GBP: Sucker punched but too early to throw in the bullish towel

The pound has been knocked by a couple of sucker punchers of late but it still feels too early to throw in the bullish towel

(P.S. Being a GBP analyst in a post-Brexit world these days can often feel like you've done 12 rounds in the ring. So please excuse us for our use of boxing analogies)

Source: iStock

Our latest thoughts on the pound after a dismal few weeks

- While sterling looked to be breezing its way through the early rounds of 2018, a couple of heavy sucker punches - landed by softer UK data and a more guarded Bank of England governor - have knocked the pound lower and left the currency on the ropes.
- **We still think it's too early to throw in the towel on our bullish GBP outlook.** There is a temptation to say that this is as good as it gets. But taking a step back – one set of data releases does not alter a medium-term outlook, while the forces that have underpinned a more buoyant GBP in 2018 – namely a slow repricing of a structural Brexit risk premium and lower economic uncertainty – still to some degree remain in place.
- **Bank of England policy is the channel through which the pound's positive repricing gets realised.** Markets have been way too flippant when it comes to pricing in BoE policy

tightening – taking an all or nothing view. In a sense, it's down to a misunderstanding over how Brexit interacts with the traditional policy reaction function.

- **We do think there is a middle ground – and expect tightening sentiment to come back online with a 2Q rebound in UK data. Risk-reward for us, therefore, favours GBP upside going into the May BoE meeting.**
    - GBP/USD's pullback to the 1.3750-1.3800 area is consistent with markets fully pricing out a May BoE rate hike. We don't think that this is completely dead and buried but we would need to see some bounce back in the April UK PMI readings this week to keep lingering hopes alive.
    - More broadly, we would expect renewed BoE tightening sentiment – in line with a 2Q rebound in UK data – to see a modest rebound in GBP/USD towards the low 1.40 area.
    - Only a scenario in which the Bank of England comes out and says it's not hiking again would cause further short-term pain for GBP. We don't see that happening and if we can hold 1.37 – risk-reward for us favours GBP upside going into the May BoE meeting.
- **UK political uncertainty not strong enough to make short GBP plays attractive. For GBP downside to gain traction, we would need to see a significant spike in political uncertainty - but right now the signals from UK politics and Brexit are ambiguous.**
    - Uncertainty remains GBP's kryptonite – and that might keep upside in check. But only an event that would raise the odds of the UK crashing out of the EU in April 2019 would really send GBP spiralling lower. Still, checks-and-balances in the UK parliament may be effectively taking this scenario off the table – especially after the latest Lords amendment to the Brexit Bill to allow the House of Commons to block any 'No Deal' scenario from transpiring (granted that the majority wish to do so). These political developments should effectively put a floor under GBP for the time being.
    - Local UK elections take place in the week ahead but unless we see material pressure on Prime Minister Theresa May to resign – and the odds increase of a general election before April 2019 – then it's hard to see the pound trading significantly lower on this story.

Bottom Line: GBP strength now more a story for 2H18

We still think it's too early to throw in the towel on our bullish GBP outlook – but acknowledge that an appreciation will be more modest than previously thought. GBP will continue to take its cue from economic data – rather than short-term political gyrations. But a postponed rebound in the UK economy means that GBP/USD clearing to fresh post-Brexit highs above 1.45 looks like a 3Q story while 1.50 isn't off the table if (a) we end the year with lower long-run Brexit risks and (b) the US dollar bear trend remains.

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