FX FOCUS

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British pound / Brexit

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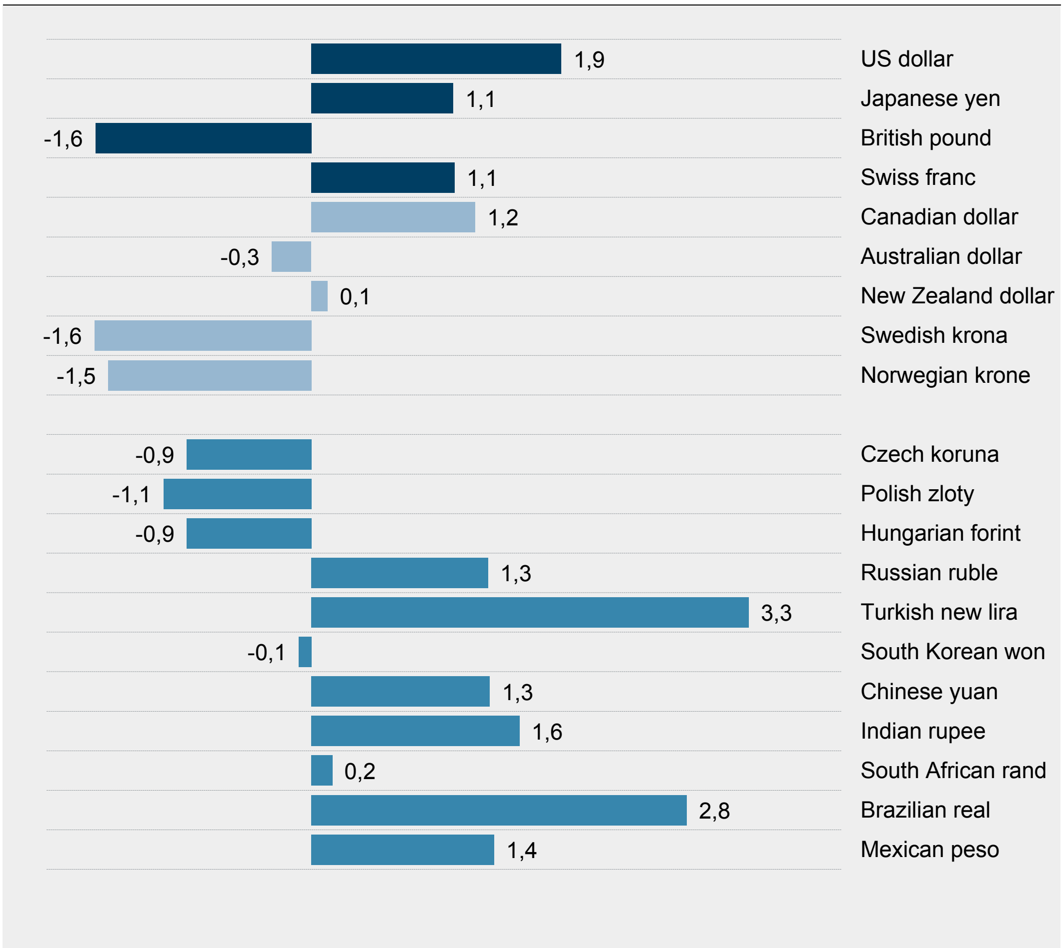
- The British pound recently depreciated significantly. With Boris Johnson's appointment as Prime Minister, concerns about a disorderly EU withdrawal are growing. But a "no deal" Brexit would probably cost him his office. While there are currently no signs of an orderly EU exit, the likelihood of new elections is increasing. This makes the outcome of the drama more and more open. The undervalued British currency would clearly benefit from waning concerns about a "no deal", but the devaluation risks have increased.
- The British pound was most recently the biggest loser. Overall, most European currencies lost ground, and the US dollar advanced. Many emerging market currencies appreciated against the euro.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 07/02 to 07/31/19)



■ Core currencies ■ Rest of G10 ■ Currencies of emerging markets
Sources: Bloomberg, Helaba Research

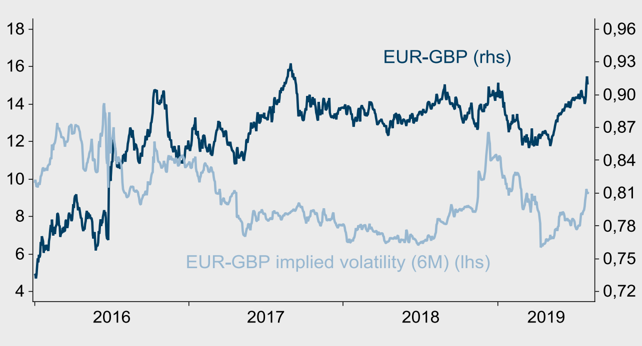
GBP: caught in a dilemma

“My chances of being PM are about as good as the chances of ... my being reincarnated as an olive,” Boris Johnson once responded to the question of whether he would ever be Prime Minister. But now he resides as Prime Minister in Downing Street 10 after having clearly defeated his party rival Jeremy Hunt. Beyond the question of reincarnation, however, it is unclear just how long Johnson can remain in office. It all depends once again on the Brexit drama.

Johnson driving the pound lower

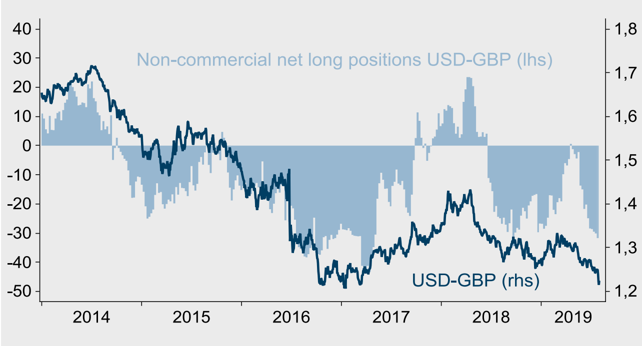
Johnson has promised many things to many people, from a "golden age" to tax cuts and spending programs. At least on Brexit he has given a clear signal: the withdrawal should take place on time on 31 October 2019. The Prime Minister wants to renegotiate the withdrawal agreement with the EU and not least eliminate the "backstop" clause for Northern Ireland. Brussels has already given him a clear rejection, so that not even new talks are certain. If all this is to be taken at face value, all that would remain would be a disorderly withdrawal from the EU. The British government is supposedly intensifying preparations for scenario. In the real economic consequences are in fact difficult to calculate. At least in the short term, however, a severe economic setback would be unavoidable. The British pound has been weakening since May. Recently, the slide accelerated again, with euro-pound exchange rate rising to 0.92, and the pound hit its lowest level against the US dollar since March 2017. Rising implicit volatilities of the pound exchange rates also reflect the increasing nervousness. The speculative bets against the pound are very high – although this was often also a counter indicator in the past.

“No Deal” worries weigh on the pound



Sources: Macrobond, Helaba Research

Speculators driving “Cable” to 2-year low



Sources: Macrobond, Helaba Research

New negotiations with the EU?

Should the British government resume negotiations with Brussels, there will be little time after the summer break. Brussels is looking for a new Commission. On the British side, the Conservative Party Congress is on the agenda at the end of September. The withdrawal agreement itself was in large parts not that controversial, even if Johnson recently questioned the payment of Britain’s financial obligations amounting to 39 billion pounds in the event of a "no deal". The crux of the exit agreement is the "backstop", i.e. the emergency solution for the Irish-Northern Irish border. Its deletion demanded by Johnson is unacceptable from the EU's point of view. Theoretically, there would be room for manoeuvre, such as the British's right to terminate. On this point, however, the EU in particular appears to be deadlocked, ruling out any changes to the agreement that failed in the British Parliament. In the declaration of intent on the future relationship, there is more leeway of movement for both sides. It is questionable, however, whether certain adjustments there will be enough for the British to accept the whole "deal".

“No Deal” Brexit no walk in the park

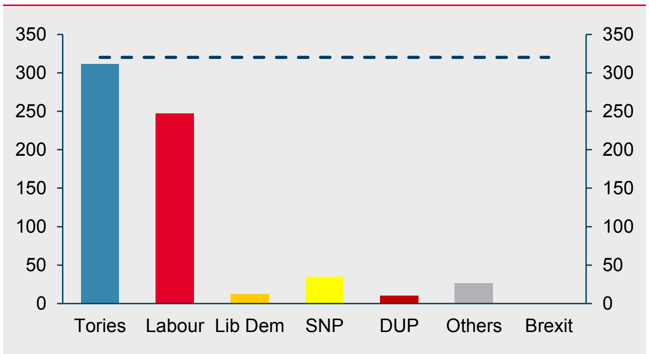
Without a rapprochement of the negotiating parties, all that remains, apart from a further extension of the deadline, is a disorderly withdrawal. The House of Commons will probably try to prevent a chaotic Brexit. A power struggle between the government and parliament with all kinds of legal tricks is possible, the outcome would be uncertain. Should Johnson be able to impose a disorderly Brexit, the economic consequences would probably be enormous. The WTO tariffs then in force would require border controls on both the UK and EU sides. Although facilities and staffing levels can be increased in principle, it is doubtful whether this could be done adequately by the end of October 2019. This would lead to congestion and disruptions in supply chains. More important are legal provisions, i.e. there is a question whether certain products such as medicines, chemicals etc. could still be imported into the EU. In theory, these problems could be alleviated with transitional solutions, as has been agreed upon in air traffic. Should Johnson deliberately seek a "no deal" withdrawal or even refuse payments, the willingness of the EU to negotiate would be low, however. The UK's negotiating position would then be particularly bad because of the pressure to find a quick solution. How to avoid customs controls at the Northern Irish border is a mystery. The British industry association CBI sees the preparations on both sides as insufficient for many areas. Estimates of economic costs for the UK vary widely – from a few percentage points of GDP to almost 20 % by 2030. In the short term, a recession in the UK would be inevitable. Such a chaotic Brexit would also be felt in the EU, but at a much lower level. The British pound would weaken in a no-deal scenario, the euro-pound exchange rates should then be expected around parity.

Is Boris bluffing?

Does Boris Johnson believe that a disorderly Brexit would have little effect? Does he believe that he can impress the EU by shooting himself in the knee just because the latter would also suffer a minor wound? Or is Johnson just bluffing in an attempt to bring the hardliners in his own party over to his side? In the new cabinet, Johnson has tended to appoint representatives of a hard course and sorted out pronounced Brexit critics.

Conservatives and the DUP with a razor thin majority

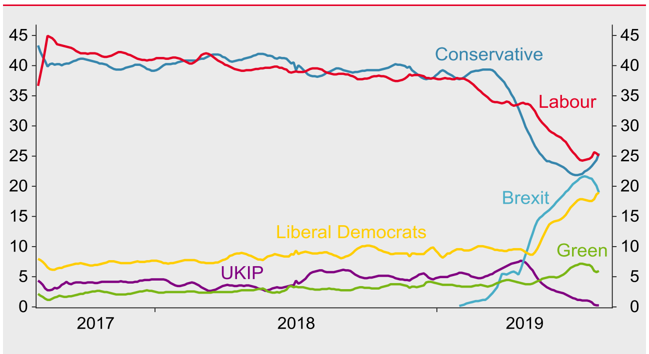
Number of seats in the House of Commons (July 31,2019), minus Sinn Fein



Sources: parliament.uk, Helaba Research

Election polls do not look good for Johnson

Share of votes in %, moving average of election polls



Sources: Macrobond, Helaba Research

Will Johnson be chased out of office again soon?

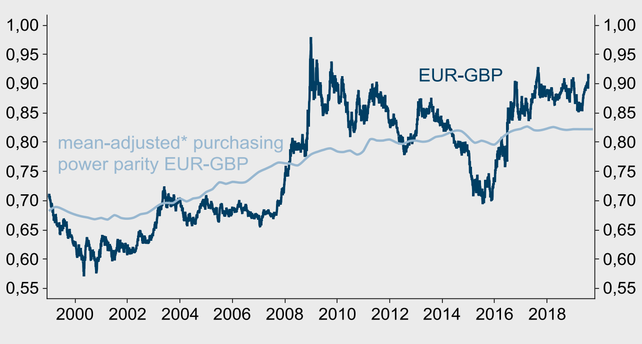
Beyond its economic consequences, a "chaotic" Brexit would also have political ones. Johnson's majority of Conservatives and the Northern Irish DUP is razor thin with only two votes – and even those are still threatened by special elections in Wales. A vote of no confidence in the House of Commons should be successful if Johnson offends EU friends in his party. This could already happen before the withdrawal date. After that there would be new elections. There is even speculation that Johnson is deliberately aiming for just that before 31 October. The polls, however, are not in his favour. If the Tories could take a few more votes from Nigel Farage's Brexit party through a tough course, the Conservatives might become the strongest party. Nevertheless, the Conservatives would probably lose their majority – even with the Northern Irish DUP or various members of the Brexit Party. Labour, under its controversial party leader Corbyn, is not doing well either. In principle, because of the first-past-the-post system in Britain, it is difficult to calculate how it would convert to seats in the House of Commons. A complete political chaos without any majorities is possible. Perhaps Labour could put together a governing majority together with the reinvigorated Liberal Democrats and the Scottish Nationalists, who are likely to win most of the seats in Scotland. New elections are really only attractive to Johnson if they are held after an EU withdrawal without chaos - in other words, an orderly exit.

Pound with opportunities, but also with high risks

Johnson's in a dilemma. If he wants to satisfy the Brexit hardliners, he will probably die a political hero's death and be driven out of office. But if he wants to stay in office – which is probably the most important thing to him – he has to break his word on some point. Experience has shown that he should have few problems with this. Unlike Theresa May, he has much greater influence on the Brexit hardliners. Perhaps he will actually accomplish the miracle of an orderly withdrawal from the EU, but till end of October the probability is low. The British pound would clearly benefit from this. The risk of a disorderly Brexit has increased from a supposed 30 % a bit, but it is still not our base case. In contrast, new elections are becoming increasingly probable. For the currency, these would be a double-edged sword. On the one hand, there could be a majority in Parliament for a second referendum (but that still would not guarantee the UK remaining in the EU); on the other hand, total chaos or a "classic-left" economic policy by a Labour government could harm the pound. A new deadline extension is also plausible – despite Johnson's words to the contrary – and from our point of view currently the most likely scenario. If Johnson wants to negotiate seriously with the EU, a further extension would be helpful in view of the short time span. Even after new elections there would be hardly any time for a new government. The EU would probably agree to a further postponement.

Pound clearly undervalued

GBP

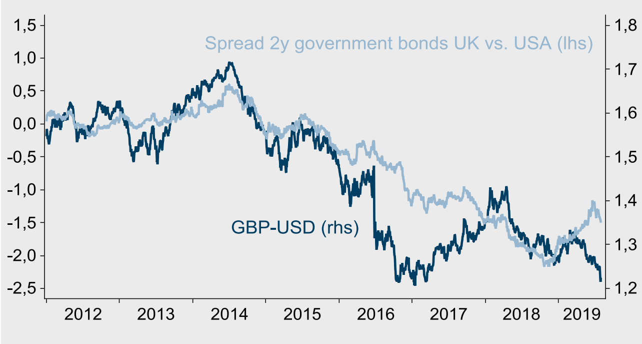


* adjusted for the mean deviation of 10.4 % from PPP t

Sources: Macrobond, Helaba Research

Interest rate differentials support the pound

% points USD



Sources: Macrobond, Helaba Research

Uncertainties weighing on the economy – Bank of England hesitant

The economic situation in the UK is not easy. Inventory build-up boosted growth in the first quarter, with the countermove taking place from the second quarter onwards. The economy will presumably just miss a recession and should then recover somewhat. If, contrary to expectations, a disorderly exit from the EU were to become a reality, it would lead not only to a recession: without a rapprochement with Brussels, this could in fact be a deep recession. In view of this uncertainty, the Bank of England is exercising caution. Interest rate hikes are not an issue for the time being, even if rising wages tend to argue for a less expansionary monetary policy. Interest rate cuts – in line with the US Federal Reserve and the ECB – are a more likely option, but are likely to be considered only in the event of increasing political uncertainties, including repercussions for the economy.

Fundamentally, the British currency should appreciate. Valuation indicators such as purchasing power parities and interest rate differentials vis-à-vis the euro or US dollar signal a stronger pound. Another Achilles heel is the significant current account deficit. Ultimately, however, as has been customary since 2016, everything depends on politics. An increased "no deal" risk is priced in, so that the pound should already recover only if the deadline is extended. And should there in fact be a regulated EU withdrawal, the euro-pound exchange rate could even fall in the direction of 0.80. The British currency would have even more room on the upside against the US dollar, and the pound-dollar exchange rate could climb to 1.40. Basically, the pound has significant appreciation potential, but this time the risks are unusually high. Not only Boris Johnson needs to have strong nerves.

Helaba Currency Forecasts

	Performance year to date	1 month	current*	Forecast horizon at end ... Q3/2019	Q4/2019	Q1/2020	Q2/2020
vs. Euro	(vs. Euro, %)						
US dollar	3,5	1,9	1,11	1,15	1,20	1,20	1,25
Japanese yen	4,4	1,1	120	123	127	127	130
British pound	-1,3	-1,6	0,91	0,85	0,85	0,85	0,80
Swiss franc	2,2	1,1	1,10	1,15	1,15	1,15	1,20
Canadian dollar	7,0	1,2	1,46	1,51	1,55	1,54	1,60
Australian dollar	0,5	-0,3	1,62	1,60	1,62	1,60	1,67
Swedish krona	-5,2	-1,6	10,71	10,30	10,00	9,80	9,70
Norwegian krone	0,9	-1,5	9,82	9,40	9,10	9,00	9,00
Chinese yuan	2,7	1,3	7,66	7,94	8,16	8,16	8,50
vs. US-Dollar	(vs. USD, %)						
Japanese yen	0,8	-0,8	109	107	106	106	104
Swiss franc	-1,2	-0,8	0,99	1,00	0,96	0,96	0,96
Canadian dollar	3,4	-0,6	1,32	1,31	1,29	1,28	1,28
Swedish krona	-8,4	-3,5	9,67	8,96	8,33	8,17	7,76
Norwegian krone	-2,5	-3,3	8,86	8,17	7,58	7,50	7,20
Chinese yuan	0,0	-0,1	6,88	6,90	6,80	6,80	6,80
US-Dollar vs. ...	(vs. USD, %)						
British pound	-4,7	-3,4	1,22	1,35	1,41	1,41	1,56
Australian dollar	-2,9	-2,1	0,68	0,72	0,74	0,75	0,75

*31.07.2019

Sources: Bloomberg, Helaba Research ■