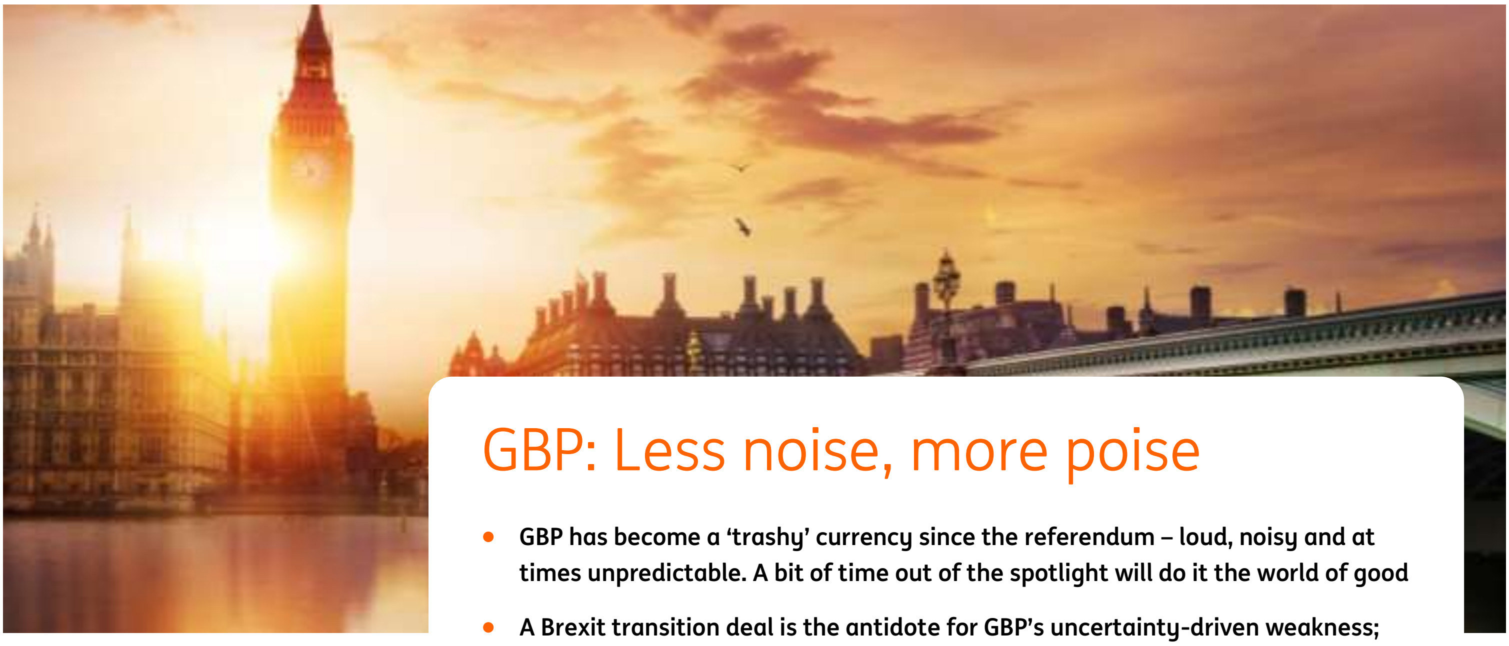

GBP: Less noise, more poise

- **GBP has become a 'trashy' currency since the referendum – loud, noisy and at times unpredictable. A bit of time out of the spotlight will do it the world of good**
- **A Brexit transition deal is the antidote for GBP's uncertainty-driven weakness; markets are underestimating the cyclical economic benefits this would bring**
- **With Brexit talks moving away from deadlock, we look for a positive re-pricing of GBP risks to come through by 1Q18 and target GBP/USD moving up to 1.40**

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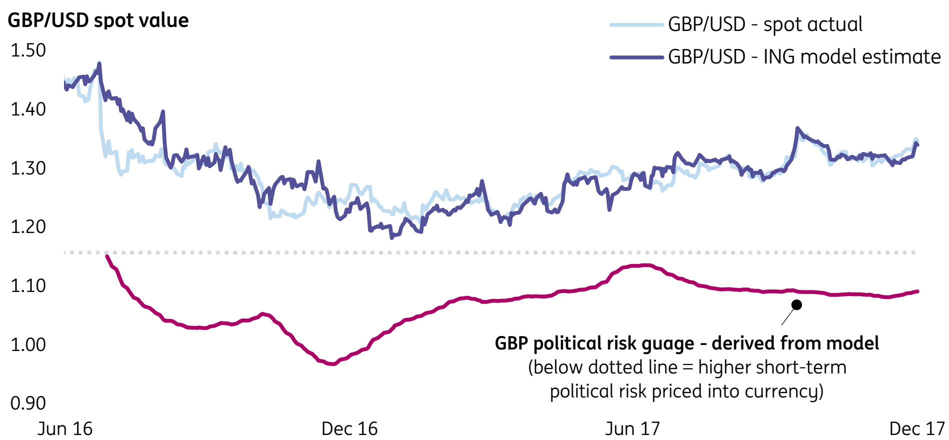
Trading under Knightian uncertainty

One things clear – Brexit won't be solved overnight. The complexities underpinning the negotiations, the ever-changing political incentives and the sheer enigma surrounding the end-state all suggests that trying to second-guess what Britain's future trading relationship with the EU will look like – and by extension the degree of UK economic openness that should be priced into GBP – is currently a mug's game.

But this doesn't make the pound an untradeable currency. Quite the opposite – GBP's 'trashy' nature, coupled with the Knightian uncertainty of Brexit, tends to see significant short-term mispricings. In fact, we sniff an opportunity right now for a positive GBP re-rating were we to see further Brexit progress. More generally, we note that a lot of bad news is already priced in and despite a tricky year of domestic politics, GBP's resilience – and discreetly rising bias – confirms to us that there is a high bar to sell the currency.

With a Brexit divorce deal agreed, the outlook for GBP now hinges on a transition deal. A last-minute deal between Theresa May and the DUP on the Irish Border has enabled initial Brexit divorce proceedings to be wrapped up; the EU's Jean-Claude Juncker has concluded that 'sufficient progress' has now been made, such that Brexit talks can move onto discussions over a future trade deal. But a formal agreement over a transition period is still crucial – especially given that the clock is ticking on the two-year Article 50 window. It appears as though this will be an early 2018 story for GBP markets.

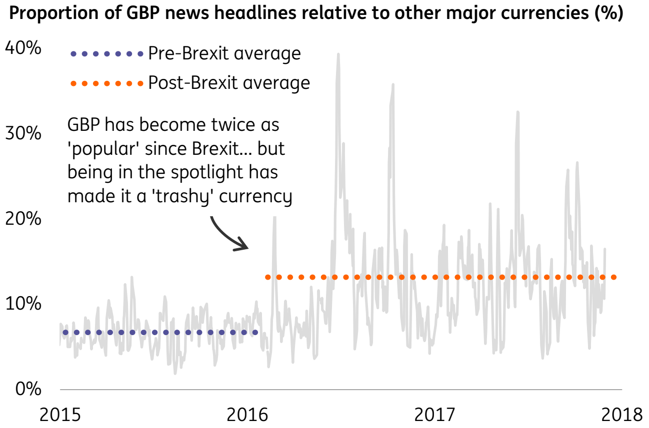
Fig 1 Still a degree of political risk priced in GBP despite having gently risen in 2017



Source: ING estimates, Bloomberg. *ING estimates based on our GBP/USD short-term financial fair value model

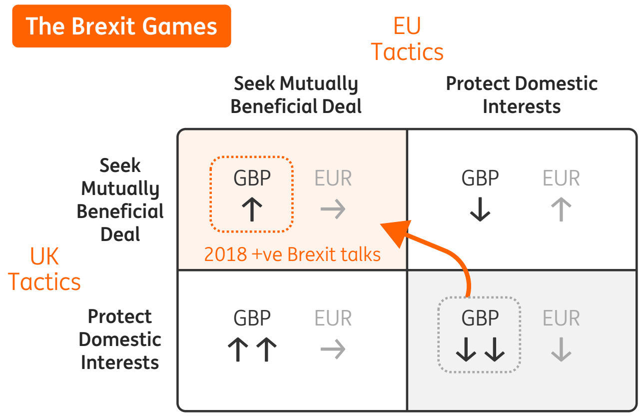
[1] Economist Frank Knight made the distinction between **risk** - a situation where we do not know the outcome, but can form a judgement on the likelihood of that outcome occurring and **uncertainty** - where we do not have enough information to derive the likelihood of an outcome occurring. Many wouldn't argue with us for placing Brexit into the latter category.

Fig 2 GBP has become a 'trashy' currency since Brexit



Source: ING, Bloomberg News data

Fig 3 Brexit talks moving away from Prisoner's Dilemma



Source: ING FX Strategy

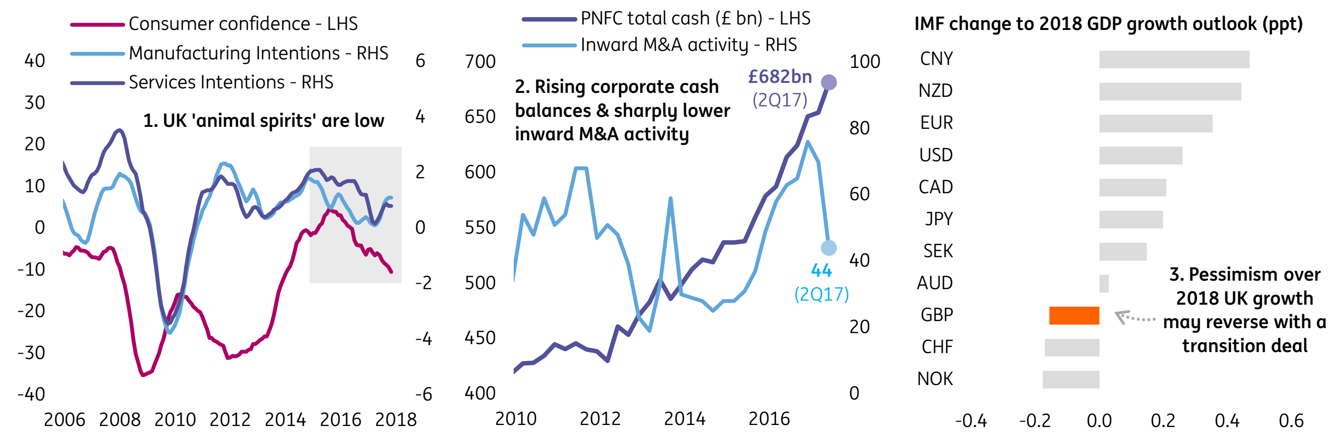
Brexit transition deal is a weak GBP's antidote

Our game theory application to Brexit negotiations is proving a handy framework for analysing the political risks to GBP. While much of 2017 has been marred by UK and EU politicians playing 'hardball' with one another, the resolution of a Brexit divorce deal suggests the tide may be turning in a constructive direction. Politicians moving away from seeking to protect their own domestic interest (the Prisoner's Dilemma scenario) – and slowly moving towards a mutual agreement – is unambiguously positive for GBP. For example, while agreeing a divorce deal has little economic significance for the price of GBP, the political significance of progress in Brexit talks is quite profound – not least as it reduces the tail risk of a 'No Deal' scenario and a complete breakdown in negotiations.

> *"Politicians moving away from the Prisoner's Dilemma scenario, and towards greater cooperation, is positive for GBP"*

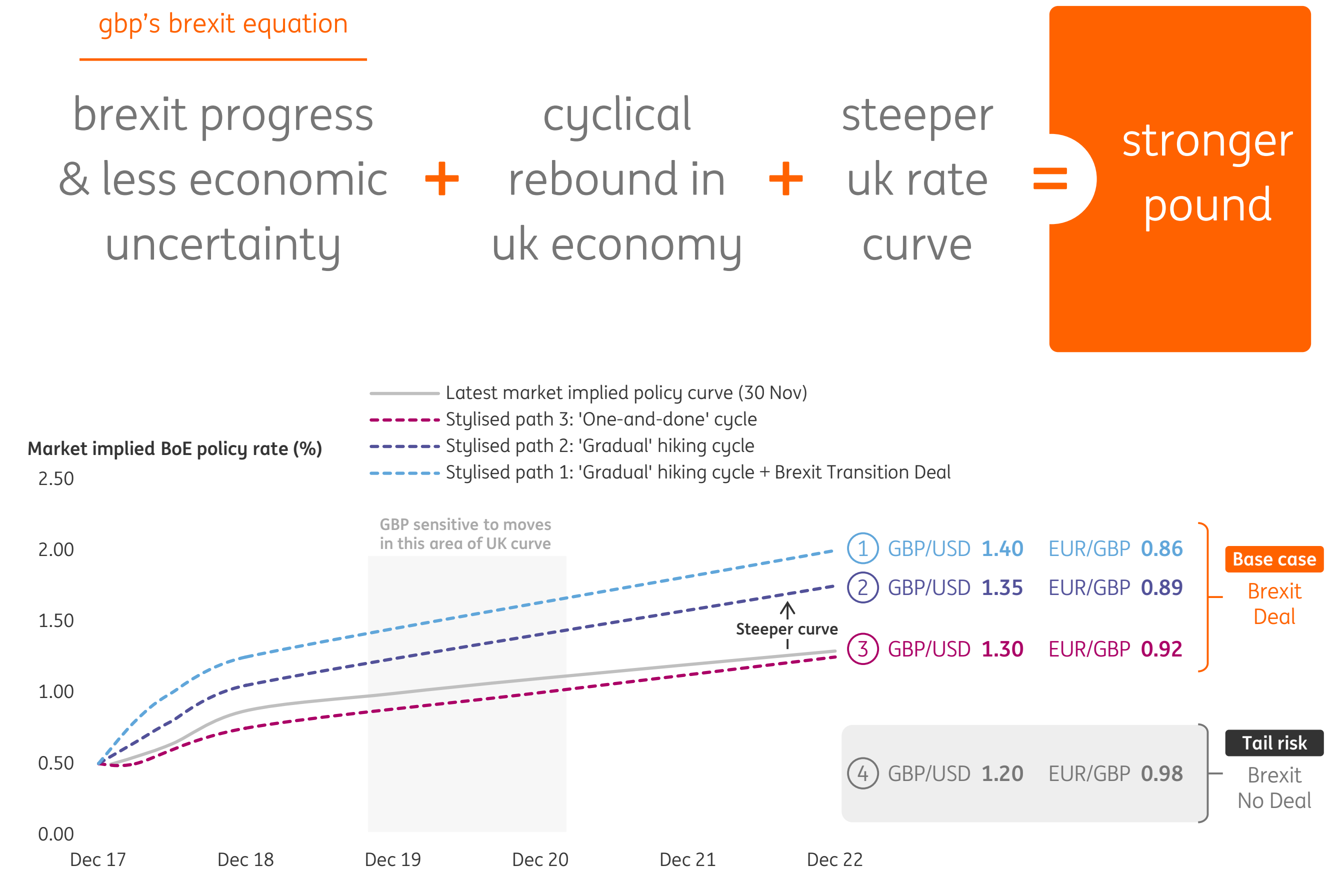
We believe that GBP markets are underestimating the cyclical economic benefits of a Brexit transition deal. Judging by GBP's rally in late November, a reassessment of the Brexit political games looks to already be underway. But we feel there is more upside to come – especially if a transition deal were to be signed, sealed and delivered in 1Q18. Our 'GBP Brexit Equation' (next page) demonstrates the chain of logic here. With a range of indicators suggesting that the UK economy is at a standstill, a reduction in medium-term uncertainty may rekindle some of the 'animal spirits' among consumers and firms – and see more cash put back to work over the coming year. At a time when the BoE are in tightening mode, positive revisions to the UK growth outlook – and a subsequently steeper rate curve – could be a powerful pick-me-up for a weak pound.

Fig 4 UK investment environment has reached a standstill... Brexit clarity (either way) will determine future direction



Source: ING, Bank of England, ONS, IMF, Bloomberg

Fig 5 GBP's Brexit Equation: Brexit progress + Greater 'animal spirits' + Steeper UK rate curve = Stronger pound



Source: ING FX Strategy, Bloomberg

1.40 With our house view for a Brexit transition deal to be agreed early next year, we look for any positive re-pricing of GBP risks to come through in 1Q18 and target GBP/USD moving up to 1.40. Equally, EUR/GBP would fall to 0.86 – with the looming spectre of the Italian elections keeping the single currency under wraps early next year.

Is that as good as it gets for GBP? For now, probably...

Beyond the 'Deal or No Deal' risks, the big picture focus for GBP remains on gauging the actual size of the post-Brexit supply shock and the evolution of productivity under a (potentially) less open UK economy. A year on from noting this in last year's Outlook, we are still none the wiser; 2018 'should' provide more clarity as Brexit talks progress onto a trade deal, but it's highly likely that we won't know *ex-ante* what the true long-run fallout for GBP will be. Hence, our GBP profile is under constant review over a very narrow rolling window – especially when taking stock of the fragile UK political environment.

- **We see EUR/GBP trading in the 0.85-0.90 range for most of 2018** as two cyclical forces - in the form of the UK and EZ economies - offset each other. Our bias, however, is for a move below 0.85 at some point next year.
- **A cyclically weakening US dollar means that GBP/USD could find itself pushing on beyond 1.40 - and up towards 1.50 by end-2018.** Given the number of hurdles to clear, this remains a low conviction call at this stage.

1 | The Carney Put

Brexit progress and solid macro data could bring into play a second BoE hike by May 2018

After raising rates by 25bp in November, it's understandable why the Bank of England have been keeping their policy cards close to their chest – amid what is set to be a pivotal few months of Brexit talks. But, on the basis that the Bank's 'smooth Brexit' assumption remains intact, we do think the UK curve is currently flatter than what a gradual hiking cycle dictates. Brexit progress and solid macro data could bring into play a second BoE rate hike by May-18.

Recall that the exchange rate must be taken in the context of achieving internal and external balance in an economy

Any view that suggests the BoE's latest policy move was a 'defensive rate hike' to offset GBP depreciation is misconstrued. The exchange rate must be taken in the context of achieving both internal and external balance in an economy. Under the unique case of Brexit, where the post-referendum price of GBP has adjusted to reflect the markets' best guess of *future* external imbalances – at the detriment of causing current internal imbalances – the Bank is faced with a trade-off. That trade-off is more supportive of tightening if one were to also see (a) lower supply potential in the economy and (b) more persistent pass-through effects of prior GBP depreciation – both of which adds to expected price shock stemming from Brexit.

Markets likely to price in gradual BoE tightening in 2018 should tail risk of a Brexit 'No Deal' fade

Be it directly or indirectly, a weak GBP is playing a more prominent role in the BoE's policy thinking. The Bank will likely continue with gradual tightening in 2018 should the tail risk of a Brexit 'No Deal' fade. **The judgement of lower supply potential means that any hiking cycle will be shallow – and any curve repricing may end up being one-off and limited.**

2 | A Minsky Moment for GBP?

If divorce negotiations slide down a path of an 'irretrievable breakdown' – then GBP may become the 'Big Short' of 2018

Make no mistake, the risks to GBP are binary over the coming months. Were our assumptions about Brexit progress prove to be wrong – and divorce negotiations slide down a path of an 'irretrievable breakdown' – then GBP could quickly find itself becoming the 'Big Short' of 2018.

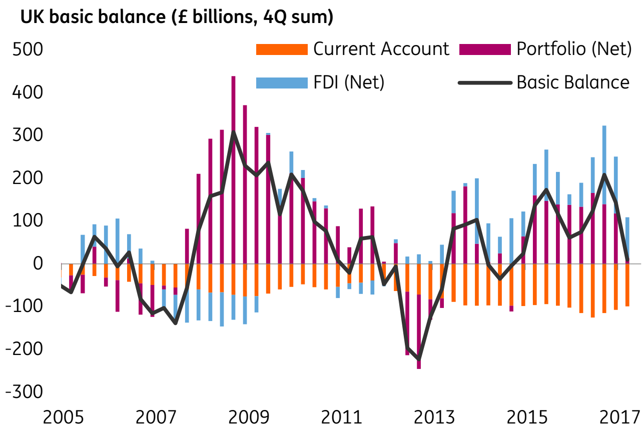
Anecdotal evidence suggests that firms need Brexit clarity by the end of March 2018 – one year before the UK leaves the EU; in November, a CBI survey noted that 60% of firms would trigger "worst-case" contingency plans if a transition deal wasn't in place by end-1Q18.

International investors – and probably en masse – may view the failure of Brexit progress by 1Q18 as a catalyst to offload their UK asset holdings

We suspect the global investment community may do the same; international investors – and probably en masse – may view the failure of Brexit progress by 1Q18 as a catalyst to offload their UK asset holdings. With the basic balance currently at a neutral point, the tailwind of capital outflows – on top of the chronic current account deficit – would inflict material downside pressure on the pound. Under this worst-case scenario, we see GBP/USD ultimately trading at 1.20 and EUR/GBP at 0.98 – though the adjustment may occur in stages.

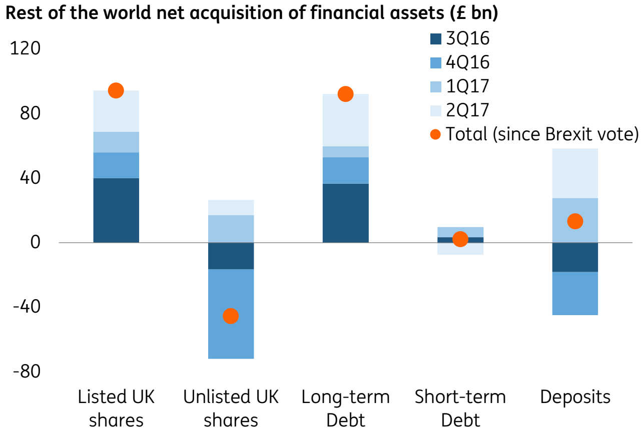
Signs of a 'sell UK assets' theme have been limited since the Brexit referendum – and in the absence of a material breakdown in Brexit talks, we expect this to remain the case. A Minsky Moment for UK assets in our view remains a tail risk for GBP markets at this stage.

Fig 6 UK's Basic Balance has fallen to an inflection point



Source: ING, Bloomberg News data

Fig 7 No evidence of a 'sell UK' theme since Brexit so far



Source: ING, ONS National Sector Accounts Data

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