Economics
Chart of the week

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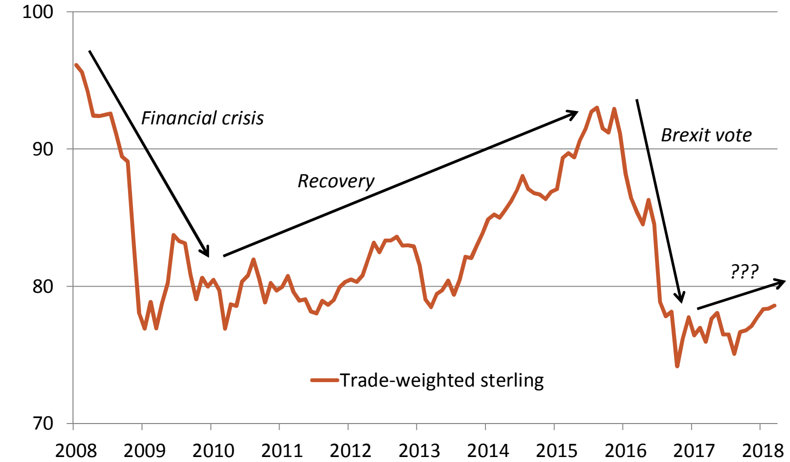
6 April 2018

Weak sterling shows markets still fear a hard Brexit

Resilient growth and progress on Brexit have not boosted sterling by much yet



Monthly data. Data shows sterling on trade-weighted basis. (2005=100). Source: Bank of England

- **Brexit has pounded sterling:** By and large, exchange rates reflect the relative health of economies. Sterling dropped sharply in 2008 when the UK was hit especially hard by the financial crisis. During the post-Lehman recovery, sterling appreciated strongly as the UK enjoyed a relatively robust upswing compared to other advanced economies. The pound peaked in late 2015 before falling sharply thereafter as Brexit opinion polls narrowed ahead of the June 2016 EU referendum. When the UK voted to leave the EU, sterling dropped to a post-Lehman low as markets slashed their expectations for long-term UK growth. On a trade-weighted basis sterling fell by about 20% peak-to-trough.
- **When resilient growth is not enough:** Because of Brexit, the UK is currently missing out on the ongoing global upswing. Nevertheless, the UK is still doing much better than the market had initially anticipated after the Brexit vote. UK real GDP expanded at a rate of 1.8% in 2017, only a bit slower than the post-Lehman average. We expect a similar growth rate in 2018 (1.7%) and 2019 (1.8%). Meanwhile, the Bank of England has started a gradual tightening cycle. After hiking by 25bp in November 2017 we expect two such hikes in both 2018 and 2019. Together, the better-than-expected growth and tighter monetary policy would normally push the exchange rate higher. As our chart shows, this effect has only been modest, in part due to the strong growth in the UK's major trading partners. Trade-weighted sterling is currently only about 2% above its post-Brexit vote average.
- **The hard-Brexit risk is weighing on sterling:** Currently, sterling embodies a range of potential outcomes for Brexit. That includes the risk of a no-deal hard Brexit, which we predict could reduce UK trend growth to below 1.5% from its pre-Brexit vote rate of more than 2.0%. As long as there is a notable hard Brexit risk – we see a 25% chance – markets will remain reluctant to price in the resilient short-run economic data and monetary tightening. After all, no one knows for sure what the economy could look like in a year's time if the UK crashes out of the EU without a trade deal.
- **Not out of the woods yet:** Having agreed the divorce and transitional terms, UK and EU negotiators will spend the rest of the summer detailing the broad aims for a future trading relationship. This includes the tricky issues relating to the Irish border and the EU Customs Union (see Brexit tail risks loom larger than before). None of what has been so far agreed, however, has any legal basis unless the EU27 and the UK pass it through their respective parliaments at the end of the negotiations. The hard Brexit risk thus cannot be discounted yet. Chief EU negotiator Michel Barnier has said the EU will need six months to ratify the final deal before Brexit happens in March 2019. We should therefore know with some confidence by October 2018 what the future terms of UK-EU trade will be.
- **Outlook for sterling**: If the UK avoids a hard Brexit, we expect sterling to gradually track upwards to a level that is in tune with the long-run economic outlook – below the pre-Brexit vote level but still above the European average. By the end of 2019 we expect GBPUSD to rise to 1.49 and GBPEUR to rise to 1.18. In the long run, with potential annual growth of 1.5-1.7% (our Brexit base case) sterling is probably undervalued on a trade-weighted basis by between 5% and 10%.

Holger Schmieding
Chief Economist
+44 20 3207 7889
holger.schmieding@berenberg.com

Kallum Pickering
Senior UK Economist
+44 20 3465 2672
kallum.pickering@berenberg.com

Florian Hense
European Economist
+4420 3207 7859
florian.hense@berenberg.com

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Contacts

BERENBERG
PARTNERSHIP SINCE 1590

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com

E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE
Ryan Booker +44 20 3753 3074
Andrew Gollan +44 20 3207 7891
Ross Law +44 20 3465 2692

AUTOMOTIVES
Cristian Dirpes +44 20 3465 2721
Alexander Haissl +44 20 3465 2749
Fei Teng +44 20 3753 3049

BANKS
Adam Barrass +44 20 3207 7923
Stephanie Carter +44 20 3207 3106
Michael Christodoulou +44 20 3207 7920
Andrew Lowe +44 20 3465 2743
Andreas Markou +44 20 3753 3022
Alex Medhurst +44 20 3753 3047
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681

BEVERAGES
Javier Gonzalez Lastra +44 20 3465 2719
Matt Reid +44 20 3753 3075

BUSINESS SERVICES, LEISURE & TRANSPORT
Roberta Ciaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
William Fitzalan Howard +44 20 3465 2640
Stuart Gordon +44 20 3207 7858
Annabel Hay-Jahans +44 20 3465 2720
Josh Puddle +44 20 3207 7881
Kate Somerville +44 20 3753 3081
Joel Spungin +44 20 3207 7867

CAPITAL GOODS
Nicholas Housden +44 20 3753 3050
Julia Kochendörfer +44 20 3753 3052
Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Jaroslaw Pominkiewicz +44 20 3753 3035
Simon Toennessen +44 20 3207 7819
Ethan Zhang +44 20 3465 2634

CHEMICALS
Anders Björkstahl +44 20 3207 7871
Sebastian Bray +44 20 3753 3011
Anthony Manning +44 20 3753 3092
Rikin Patel +44 20 3753 3080

CONSTRUCTION
Zaim Beekawa +44 20 3207 7855

DIVERSIFIED FINANCIALS
Charles Bendit +44 20 3465 2729
Chris Turner +44 20 3753 3019

FOOD MANUFACTURING AND H&PC
Rosie Edwards +44 20 3207 7880
Philip Patricha +44 20 3753 3039
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL
Dusan Milosavljevic +44 20 3753 3123

GENERAL MID CAP - DACH
Saravana Bala +44 20 3753 3043
Martin Comtesse +44 20 3207 7878
Charlotte Friedrichs +44 20 3753 3077
Gustav Fröberg +44 20 3465 2655
Alexander O'Donoghue +44 20 3207 7804
Gerhard Orgonas +44 20 3465 2635
Henrik Paganetty +44 20 3453 3140
Benjamin Pfannes-Varrow +44 20 3465 2620

GENERAL MID CAP - EU core
Beatrice Allen +44 20 3465 2662
Christoph Greulich +44 20 3753 3119
Anna Patrice +44 20 3207 7863
Trion Reid +44 20 3753 3113

GENERAL MID CAP - UK
Joseph Barron +44 20 3207 7828
Calum Battersby +44 20 3753 3118
Robert Chantry +44 20 3207 7861
Ned Hammond +44 20 3753 3017
Omar Ismail +44 20 3753 3102

GENERAL MID CAP - UK (cont'd)
Anthony Plom +44 20 3207 7908
Edward James +44 20 3207 7811
Lush Mahendrarajah +44 20 3207 7896
Benjamin May +44 20 3465 2667
Owen Shirley +44 20 3465 2731
Donald Tait +44 20 3753 3031
Sean Thapar +44 20 3465 2657

GENERAL RETAIL
Thomas Davies +44 20 3753 3104
Michelle Wilson +44 20 3465 2663

HEALTHCARE
Scott Bardo +44 20 3207 7869
Alistair Campbell +44 20 3207 7876
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Samantha Osborne +44 20 3207 7882
Michael Ruzic-Gauthier +44 20 3753 3128
Laura Sutcliffe +44 20 3465 2669
Charles Weston +44 20 3465 2746

INSURANCE
Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Philip Ross +44 20 3465 2726

LUXURY GOODS
Mariana Horn +44 20 3753 3044
Lauren Molyneux +44 20 3207 7892
Zuzanna Pusz +44 20 3207 7812

MEDIA
Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

REAL ESTATE
Kai Klose +44 20 3207 7888

METALS & MINING
Charlie Clark +44 20 3207 3133
Fawzi Hanano +44 20 3207 7910
Laurent Kimman +44 20 3465 2675
Michael Stoner +44 20 3465 2643

TECHNOLOGY
Josep Bori +44 20 3753 3058
Georgios Kertsos +44 20 3465 2715
Tej Sthankiya +44 20 3753 3099
Gordon Tveito-Duncan +44 20 3753 3100
Tammy Qiu +44 20 3465 2673

TELECOMMUNICATIONS
David Burns +44 20 3753 3059
Nicolas Didio +44 20 3753 3091
Usman Ghazi +44 20 3207 7824
Laura Janssens +44 20 3465 2639
Carl Murdock-Smith +44 20 3207 7918

THEMATIC RESEARCH
Nick Anderson +44 20 3207 7838
Oyvind Bjerke +44 20 3753 3082
Steven Bowen +44 20 3753 3057
Asad Farid +44 20 3207 7932
Robert Lamb +44 20 3465 2623
Paul Marsch +44 20 3207 7857
Saliha Shariff +44 20 3753 3097

TOBACCO
Jonathan Leinster +44 20 3465 2645

UTILITIES
Oliver Brown +44 20 3207 7922
Andrew Fisher +44 20 3207 7937
Neha Saxena +44 20 3753 3048
Lawson Steele +44 20 3207 7887

ECONOMICS
Florian Hense +44 20 3207 7859
Carsten Hesse +44 20 3753 3001
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

EQUITY SALES

SPECIALIST SALES

AEROSPACE & CAPITAL GOODS
Cara Luciano +44 20 3753 3146

AUTOS & TECHNOLOGY
Edward Wales +44 20 3207 7815

BANKS, DIVERSIFIED FINANCIALS & INSURANCE
Iro Papadopoulou +44 20 3207 7924
Calum Marris +44 20 3753 3040

BUSINESS SERVICES, LEISURE & TRANSPORT
Rebecca Langley +44 20 3207 7930

CONSTRUCTION,CHEMICALS, METALS & MINING
James Williamson +44 20 3207 7842

CONSUMER DISCRETIONARY
Victoria Maigrot +44 20 3753 3010
Emma Buchy-Dury +44 20 3207 7816

CONSUMER STAPLES
Molly Wylenzek +44 20 3753 3064

HEALTHCARE
David Hogg +44 20 3465 2628

MEDIA & TELECOMMUNICATIONS
Julia Thannheiser +44 20 3465 2676

THEMATICS
Chris Armstrong +44 20 3207 7809

SALES

BENELUX
Miel Bakker +44 20 3207 7808
Bram van Hijfte +44 20 3753 3000

FRANCE
Alexandre Chevassus +33 1 5844 9512
Dalila Farigoule +33 1 5844 9510

SCANDINAVIA
Mikko Vanhala +44 20 3207 7818
Marco Weiss +49 40 350 60 719

UK
James Burt +44 20 3207 7807
Fabian De Smet +44 20 3207 7810
Marta De-Sousa Fialho +44 20 3753 3098
Jules Emmet +44 20 3753 3260
Robert Floyd +44 20 3753 3018
David Franklin +44 20 3465 2747
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
Stuart Holt +44 20 3465 2646
James Hunt +44 20 3753 3007
Gursumeet Jhaj +44 20 3753 3041
James McRae +44 20 3753 3036
David Mortlock +44 20 3207 7850

UK (cntd)
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Kushal Patel +44 20 3753 3038
Richard Payman +44 20 3207 7825
Christopher Pyle +44 20 3753 3076
Adam Robertson +44 20 3753 3095
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smibert +44 20 3207 7911
Alexander Wace +44 20 3465 2670
Paul Walker +44 20 3465 2632

GERMANY
Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734
Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

SWITZERLAND, AUSTRIA & ITALY
Duncan Downes +41 22 317 1062
Andrea Ferrari +41 44 283 2020
Gianni Lavigna +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Yeannie Rath +41 44 283 2029

CRM
Laura Cooper +44 20 3753 3065
Jessica Jarmyn +44 20 3465 2696
Madeleine Lockwood +44 20 3753 3110
Vikram Nayar +44 20 3465 2737
Rita Pilar +44 20 3753 3066

COO Office
Greg Swallow +44 20 3207 7833
Fenella Neill +44 20 3207 7868

CORPORATE ACCESS
Lindsay Arnold +44 20 3207 7821
Robyn Gowers +44 20 3753 3109
Jennie Jiricny +44 20 3207 7886
Ross Mackay +44 20 3207 7866
Stella Siggins +44 20 3465 2630
Lucy Stevens +44 20 3753 3068
Abbie Stewart +44 20 3753 3054

EVENTS
Charlotte David +44 20 3207 7832
Suzy Khan +44 20 3207 7915
Natalie Meech +44 20 3207 7831
Eleanor Metcalfe +44 20 3207 7834
Rebecca Mikowski +44 20 3207 7822
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

BERENBERG CAPITAL MARKETS LLC

Member FINRA & SIPC

E-mail: firstname.lastname@berenberg-us.com

EQUITY RESEARCH
Donald McLee +1 646 949 9026
Adam Mizrahi +1 646 949 9022
Gal Munda +1 646 949 9021
Patrick Trucchio +1 646 949 9027

ECONOMICS
Mickey Levy +1 646 949 9099
Roiana Reid +1 646 949 9098

EQUITY SALES

SALES
Enrico DeMatt +1 646 949 9230
Kelleigh Faldi +1 617 292 8288
Ted Franchetti +1 646 949 9231
Shawna Giust +1 646 949 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 949 9202
Michael Lesser +1 646 949 9221
Jessica London +1 646 949 9203
Anthony Masucci +1 617 292 8282
Ryan McDonnell +1 646 949 9214
Emily Mouret +1 415 802 2525
Peter Nichols +1 646 949 9201
Kieran O'Sullivan +1 617 292 8292
Rodrigo Ortigao +1 646 949 9205

SALES (cont'd)
Ramnique Sroa +1 415 802 2523
Matt Waddell +1 646 949 9220

CRM
LaJada Gonzales +1 646 949 9213
Monika Kwok +1 646 949 9212

CORPORATE ACCESS
Olivia Lee +1 646 949 9207
Tiffany Smith +1 646 949 9208

EVENTS
Laura Hawes +1 646 949 9209

SALES TRADING
Ronald Cestra +1 646 949 9104
Michael Haughey +1 646 949 9106
Christopher Kanian +1 646 949 9103
Lars Schwartau +1 646 949 9101
Brett Smith +1 646 949 9105
Bob Spillane +1 646 949 9102
Jordan White +1 646 949 9222