FOREX FOCUS: GBP – PLAYING CHICKEN

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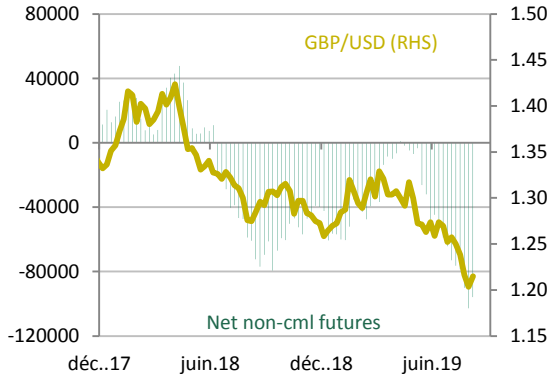
Prime Minister Johnson comes for tea

UK Prime Minister Boris Johnson will travel to Biarritz on 24 August for the G7 meeting. This will be the first time that Johnson will meet German Chancellor Angela Merkel and French President Emmanuel Macron in an official capacity. The UK media has reported that Johnson will demand that the EU removes the Irish border backstop. The EU has stated consistently that the withdrawal agreement, including the backstop, is not up for renegotiation.

It seems as though the EU and the UK government are playing a game of chicken. The problem is that neither side can afford to blink. The EU will not renege on its commitments to Ireland to suit the interests of a departing member (UK). Moreover, the EU does not want to reward the UK for perceived recalcitrant behaviour. Johnson has staked his premiership on taking the UK out of the EU by 31 October with or without a withdrawal deal. Timing is also an issue. There is simply not enough time for the UK and the EU to renegotiate an agreement. As a result of this, our base case scenario is for the UK to leave the EU on 31st October without a transition agreement / trade deal.

Chart 1: **The market is very short GBP**

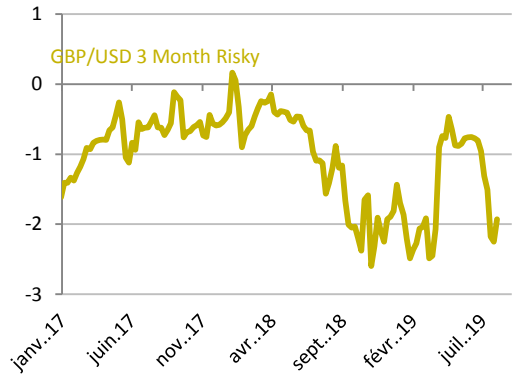
GBP/USD spot, IMM net non-commercial futures



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

Chart 2: **Options market bearish on GBP**

GBP/USD 25 Delta 3 month risk reversal, %



Sources: UBP, Bloomberg Finance L.P.

What is priced in?

Nine months ago, the consensus estimate was that GBP/USD would trade at levels of around 1.20 in the event of a no deal Brexit. GBP/USD traded to lows of around 1.2014 in recent weeks. It is fair to say that markets have broadly priced in a no deal Brexit. GBP/USD risk reversals trade at levels of around -2%, meaning that options to sell GBP are significantly more expensive than options to buy GBP. Market positioning also reflects expectations of a no deal Brexit. According to the latest IMM data, investors and speculators hold a large short GBP position (chart 1). Consequently, we believe that markets conclude a no deal Brexit is the most likely outcome over the coming months. Overnight index swaps (OIS) show that markets expect the Bank of England (BoE) to cut rates by 25bps over the coming months. We think this is a possibility, but much will depend on the evolution of GBP exchange rates and subsequent pass through inflation.

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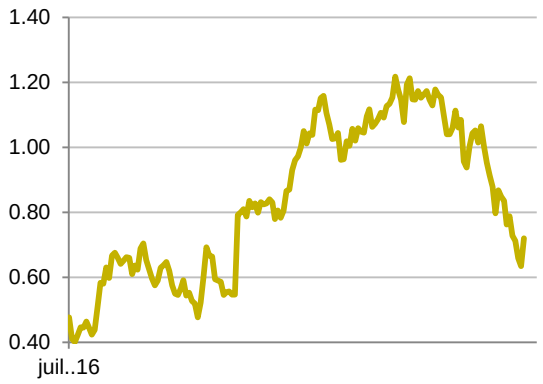
What about UK domestic politics?

The UK Parliament will reconvene in early September. The opposition Labour Party has said that it will table a motion of no confidence in Johnson's government, probably by the 4th or 5th of September. Johnson's government has only a single seat majority. Around 20 Conservative MPs are said to be willing to vote against the government. However, the opposition parties remain divided. UK Labour Party leader Jeremy Corbyn has suggested forming a government of national unity which will seek to extend the UK's departure from the EU until after a UK general election is held. Corbyn will campaign on giving the electorate another Brexit vote / referendum.

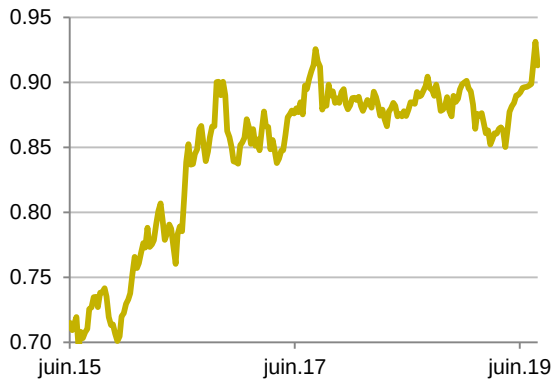
If the government loses the confidence vote, Parliament has 14 days to try and form a new government. If Parliament is unable to form a new government, a general election must be held within seven weeks. Johnson's calculus is that the UK will have left the EU by that time. He will then seek to run an election campaign where he takes votes from the Brexit Party. Many analysts believe that Parliament will prevent a no deal Brexit from happening, but we are not so sure. Parliament has so far proven itself to be quite incapable of changing the government's Brexit strategy. Johnson has simply to run down the clock and he will 'deliver' Brexit. The optics surrounding Brexit will be awful in this scenario. We anticipate in the initial phase the media will seize upon any Brexit related delays at borders or airports and this may lead to modest GBP declines.

Chart 3: **Markets pricing in BoE rate cuts**
2 Yr. GBP IRS, %



Sources: UBP, Bloomberg Finance L.P.

Chart 4: **EUR/GBP at multi-year highs**
EUR/GBP spot



Sources: UBP, Bloomberg Finance L.P.

Is there a silver lining?

If Johnson manages to secure a majority in a general election, we anticipate he will change his stance regarding dealing with the EU. In this situation, Johnson would no longer have to rely on the support of the Democratic Unionist Party (DUP) and he could agree that the backstop only applies to Northern Ireland. The EU will surely agree to this proposal (so would the Irish government) and then the UK and the EU could proceed to full blown trade talks. The UK side would do so from the position of a so called third country, which is an inferior starting point from the UK's perspective, but it would be a benign development for GBP. GBP/USD could easily rise to levels of around 1.30 in this situation.

What do the polls say?

The latest polls indicate the UK's political parties will receive the following vote share:

i) Conservatives 30%

ii) Labour 25%

iii) Liberal Democrats 19%

iv) Scottish National Party 3%

v) Brexit Party 15%

vi) Greens 4%

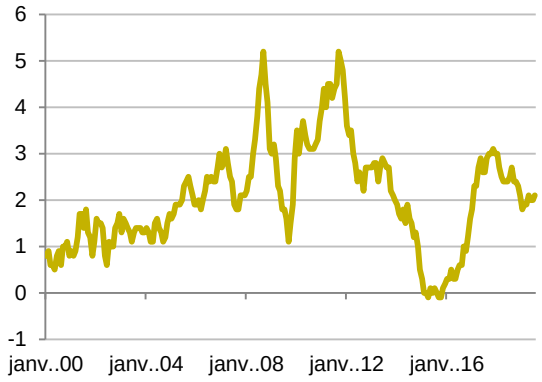
If the general election takes place after Brexit and the Brexit Party's voters switch their support to the governing Conservative Party, this will give the Conservatives a significant majority in the next Parliament. There is one caveat. At the last election, the polls underestimated the Labour Party's share of the eventual vote. If this were to happen again, it could result in another hung parliament. This would be a malign outcome for GBP and lead to modest losses. If the Labour Party, under Corbyn, somehow manages to achieve a majority this would lead to severe GBP losses.

What about the Bank of England?

At its August Inflation Report press conference, the BoE said that rates could go up or down depending on how Brexit plays out. According to overnight index swaps (OIS) markets believe that the BoE would cut rates. OIS have priced in a November 25bp rate cut with a 48% probability. A rate cut is a reasonable assumption to make, given the potential shock to activity and employment levels. However, we think the BoE would wait until it sees evidence of an actual slowdown rather than act immediately.

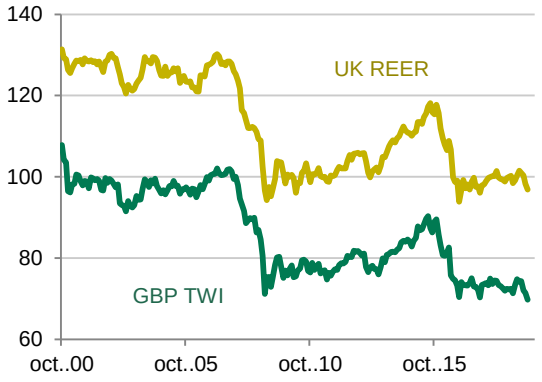
BoE Chief Economist Andy Haldane recently noted that rate cuts are not a given because the UK's unemployment rate is so low and that Brexit is a supply side shock and not a demand side shock. Haldane also observed that UK consumption was robust and that inflation is on target while inflation expectations remain elevated. This stands in stark contrast to the rest of the eurozone. Haldane's comments make sense from the BoE's perspective, but historically the BoE has always preferred to sustain demand rather than contain inflation pressures. Nonetheless, it is too easy to expect BoE rate cuts – much will depend on the evolution of GBP exchange rates and consequent pass through inflation.

Chart 5: **UK CPI is at target**
UK headline CPI, %, y/y



Sources: UBP, Bloomberg Finance L.P.

Chart 6: **GBP is incredibly cheap**
UK REER, GBP TWI



Sources: UBP, Bloomberg Finance L.P. BIS

GBP is exceptionally cheap

Our models indicate that GBP/USD fair value is at levels of around 1.40 / 1.45 and EUR/GBP fair value is at levels of around 0.82. GBP is clearly cheap according to most standard valuation measures; it trades at crisis like levels in TWI and REER terms. This does not mean that GBP is about to rally aggressively. For GBP to rally it requires a positive catalyst in the form described above. At a minimum, however, it does make sense for external investors with a long-term investment horizon to consider buying GBP. To give an example, central London property is now around 40% cheaper in USD terms than during the peak of the London property market in 2014.

In summary, our base case is for the UK to leave the EU without a withdrawal agreement / transition agreement. We believe much will depend on the subsequent general election and how the governing Conservative Party performs. As discussed above, there is a positive scenario in which Johnson secures a majority and applies the backstop to Northern Ireland alone; GBP/USD could rally aggressively to levels of at least 1.30 in this case. Absent this development, the outlook for GBP exchange rates remains poor in the short term.

	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
GBP/USD	1.20	1.20	1.20	1.24	1.24	1.24

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