

Starry-eyed BoE not enough to offset short-term political risks for the pound

While the unanimous 9-0 MPC decision for a 25 basis point hike, higher-than-expected nominal neutral interest rate estimate (2-3%) and the overall constructive UK economic outlook are all medium-term positives from today's BoE meeting, the post-meeting decline in the pound should not be all that surprising given the Brexit risks that lie ahead



Source: Source: Bank of England

Bottom line: Short-term GBP bears, long-term GBP bulls

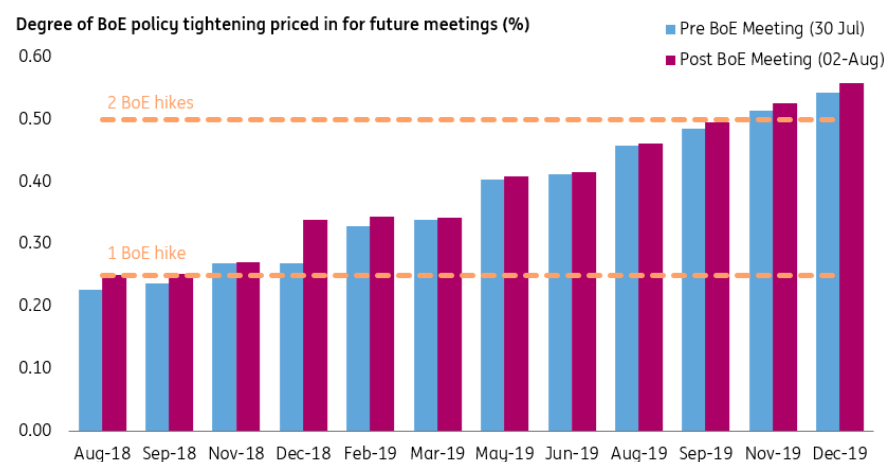
Today's hawkish Bank of England rate hike was no game-changer for our short-term bearish GBP view – as we feel that Brexit political risks will continue to weigh on the currency over the coming months. We have pencilled in a 1.27-1.28 trough for GBP/USD to reflect peak 'no deal' Brexit risks (EUR/GBP risks moving up to 0.91-0.92). However, the relatively more hawkish BoE that we've seen today may buffer some of the possible downside GBP risks – and we still remain medium-term bulls, looking for GBP/USD at 1.38-1.40 and EUR/GBP at 0.85-0.86 in 1Q19. Catalysts for this sharp positive GBP re-rating will be (1) an agreed withdrawal deal and resolution on the Irish border 'backstop' dispute and/or (2) positive UK economic data surprises that oppose short-term Brexit risks. Both at this stage seem more of a 4Q18 story.

[Click here for our economists' reaction to today's Bank of England rate hike](#)

Tough to price in BoE's optimistic rate hike outlook just yet

Investors are aware that the Bank's economic assessment has to be conducted with the rose-tinted glasses of a smooth Brexit adjustment – and not necessarily factoring in the worst-case outcome (a cliff-edge Brexit) as a central scenario. This is not a view that everyone in the market currently shares – not least given recent political development and heightened noise of a no-deal Brexit. Hence as we noted in our preview, hawkish BoE rhetoric alone today was never going to be the catalyst for driving short-term UK rates – or the pound – higher in the near-term.

The lacklustre reaction in GBP can be primarily linked to the lack of willingness for investors to bring forward their expectations for the timing of the next BoE rate hike. The UK OIS curve has barely budged following the BoE meeting (see below) – with markets still seeing 2H19 as the next likely period for when the Bank will hike again. This makes sense – while under normal circumstances one could conceivably pencil in a February or May 2019 BoE hike following today's meeting, the likely political turbulence in the near-term – with Brexit talks in a crucial phase – means that markets will remain reluctant to price this in.



Source: ING, Bloomberg

Today's BoE meeting has no major implications to our GBP view: we continue to think the pound will remain under pressure in the near-term as the currency continues to price in a significant degree of political uncertainty. We do feel the balance of risks is for further political turbulence between now and October – and have pencilled in a 1.27-1.28 trough for GBP/USD in 3Q18 to capture peak 'no-deal Brexit' risks (we see EUR/GBP at 0.92).

However, we remain constructive on the medium-term prospects for GBP – given our house-view that a politically acceptable withdrawal deal will be struck between the UK and EU.

- Based on the BOE's latest r^* estimates, we note that the term structure of UK interest rates is around 75-100 basis points too low right now (see chart below). Long-term UK interest rate expectations will remain distorted by Brexit no-deal risks in the immediate future – and any sustained shift higher in the UK curve won't transpire until some of these

Brexit tail risks have been concretely taken off the table. Indeed, throw into the mix the unique Brexit uncertainties surrounding the UK economy – and this renders r^* an almost redundant factor for UK rate markets right now. Indeed, when we think about the conceptual factors that drive r^* – demographics, productivity, fiscal policy, savings-investment imbalances, demand for safe assets – one could argue that these would look inherently different in a ‘soft’ versus ‘hard’ Brexit world.

- We'll also need to see actual signs of a UK economic recovery – and positive UK data surprises over coming months could also lift short-term domestic rates and the pound. Our medium-term bullish GBP view – which sees GBP/USD at 1.40 (EUR/GBP 0.85) at the turn of the year – is partly based on this structural re-pricing in UK interest rates.

		Status of Brexit Withdrawal Deal			
		Deal Done (in principle)	Solid signs of Progress	No Progress (status quo)	Sliding towards a No Deal
August BoE meeting outcome	Hawkish 25bp hike ING	£/\$: 1.38 €/: 0.85	£/\$: 1.35 €/: 0.87	£/\$: 1.33 €/: 0.88	£/\$: 1.27 €/: 0.92
	Dovish 25bp hike	£/\$: 1.36 €/: 0.86	£/\$: 1.34 €/: 0.87	£/\$: 1.32 €/: 0.89	£/\$: 1.26 €/: 0.92
	Ultra Dovish 25bp hike	£/\$: 1.35 €/: 0.87	£/\$: 1.32 €/: 0.88	£/\$: 1.30 €/: 0.89	£/\$: 1.25 €/: 0.93
	No 25bp rate hike	£/\$: 1.33 €/: 0.87	£/\$: 1.30 €/: 0.89	£/\$: 1.28 €/: 0.90	£/\$: 1.23 €/: 0.94

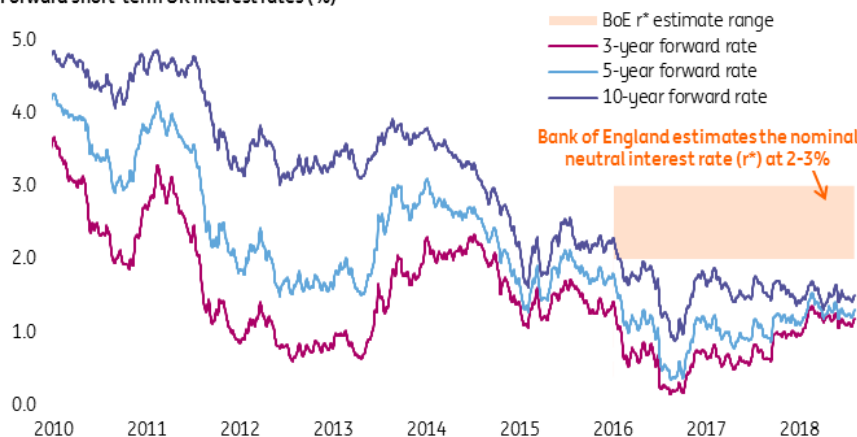
← Increasing 'No Deal' Brexit risks →

Our BoE-Brexit matrix shows an array of outcomes for GBP/USD and EUR/GBP under (1) varying no deal Brexit risks and (2) alternative BoE policy stances. Given that the two drivers are not mutually exclusive - and the degree to which the Bank of England can exert a credible hawkish stance depends on the Brexit political climate - we expect sterling to ultimately settle at one of the more extreme outcomes (ie, corner points).
With our house view that a no deal Brexit will ultimately be avoided, we continue to see upper quadrant as GBP's most likely settling point over the coming months.

Source: ING FX Strategy. Note: Current = Current GBP dynamics; ING = Medium-term GBP house view

Source: ING FX Strategy

Forward short-term UK interest rates (%)



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