Economics

Chart of the week

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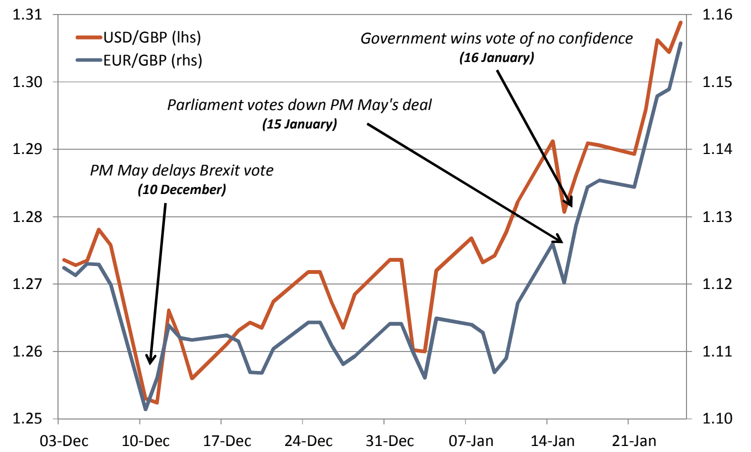
··· CHART OF THE WEEK ··· CHART OF THE WEEK ··· CHART OF THE WEEK ··· CHART OF THE WEEK

25 January 2019

Brexit: Turning the pound frown upside down

Rebound in sterling highlights the market's improved optimism about Brexit



Daily data. Source: Bloomberg. X axis dates – 3 December 2018 to 25 January 2019

- **Sterling – on the up:** No asset class captures the market's collective judgement on an economy's long-run prospects better than the value of its currency. Since the 10 December 2018 low when Prime Minister Theresa May decided to delay UK parliament's vote on her Brexit deal by more than a month, sterling has gained 4.5% against the dollar and 4.9% versus the euro – see chart. The pound has defied continued infighting in parliament that eats into the precious little time left to avoid the economic disaster of a hard Brexit on 29 March 2019.
- **Re-pricing the risks:** Our base case remains that parliament will not let the UK crash out of the EU on 29 March without a deal, as only a small minority favours that outcome. The risk we attach to a hard Brexit is still fairly low (20%), see our Brexit probabilities. Amid all the noise, delays and shenanigans, markets have moved closer to our view, becoming less pessimistic about the outlook for Brexit.
- **Parliament is taking back control:** On 29 January, parliament can further strengthen its influence over Brexit if it grants itself the ability to: a) force May to seek a delay to Brexit if no deal is approved by parliament by 26 February; and b) debate and signal to the government what alternative – including a second referendum – it prefers to May's deal. If a parliamentary majority backs these policies, the hard Brexit risk could recede. At least the first amendment is likely to pass, in our view.
- **Watch the external factors:** The recent dovish tilt by the Fed and the ECB in response to gathering clouds over the global economy has supported the pound's uptick. Nevertheless, the rise is mostly a UK story. The rebound occurred in anticipation of parliament voting down May's original Brexit deal on 15 January to potentially make way for a softer Brexit. A day later, May's Conservative-led government saw off a no confidence motion by left-wing Labour leader Jeremy Corbyn. Responding to a lower risk of snap elections, sterling made further gains.
- **Uncertainty begets volatility:** Ever since the UK voted in June 2016 to leave the EU, markets have paid close attention to UK politics and the Brexit negotiations. Will the UK commit an extraordinary act of economic self-harm by going for a hard Brexit? Or will it reach a sensible agreement with the EU to limit the damage from leaving its biggest market? The assessment of the likely outcome has shifted a lot over the past two and a half years – as highlighted by sterling's volatility. On several occasions, a day or two of bad headlines to stoke fears of a hard Brexit wiped off erstwhile gains from rising optimism of a soft Brexit. Is this time *really* different?
- **Sterling outlook:** Parliament may not get a chance to vote again on May's deal until mid-February. This is worrisome, to put it mildly. Every day that passes without a resolution is a day closer to a hard Brexit. Still, if markets see that the majority in parliament that opposes a hard Brexit continues to strengthen its influence over Brexit, sterling can edge higher. If and when the UK actually dodges the hard Brexit bullet by agreeing some soft Brexit outcome, or by deciding to remain in the EU, sterling could rise significantly further. We look for a further medium-term gain of up to 10% on a trade-weighted basis.

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