Helaba Research

FX FOCUS

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British pound / Brexit

AUTHOR
Christian Apelt, CFA
phone: +49 69/91 32-47 26
research@helaba.de

EDITOR:
Claudia Windt

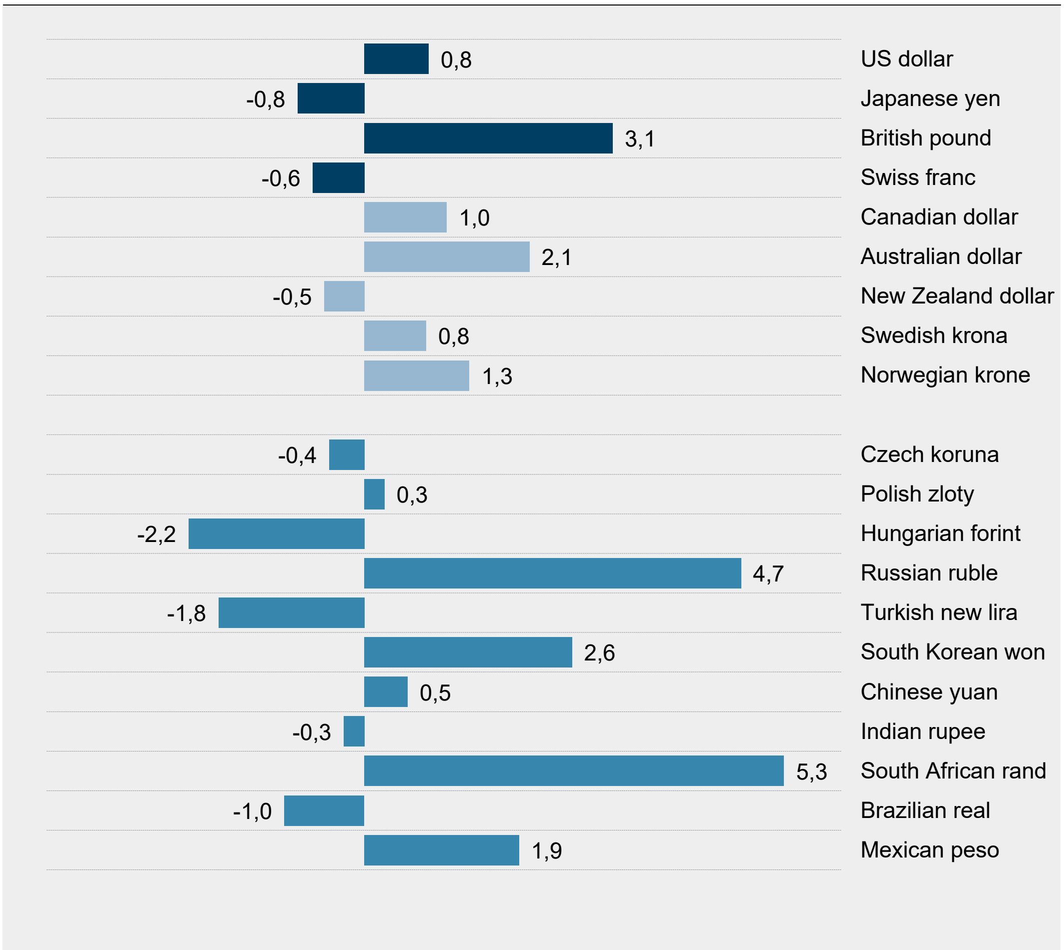
PUBLISHER:
Dr. Gertrud R. Traud
Chief Economist/
Head of Research

Helaba
Landesbank
Hessen-Thüringen
MAIN TOWER
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
phone: +49 69/91 32-20 24
fax: +49 69/91 32-22 44

- The British pound recovered after Parliament passed a law that made it virtually impossible for a disorderly exit from the EU on 31 October. Prime Minister Johnson is in trouble; new elections are on the horizon. A solution to the Brexit dilemma is currently not foreseeable, but an orderly departure remains plausible. The undervalued British currency should recover, especially if political uncertainties decline.
- The British pound move up sharply. The euro tended toward weakness. Safe havens like the Swiss franc and the Japanese yen were even less in demand. The Russian ruble and the South African rand appreciated noticeably.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 08/16 to 09/16/19)



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

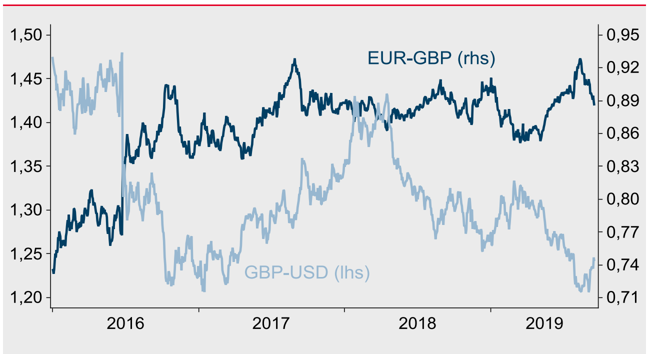
GBP: a breather

Events surrounding the Brexit drama came fast and furious. But it seems that calm has returned for now. The danger of an unregulated Brexit on October 31 has presumably been averted. The British pound recovered against the US dollar at times by more than 4 %, after the pound-dollar exchange rate initially dropped below 1.20, its lowest rate since October 2016. The euro-pound exchange rate also fell clearly below 0.90.

Brexit postponement until January 31, 2020

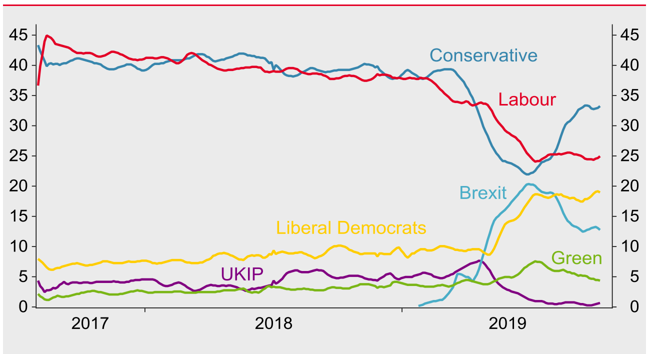
Prime Minister Johnson tried to ram through the Brexit and to accept the possibility of a disorderly departure. To that end, he wanted to sideline Parliament by sending it into a forced five-week break, a move which has now been challenged in court. The House of Commons countered with a law that constrains the Prime Minister with respect to the exit from the EU. The law obligates the Prime Minister to ask the EU for an extension of the deadline by October 19 if no other agreement has been reached by then. The new withdrawal date would be January 31, 2020, unless the EU proposes another date. Johnson would "rather be dead in a ditch" than request such a Brexit postponement. If he does not find another legal loophole, he would have no choice. Unless he wants to break the law or resign, or he is able to make a deal with the EU. Although the necessary unanimous approval of the extension on the part of the EU is not guaranteed, one can assume that it would be granted. Johnson's Plan B – new elections in mid-October – also failed because the opposition refused him the two-thirds majority needed to dissolve the House of Commons.

Pound sterling plummets and then recovers



Sources: Macrobond, Helaba Research

Tories already past their peak in polls?



Sources: Macrobond, Helaba Research

We do not believe it is a realistic scenario that Johnson would break the law. Resigning would spare him the disgrace of applying for a postponement of Brexit. However, a transitional government could then be appointed by the current opposition, which would submit this request in Brussels or even take other measures. This also entails risks for Johnson. A disorderly Brexit on October 31 has at least become quite unlikely.

Outcome of new elections completely uncertain

New elections, on the other hand, are inevitable sooner or later. After all, the Prime Minister lost his majority with the purging of the 21 conservative dissenters from the parliamentary group. Should Johnson's Conservatives achieve a clear victory in the election – presumably in November or December – he could still realise a disorderly Brexit in 2020 – or seal a deal with greater parliamentary support. The outcome of possible new elections can hardly be calculated at present. Surveys show that the "Tories" will be the strongest party. However, an absolute majority in the House of Commons is very uncertain, even though it is not impossible due to the first-past-the-post system and the fragmentation of the opposition into Labour, Liberal Democrats, Greens, and Nationalists. Conceivable alliances in certain constituencies between Conservatives and the Brexit Party on the one hand, and opposition parties on the other, also render such calculations difficult.

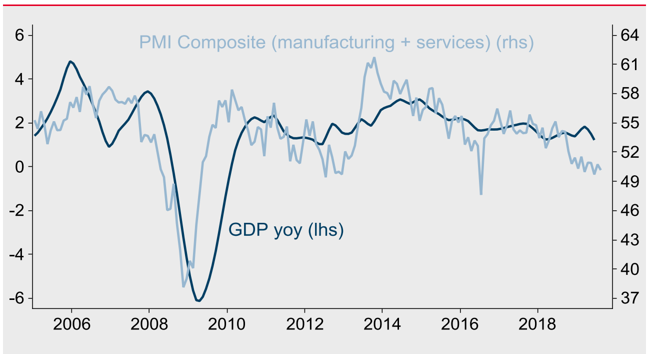
New Prime Ministers often start with a tailwind for a brief period. The Conservatives' current peak in the polls could end quickly, especially after recent events. Moreover, conservative prime ministers have repeatedly overestimated their voter appeal in recent years. In fact, initial surveys have already shown that the Tories have passed their zenith. But whether there is an alternative, workable majority – of Labour, Liberal Democrats and the Scottish SNP – is equally uncertain. For there are some serious substantive differences, not only with regard to Brexit. New elections would not necessarily bring clarity.

A deal with the EU, after all?

In view of the problems with the extension of the deadline and new elections, Johnson and the entire country are in need of an act of liberation more so than ever: a deal with the EU! This would not least significantly improve the Conservatives' electoral prospects. There were hardly any serious negotiations recently. Since the EU will certainly not do get rid of the "backstop", the emergency solution for the Northern Irish border, as demanded by Johnson, the British government would have to make corrections. Rumours that the Northern Ireland position could be adjusted, i.e. that different rules would apply in trade between Great Britain and Northern Ireland, have been denied. But since the Tories no longer have a majority anyway, the influence of the Northern Ireland coalition partner DUP could diminish. In the absence of a majority, Johnson would in any case be dependent on support from the opposition. Whether he – unlike was the case with May – will receive this support is questionable, but not impossible. There are also no simple solutions for Labour – in contrast to the clear anti-Brexit parties of the Liberal Democrats and the SNP.

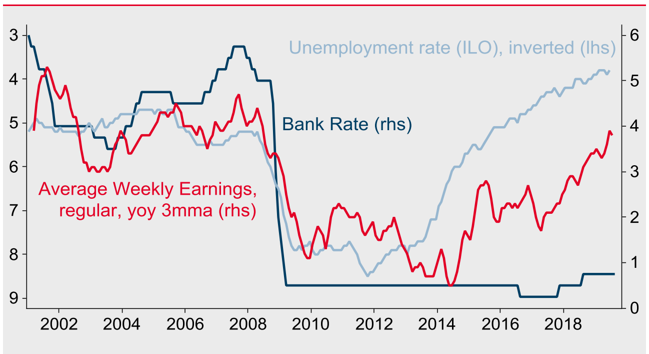
The outcome of the Brexit drama remains open beyond October 31. Nothing can be ruled out: from a deal with the EU, to an unregulated withdrawal, to a second referendum, to an endless series of deadline extensions. A disorderly Brexit would bring with it some distortions (see box), so that not even a conservative government should be pursuing it. A second referendum will probably not pacify the country either and would only be considered by a different government anyway. And what would be the question of the vote? Remain in the EU or a "no deal" exit? Or an agreement negotiated by a Labour government, which conservative Brexit supporters would hardly support? Actually, in the end all that remains is a withdrawal with an agreement, which, although the timing is uncertain, we continue to see as the most likely scenario.

Economic weakness, but no collapse



Sources: Macrobond, Helaba Research

Time for BoE rate hikes, unless …



Sources: Macrobond, Helaba Research

Anaemic growth instead of recession

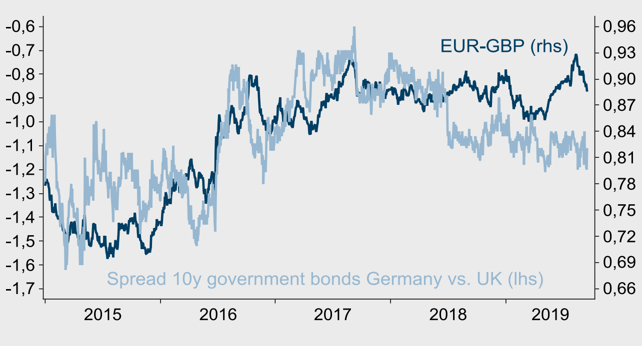
Considering the political chaos, the British economy is holding up remarkably well. The decline in the gross domestic product in the second quarter can be explained as an offset entry after the significant inventory build-up in the first quarter. In the second half of the year, the British economy should weaken and grow only slightly, but at least not collapse. Solid consumer spending is supporting growth, while investments are suffering from political uncertainty. A more free-spending government will also support the economy. The Bank of England will remain in its waiting position. Brexit chaos and economic concerns as well as the international trend point to interest rate cuts, but national data such as wage increases would tend to point to higher interest rates.

Pound with chances for further recovery

The British pound remains significantly undervalued. This applies on the basis of interest rate differentials against the euro and above all the US dollar, but also on the basis of adjusted purchasing power parities or real exchange rate indices. However, the Brexit uncertainty continues to weigh on the currency. Acute concerns are diminishing, so that some of the currently high speculative positions against the pound are being reduced. The recovery of the pound could well continue, and the euro-pound exchange rate could fall to 0.85. But a sustained strength in the pound required a real solution to the Brexit dilemma.

Pound with yield advantage

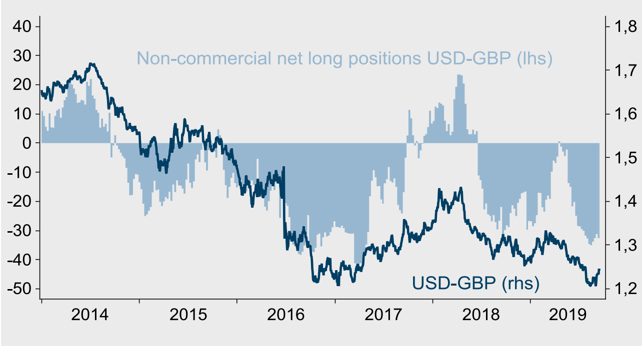
% points GBP



Sources: Macrobond, Helaba Research

Large bets against pound bear chances of recovery

% of open interest USD



Sources: Macrobond, Helaba Research

Repercussions of the “No-Deal” Brexit

A disorderly departure from the EU is likely to have grave economic consequences for the UK. At least this is suggested by internal government contingency plans (“Operation Yellowhammer”) which has now been made public:

In the wake of a disorderly withdrawal, trade in goods between the United Kingdom and the EU would have to be conducted in accordance with WTO rules. This requires not only import tariffs, but above all border controls. According to the paper, the flow rate of commercial traffic entering France could be reduced by 40-60 % for up to three months. Backlogs in southern England would be expected. Bottlenecks would be possible for certain fresh food products, as well as for some medicines. While electricity and water supplies appear to be secure, regional fuel shortages could occur. Protests and roadblocks are also considered possible. One fear is that companies will stop or relocate trade if the border is hard. Due to tariff and non-tariff trade barriers, politicians would come under pressure to reach agreements as quickly as possible – at least for the transition. In general, small and medium-sized enterprises – unlike large ones – are not yet considered adequately prepared for Brexit.

From the government's point of view, the paper only describes an unlikely worst-case scenario and preparations have already gone much further. However, this scenario does not sound entirely unlikely. To what extent authorities and companies are actually prepared for a disorderly Brexit can hardly be predicted. Certain distortions due to organisational problems at the borders are unavoidable, at least initially. Customs formalities are new territory for many companies. Import tariffs in the EU average only 2.7% on non-agricultural products and 8.1% on agricultural products. However, this includes, among other things, tariffs of 10% for cars or 44.8% for dairy products.

Drugs or chemicals from the UK would require additional approval or registration in the EU. Financial services would likely be subject to restrictions that would presumably apply even in case of a later, orderly withdrawal. Many legal difficulties could be solved temporarily with transitional agreements. Regulations of that kind have been put in place for aviation and road transport. In view of the current confrontational course of the British government, however, further concessions on the part of the EU countries are not necessarily foreseeable. A "hard" Ireland-Northern Ireland border that would be required is above all a political problem; the economic consequences are locally contained. Not all the effects of an unregulated EU withdrawal can be foreseen and planned. The big unknown also remains a risk.

The British economy is likely to slide into recession in the event of a disorderly Brexit. Estimates vary widely and are difficult to calculate. A GDP decline of a few tenths to a few percentage points is conceivable. The British pound will then presumably continue to fall. The euro-pound exchange rate could reach parity or at least temporarily rise above it. The British currency would probably depreciate even more against the US dollar.

In addition to the short-term organisational and legal problems associated with an unregulated Brexit, a longer-term solution is also needed in the UK's relationship with the EU – which, incidentally, also applies in the event of an approval of the withdrawal agreement. However, due to many unresolved issues and the lack of a transitional period, the time pressure would be particularly high. As the UK would suffer more economically from a disorderly Brexit, the EU is in a stronger position, and the willingness to negotiate (see above) might not be so pronounced. In any case, negotiations on free trade agreements often take several years, and they would also have to be ratified by every EU member state (including Wallonia). The prospects for a speedy deal with the EU after an unregulated withdrawal are therefore poor. Many uncertainties remain, market access would be limited. It is more than questionable whether the British could conclude a major agreement with the USA as a substitute. On the one hand, the US is far less relevant to British trade than the EU, and, on the other hand, US President Trump will hardly be an easy negotiating partner. Even in the longer term, the British economy would probably suffer severely from the consequences of a "no deal" Brexit.

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	4,2	0,8	1,10	1,15	1,15	1,15	1,20
Japanese yen	5,8	-0,8	119	123	122	122	125
British pound	1,6	3,1	0,89	0,90	0,85	0,85	0,85
Swiss franc	3,0	-0,6	1,09	1,10	1,10	1,10	1,10
Canadian dollar	7,3	1,0	1,46	1,52	1,51	1,50	1,54
Australian dollar	1,5	2,1	1,60	1,67	1,64	1,64	1,67
Swedish krona	-4,5	0,8	10,63	10,50	10,30	10,20	10,00
Norwegian krone	0,5	1,3	9,86	9,80	9,60	9,50	9,40
Chinese yuan	1,2	0,5	7,77	8,05	8,17	8,05	8,28
vs. US-Dollar	(vs. USD, %)						
Japanese yen	1,5	-1,6	108	107	106	106	104
Swiss franc	-1,1	-1,5	0,99	0,96	0,96	0,96	0,92
Canadian dollar	3,0	0,2	1,32	1,32	1,31	1,30	1,28
Swedish krona	-8,4	0,0	9,67	9,13	8,96	8,87	8,33
Norwegian krone	-3,6	0,5	8,96	8,52	8,35	8,26	7,83
Chinese yuan	-2,7	-0,3	7,07	7,00	7,10	7,00	6,90
US-Dollar vs. ...	(vs. USD, %)						
British pound	-2,5	2,3	1,24	1,28	1,35	1,35	1,41
Australian dollar	-2,6	1,3	0,69	0,69	0,70	0,70	0,72

*16.09.2019

Sources: Bloomberg, Helaba Research ■