FOREX FOCUS: GBP – NIGHTMARE ON DOWNING STREET

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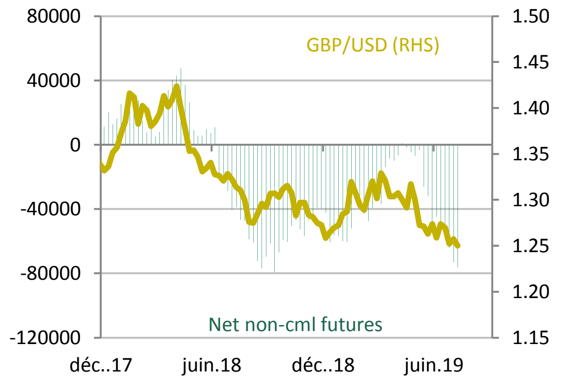
Boris Johnson is in the driving seat

As was widely expected, former UK Foreign Secretary Boris Johnson achieved a landslide victory in the Conservative Party leadership contest, beating current UK Foreign Secretary Jeremy Hunt by a 2-1 margin. During the campaign, Johnson promised that the UK would leave the EU with or without a deal by the 31st of October. It would be a mistake to dismiss his words as mere electioneering. However, there are reasons to believe Johnson will take a more constructive tone with the EU, but this is unlikely to lead to material changes to the withdrawal agreement. We consider a number of scenarios and the likely implications for sterling exchange rates.

Price action and positioning

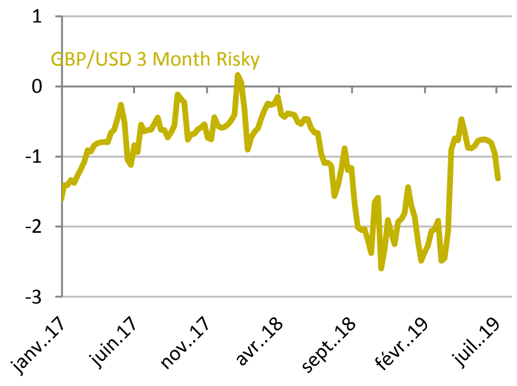
Since the beginning of May, GBP exchange rates have depreciated on a trade-weighted basis. GBP/USD moved to levels of around 1.24 and EUR/GBP moved to levels of around 0.90. These are some of the weakest levels for GBP exchange rates since the June 2016 Brexit referendum. Speculators have increased their short GBP positions. The latest IMM data indicate that investors now hold their largest short GBP position since mid-2018. The positioning data indicate investors anticipate further GBP weakness. The level of bearishness is not yet replicated in the options market. GBP/USD three-month risk reversals give a mild bid to GBP puts, which give the right but not the obligation to sell GBP. The level of the risk reversal does not indicate the options market holds a highly bearish view on GBP exchange rates. We note that GBP volatilities remain at subdued levels, considering heightened political risks.

Chart 1: **Speculators increased short GBP positions**
GBP/USD, IMM net non-commercial futures



Sources: UBP, Bloomberg Finance L.P., CFTC

Chart 2: **Risk reversals moving lower**
GBP/USD 25 Delta risk reversal, % vol.



Sources: UBP, Bloomberg Finance L.P.

When rhetoric meets reality – Johnson will have to compromise

The EU and UK will begin negotiations over the coming weeks. The EU, for its part, has said that it will not reopen the withdrawal agreement. However, some tweaking of the political declaration is entirely possible. Remember, the political declaration holds no legal standing; it is merely a statement of intent. During the leadership campaign, Johnson said the Irish border backstop would have to be removed in its entirety. This is where things will get tricky. The EU cannot be taken seriously if it removes the backstop at this point in the negotiations. Brexit is a problem for the EU but it will become an existential crisis for the EU if the UK is seen to do better after Brexit than when it was an EU member. On that basis, there is no way the EU could negotiate strongly with Italy, for example, if the Italians believed the EU would fold at the last minute. There is little incentive in EU capitals to remove the backstop and throw the interests of a remaining member (Ireland) under the bus to suit the interests of a departing member (UK). EU politicians and European Commission staff despise Johnson and they will not give him any meaningful compromises.

In effect this means that Johnson will have to compromise and try to sell a tweaked version of the withdrawal agreement to the UK Parliament. The UK's parliamentary calculus has not changed. There is still no majority for a no deal Brexit and there is still no majority for an agreed way forward. Johnson's government will have a wafer thin majority (a mere 2 members of parliament) meaning that whatever deal he comes back with will be difficult to get through the UK Parliament.

During the leadership campaign Johnson pledged that there would not be a border under any circumstances between Southern and Northern Ireland. He also said that there would be no border in the Irish sea. Both statements are mutually inconsistent. If there is no sea border, then a land border is inevitable in a no deal scenario. What this means is that Johnson will have to renege on one or more of the many promises he has made.

Facing the facts

When Johnson assumes office the first thing on his desk will be two assessments from the UK civil service. First, the civil service will state bluntly that the EU will not change or reopen the withdrawal agreement. Second, the civil service will state its strong opposition to a no deal Brexit. Johnson may be untrustworthy but he is not a fool and he will treat the situation with the seriousness it deserves. Consequently, we are left with one of two options. Either Johnson pulls back from his red lines on the backstop (this is by no means impossible given the way he has changed his mind before) or he prepares the UK electorate for a no deal scenario. Because of the difficulty with getting a no deal Brexit through Parliament, it means that Johnson may decide to put the question to the people via a general election (a second referendum would be fraught with difficulty and it would take at least six months to organise).

The Irish government is likely to be a kingmaker in this regard. If the Irish government allows the backstop to have a time limit, of say three years, this would enable Johnson to sell the deal to the electorate and return with a strong parliamentary majority. In this case GBP would rally significantly, but as stated below, much will depend on the circumstances surrounding any general election.

We outline some scenarios below and analyse the impact on GBP exchange rates.

Six scenarios

i) **No deal Brexit**: This would entail the UK leaving the EU without a transition period and without an EU-UK trade deal, meaning the UK would revert to World Trade Organisation (WTO) rules. UK GDP would decline by between 3% and 8% over a five year period, though the adjustment would be frontloaded, meaning a sharp recession following Brexit. The BoE would likely cut interest rates in this scenario and GBP would depreciate by between 5% and 10% on a trade-weighted basis. GBP/USD would decline to levels of around 1.18 and EUR/GBP would rise to levels of around 0.95.

ii) **Extend Article 50**: The EU and the UK may extend Article 50 one more time, giving the UK more time to figure out what it wants. This would be the least economically damaging option in the short-term. However, many European governments may be unwilling to 'extend and pretend' the entire process any further.

iii) **General election**: Johnson may decide to consult the electorate following talks with the EU. If Johnson goes to the electorate before Brexit there is a chance that the Conservative party would face large losses. Much will depend on the circumstances surrounding any election and how the Brexit issue is framed. However, the prospect of a Labour government is enough to petrify investors with the result that GBP would sell off before the election.

iv) **Second referendum**: We believe the chances of a second referendum are low. There seems to be very little appetite for a second referendum, despite Labour's changed stance. The mechanics of a referendum would be fraught with difficulty – from framing the questions to figuring out who would actually campaign for the Remain side (the government would not).A second referendum would lead to GBP/USD appreciation in the short term, probably to levels of around 1.30.

v) **Revoking Article 50**: The European Court of Justice (ECJ) decided that the UK could unilaterally revoke Article 50 and remain in the UK. However, there is little appetite for this option and it would sever any claim to democratic principles.

vi) **Passing the Withdrawal Agreement**: If the UK Parliament somehow manages to pass the withdrawal agreement, we believe GBP/USD would rally aggressively and move to levels of around 1.35.

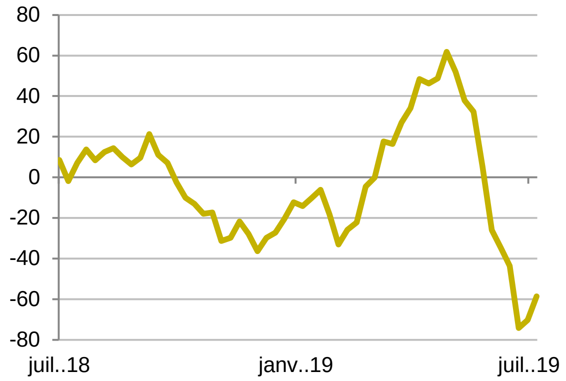
The UK economy is slowing

Recent economic data from the UK have been disappointing. The latest manufacturing PMI data for June printed at 48.0, showing a contraction of manufacturing activity. Investment and productivity have stagnated, meaning that underlying GDP growth has been driven by a surge in labour inputs. Because the unemployment rate is so low, that means this trend is probably near its limit. The implication is that the UK's 'new normal' GDP growth rate is somewhere between 1.0% - 1.5%.

Money markets are starting to price in the possibility of Bank of England (BoE) rate cuts. Overnight index swaps (OIS) give a 42% probability of a 25bp rate cut by December 2019. A rate cut is reasonable and reflects slowing economic activity and the decline in UK inflation. At the margin, lower BoE rates will weigh on GBP, mainly because they are not fully priced in (yet). The bottom line is that Johnson will inherit an economy with lower growth potential, even if it might see a small bounce in investment activity if the UK manages to avoid a no deal Brexit.

Chart 3: **UK data deteriorated**

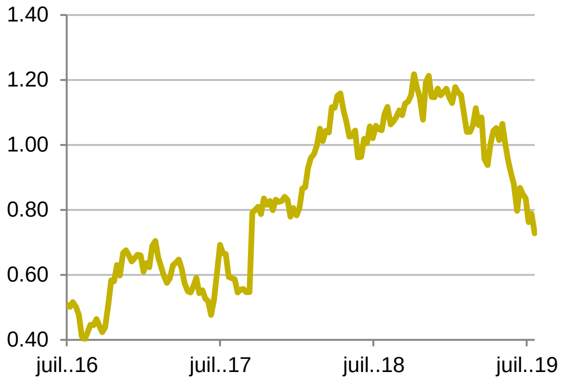
UK Economic Surprise Index



Sources: UBP, Bloomberg Finance L.P., Citi

Chart 4: **Interest rate swaps have fallen**

GBP 2 Yr. IRS, %



Sources: UBP, Bloomberg Finance L.P.

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