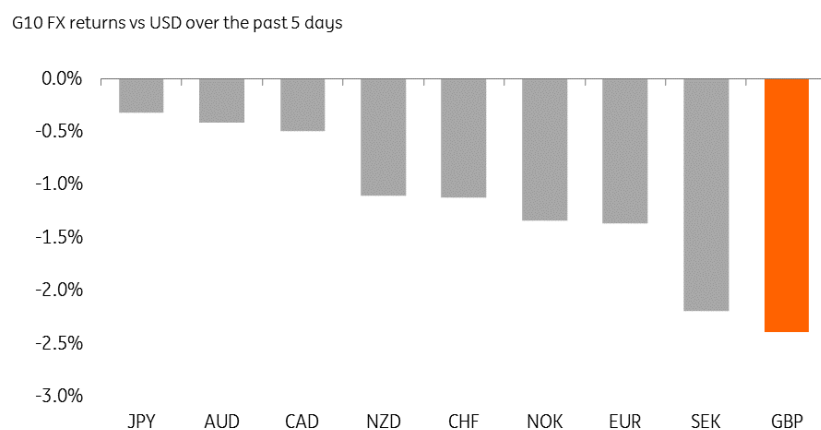
Figure 5: Risk reversals already at stressed levels but can get stressed even more



Source: ING, Bloomberg

The recent decline of the pound over the last few days has turned sterling into the **G10 FX underperformer yet again** (figure 6) but we **don't expect the Bank of England to provide any help** to the struggling pound, with dovish market pricing to firmly remain in place (figure 7). Currently, more than one full 25bp rate cut is priced in within six months.

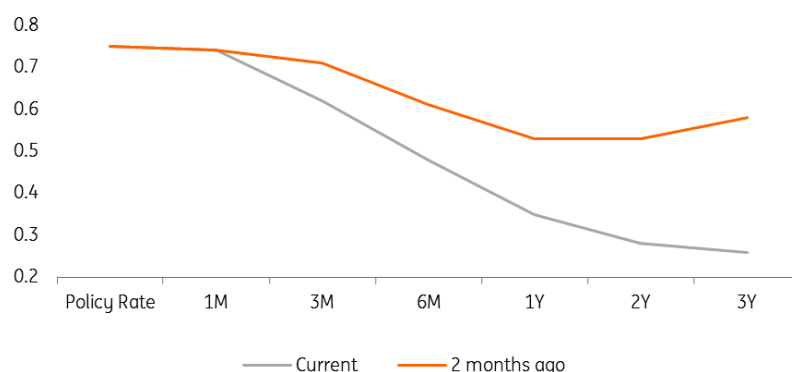
Figure 6: GBP turning into a G10 FX underperformer yet again



Source: ING, Bloomberg

Figure 7: Market pricing Bank of England rate cuts

Market implied policy curve for the BoE policy rate



Source: ING, Bloomberg

What to look for?

If parliament moves a step closer to legislating against no-deal Brexit today by seizing control of the parliamentary agenda and prime minister Boris Johnson subsequently and successfully calls for early elections (likely in mid-October), we would see this as GBP negative given that (a) the Conservative party under PM Johnson's leadership will likely run on the ticket of a divisive stance vs EU ("no ifs or buts"), (b) the alternative option of a Labour government under Jeremy Corbyn may not be seen as an overly positive for market participants.

As [we've written before](#), we view early elections as negative for GBP and continue to see downside risks to sterling. This is consistent with our forecast of EUR/GBP 0.95 within 1-3 months and [GBP/USD falling to 1.17](#).

[Read our detailed view on currencies here - FX Talking: Currencies move to the frontline of the trade war](#)