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Article

GBP: Brexit deal done but UK parliament approval now the key hurdle

Although the UK and the EU have reached a Brexit deal, it remains uncertain if it can pass in parliament, largely due to the position of the DUP. This, coupled with GBP already trading with a premium against EUR, suggests a limited upside to GBP from here. But we can conclude that the odds of a hard Brexit has decreased and so has the downside to GBP

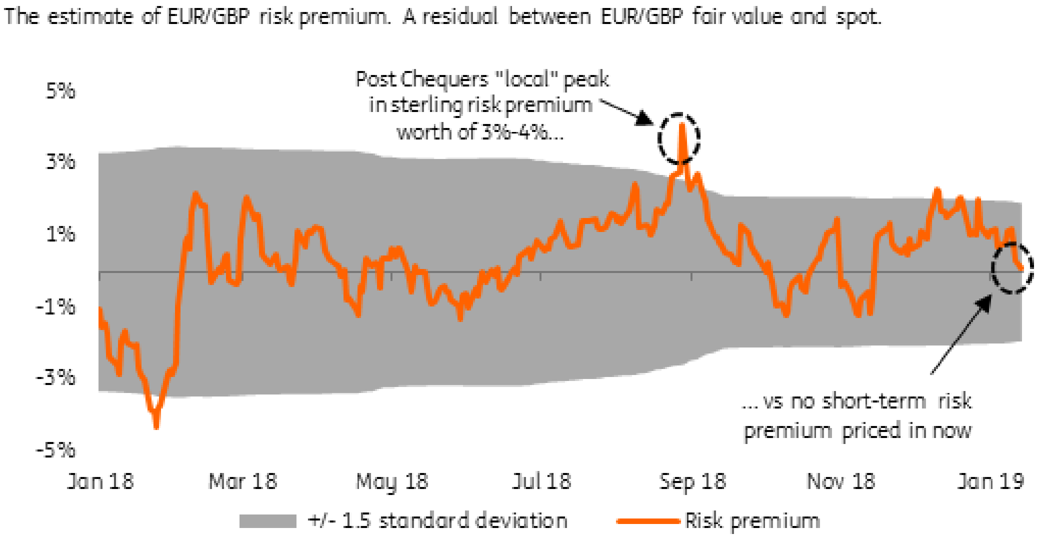
Content

The UK parliament approval the key hurdle for further GBP gains...

While the announcement of the EU-UK withdrawal agreement is good news for the pound, the key hurdle of the deal being approved in the UK parliament remains. With the Democratic Unionist Party announcing that its position towards the proposed deal remains unchanged (that is no support for the deal) there is a high risk that the government won't have the majority for the deal in the UK Parliament (as was the case for the previous government of PM May). With GBP already trading with a premium against EUR (around 2% expensive based on our short term financial fair value model as per Figure 1) and the large rally in sterling observed over the past few days, the uncertainty about the success of the UK parliament vote on the deal should limit GBP upside ahead of the vote this weekend.

Thereafter, should the UK parliament fail to ratify the deal, we would expect GBP to reverse some of its recent gains and to converge towards its short term fair value (which we currently estimate to be around 0.88). However, the degree of potential GBP downside reduced sharply, in our view, given the developments of the past weeks – see below.

Figure 1: GBP now trading modestly expensive vs EUR



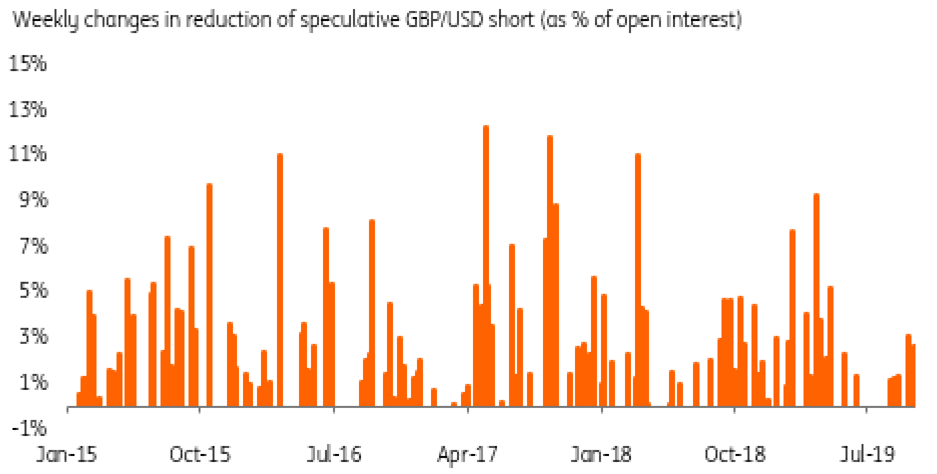
Source: ING

... but the GBP downside risk reduced sharply

While the prospects for the deal being voted through the UK parliament remain uncertain, one thing we can conclude is that the odds of a hard Brexit have decreased.

Before this week's events, with the Benn Act in place, the realistic worst case scenario for the pound was one where the Conservative Party won a majority in a late-2019 election, whereby the perceived risk of 'no deal' would rise. But following a notable change in the government's negotiating approach, markets will infer that the likelihood of 'no deal' after an election (with a Conservative majority) has fallen. This, in turn, suggests that even if there is not a deal agreed or ratified this month, the downside for GBP should be more limited. We now see EUR/GBP 0.90 as the possible peak for the pair (vs 0.95 previously) the case of the failure of parliament to ratify the deal and early elections.

Figure 2: multiple occasions of around 10% adjustment in the reduction of speculative shorts



Source: CFTC, ING

Lower probability of hard Brexit to prevent a material re-building of speculative shorts

The lower perceived probability of a hard Brexit should also prevent a material re-building of speculative shorts should parliament fail to ratify the deal. Although, the latest position data still doesn't account for the GBP rally of the past 5 days, we would not be surprised if the speculative positions were reduced by 10% or more (from 32% currently to 20% or less) given the scale of the move and past instances of the adjustments in positioning. As Figure 2 shows, we have seen multiple occasions of around 10% adjustment in the reduction of speculative shorts over the past four years (which in fact translated into a less abrupt move in GBP/USD higher than we observed over the past days).

The next move in GBP hinges on the UK parliament vote this weekend. But even in the case of the realistic worst case scenario outlined above, the build-up of shorts may not be particularly intense given the reduced odds of a hard Brexit.

We will update our GBP forecasts after the 'meaningful vote' in the UK parliament this weekend.

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