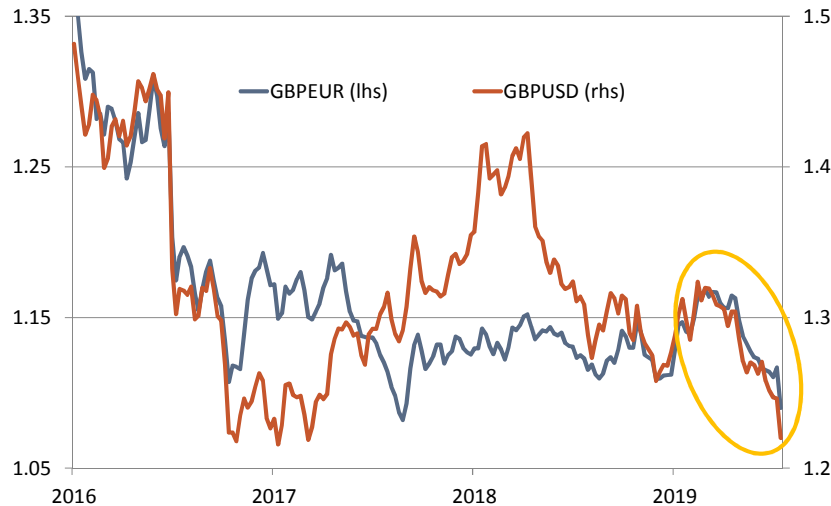


31 July 2019

Sterling tumble highlights the risks of Boris's Brexit plan

Sterling is back to post-Brexit vote lows as markets worry about hard Brexit risk



Weekly data. Source: Financial Time. Latest data point based on 30 July 2019 values

- Polls bounce, markets sag:** Since Boris Johnson became UK prime minister (PM) on 23 July, support for the Conservative Party has risen from c25% to around 30% while support for The Brexit Party has dropped from 19% to around 14%. However, while Johnson's upping of the Brexit ante may be winning him support at home, he is not inspiring confidence in the financial markets. The 1.9% depreciation of sterling versus the euro, and 2.4% drop versus the US dollar, since 22 July – the day before Johnson became PM – reflects the markets' increased worries about a hard Brexit on 31 October. The drop partly reflects the market's belief that a hard Brexit would be an act of economic vandalism that could tip the UK into a recession and lower the UK's long-run growth potential.
- Additional risks:** The increased concern about a hard Brexit – [we continue to put that risk at 40%](#) – is probably not enough on its own to explain the pound's latest slide. Johnson has just a two-seat working majority in parliament. That a handful of moderate Conservatives threaten to bring down the government if he genuinely tries for a hard Brexit partly contains the risk. The recent selling of sterling probably also reflects genuine uncertainty about how Brexit will be resolved and captures other possible downside risks – including the prospect of a snap election that ends with a Conservative-Brexit Party coalition or a Labour-led coalition with far-left Jeremy Corbyn as PM.
- Noisy summer ahead:** Boris Johnson seems to be picking fights on two fronts – with the EU and with moderate Conservatives. We are probably heading for a noisy, but fruitless, summer of UK-EU talks followed by an almighty clash between Johnson, who may try his luck with a hard Brexit, and a majority-moderate parliament that will try to stop him. This sets the stage for an autumn of action when the pieces of the Brexit puzzle begin to shift again.
- Further near-term pressure on sterling:** Three factors could push sterling lower still in the near term: 1) market worries about a hard Brexit continue to rise because the UK and EU remain at odds over the terms of the Withdrawal Agreement; 2) UK economic data continue to surprise to the downside; and 3) in response to the increased threat of a no-deal Brexit, the Bank of England (BoE) takes a dovish tilt to reassure markets that it would support the economy in such a scenario. [This could happen this Thursday already.](#)
- Weak currencies do not build strong economies:** Some proponents of Brexit claim that the UK benefits from a weaker sterling via more competitive exports. The evidence since the Brexit vote suggests this is not the case. Average annual export growth has fallen from 3.5% in the two years to the Brexit vote to 2.6% since, despite a more than c15% depreciation of trade-weighted sterling. A further drop would only make the UK poorer.
- Is sterling undervalued?** Probably yes. [We put the UK's chances of avoiding a hard Brexit at 60%](#). In an orderly Brexit, the UK would be set to enjoy a medium-term economic relief rally on the back of lower uncertainty and rising confidence. [The prospect of a modest fiscal stimulus would further boost medium-term demand growth.](#) Chances are that the BoE would hike rates in the event of an orderly Brexit. In this scenario, risks to sterling would be tilted to the upside. By the end of 2020, we would see GBP:USD at 1.40 and GBP:EUR at 1.16.

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