Economics

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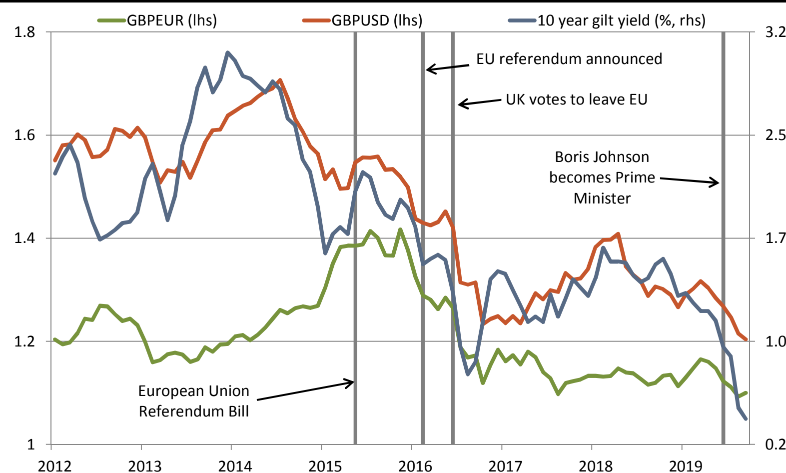
Not over yet: hard Brexit impact on sterling and gilts

Sterling and gilt yields have declined as the Brexit risks have increased



Monthly data. September data taken on 03/09/2019. Source: Bank of England, Bloomberg

- **The rebels strike back:** With a 27-vote margin, rebel MPs out to stop a hard Brexit backed a move yesterday to take control of the UK parliamentary agenda. This was first step towards a further Brexit delay. Reacting to the loss, UK Prime Minister Boris Johnson in effect cast 21 of his MPs out of government. He is now 43 seats short of a working majority in the House of Commons. Johnson said he wants an election on 15 October. While the initial market reaction is positive –sterling up c1.6% versus the dollar (at 9:00 today) and c1.2% versus the euro compared with yesterday's open – the outlook remains uncertain. As our chart shows, sterling and gilt yields have slid in recent weeks as UK political risks have increased. Depending on forthcoming political developments, we may see further drops yet.
- **No hiding from markets:** Since the UK's European Union Referendum Bill was unveiled in the queen's speech in May 2015, sterling has fallen by c26% against the euro and c29% against the dollar. By comparison, trade-weighted sterling dropped by c27% peak-to-trough during the financial crisis of 2007-09.
- **The economics of a hard Brexit:** In the short run, severe border disruption, a major drop in confidence from high uncertainty, and a rise in inflation due to a weaker sterling could tip the UK into recession. In the long run, switching to bare-bones WTO trade rules for UK-EU trade could depress UK potential growth from c2.1% – inside the EU – to as low as c1.5%. Reduced inflows of migrants to the UK would weaken employment gains. Lower growth in trade and investment between the UK and the EU could reduce long-run productivity growth.
- **How much hard-Brexit risk is priced into the pound?** In our view, fair value for sterling versus the euro in an orderly Brexit is 1.20. In the event of a hard Brexit, sterling could fall to parity against the euro in the short run. Many factors determine exchange rates. Based on the current sterling-euro rate of c1.10, we calculate that the market sees a roughly 50% probability of a hard Brexit. We put the risk of a hard Brexit at 40%. Recent developments and the outlook for UK politics tilt the risk to our call to the upside.
- **Record low gilt yields:** The US-China trade war and the resulting global industrial recession have hit the UK hard. This adds to the Brexit risks. 10-year gilt yields hit a record low of 0.34% in intraday trading yesterday, down from a recent peak of 1.7% in May 2018. The fall reflects the weaker growth outlook and a market bet that the BoE would ease policy in response to a hard Brexit. We share this view. In case of a hard Brexit, we would expect the BoE to cut rates – by up to 50bp – and buy more government and corporate bonds via its quantitative easing programme.
- **Consequences of the weaker sterling:** On its own, the latest drop in the pound may add a few tenths of a percent to the headline inflation rate in the near term. This direct impact will be modest unless sterling drops much further. The bigger impact could be on inflation expectations, which have risen materially since the Brexit vote. After Boris Johnson became prime minister on 24 June, the UK's five-year breakeven rate increased by c10bp to c3.3% – well above the BoE's 2% inflation target. By comparison, the US five-year breakeven is currently c1.3%, down from c1.6% since 24 June. The lesson from Brexit so far is clear – bad economic policies cause inflation.

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