FX FOCUS

9 December 2019

British pound

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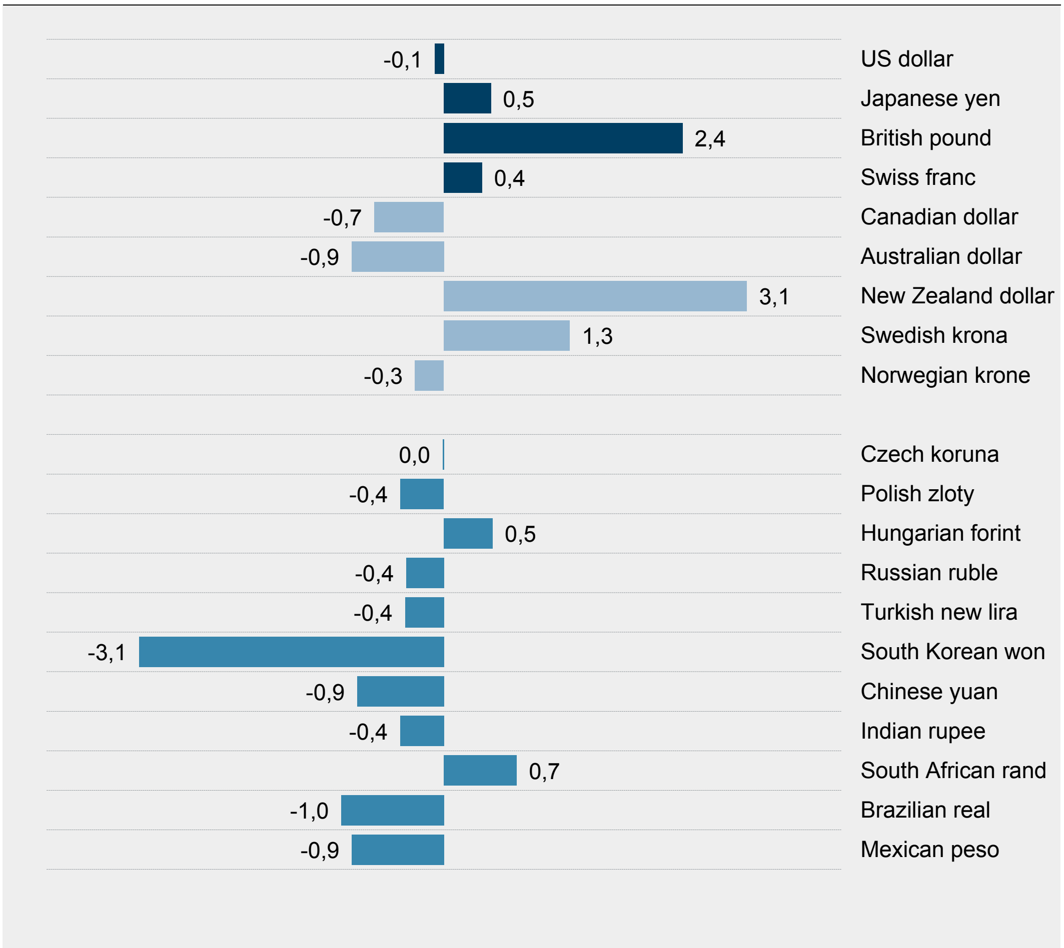
- The British pound gained ground in anticipation of a Conservative election victory. Should that come to pass, Prime Minister Johnson will probably get his Brexit deal through parliament and Britain will leave the EU at the end of January 2020 in an orderly fashion. The Labour opposition under its leader Corbyn, on the other hand, is causing concerns over its economic policy, even if the Brexit could still be cancelled should they come to power. The pound is unlikely to gain further against the euro until 2020, if the negotiations over the future relationship with the EU are going well or the British economy shows more dynamism.
- The British pound appreciated noticeably. But the New Zealand dollar advanced even more. Among the losers were a few emerging market currencies like the Korean won and the Brazilian real.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 11/07 to 12/06/19)



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

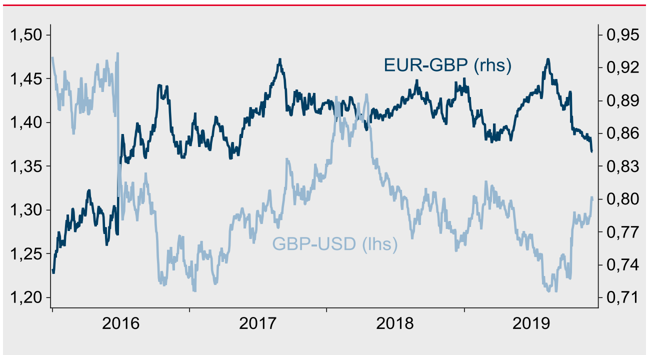
GBP: Brexit elections

December 2019, Britain is still a member of the European Union. The planned Brexit on 31 October has been postponed by three months. New elections on 12 December are to resolve the blockage in the British House of Commons. But will there be real clarity after the elections? The British pound gained appreciably in anticipation of a sufficient election victory by the Conservatives: the euro-pound exchange rate fell below 0.85, against the US dollar the British currency climbed above 1.31.

Brexit 01/31/2020

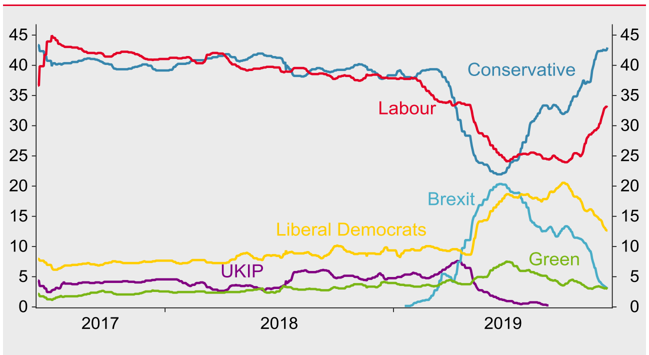
With an absolute majority, Prime Minister Johnson could get the deal he himself negotiated with the EU through the House of Commons. In view of potential dissenters within his own party, a clearer majority would be helpful. EU withdrawal could then take place on 31 January 2020. That would be followed by a transitional phase at least until the end of 2020, during which the current rules would be largely retained. The future relationship of the British to the EU is to be negotiated during that time.

Pound sterling stronger than it's been in a long time



Sources: Macrobond, Helaba Research

Tories ahead, but Labour catching up



Sources: Macrobond, Helaba Research

In the polls, the two major parties, the Conservatives and Labour, have made significant gains in recent weeks. However, the "Tories" are by far the strongest party. Their approval rose mainly at the expense of the Brexit party, which is disappearing again, especially since it will only run in constituencies without a previous Conservative seat. Labour gained at the expense of the Liberal Democrats, whose surge subsided. While the latter have a clear position on the Brexit issue with their complete opposition, Labour's position is less clear. It is concentrating more on classic "left" politics. The shift in election polls suggests that the Brexit no longer plays the overriding role in the election campaign.

Labour programme: "Cuba without the sun"“

Labour's election programme provides for substantial additional spending, nationalizations, and tax increases. Health care spending is to increase significantly, as is the minimum wage. The retirement age must not be raised any further. Major public investments in housing and infrastructure are also planned. Energy and water utilities, the postal service, the railways and broadband internet are to be nationalized. Taxes for companies and higher earners (from 80,000 pounds p.a.) will be raised. Carbon dioxide emissions are to be drastically reduced by 2030. Overall, the budget deficit is likely to increase considerably, and the Bank of England may support this with a looser monetary policy. On the Brexit question, Labour wants to renegotiate the EU deal and then confirm the result in a new referendum. It's an open question whether the party would advocate for its own deal or for remaining in the EU or strike a neutral stance in the referendum. While the stance on Brexit would likely appeal to the financial markets, the shouts of joy will be very restrained should the party take one of the other positions and win an absolute majority. However, election programmes are not yet concrete government programmes, especially if Labour were forced to seek allies.

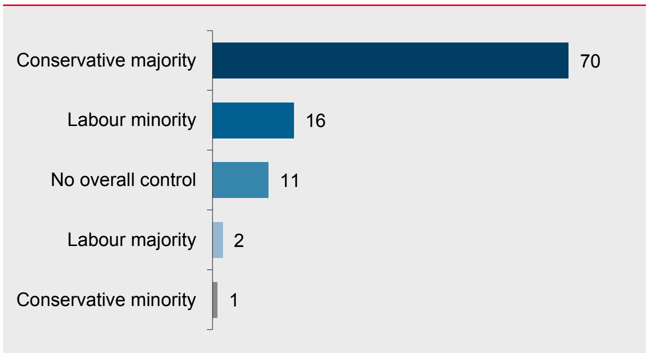
Lib-Dems and SNP

One potential ally would be the Liberal Democrats. They stand out with their clear "anti-Brexit" stance and would cancel the EU withdrawal even without a second referendum. Apart from that, the party favours, among other things, more environmental and climate protection as well as higher government spending on some things. Different from Labour, however, the budget deficit is not to increase, as additional expenditures are to be counter-financed with tax increases. While the Liberal Democrats have ruled out a cooperation with Labour under Corbyn, presumably they would cooperate with or tolerate him should it come to that. In addition, Labour would probably also depend on the votes of the Scottish Nationalists, who, due to their strength in Scotland, are likely to be the third largest faction in the House of Commons. In substantive terms, the SNP stands out with a similarly hard anti-Brexit course. However, the party could demand a second independence referendum for Scotland in return for cooperation. Apart from that, the SNP should be able to come to an agreement with Labour on substantive issues.

However, the election is not likely to produce a coalition of Labour, Liberal Democrats, and the SNP, nor a government by Labour alone; rather, by far the most likely result is an absolute majority for the Conservatives. Because of the first-past-the-post system, using national polls to make projections about MP seats is fraught with uncertainty. Since the Brexit is splitting up the electoral camps somewhat differently and the classic party spectrum is also dissolving in Great Britain, the models can be misleading, especially since there could be tactical alliances in individual constituencies. Moreover, before the 2017 elections, Labour was able to reduce its lag in the polls considerably. Still, given the Conservatives' current average lead of around ten percentage points over Labour, the former should get a sufficient majority. Incidentally, if, contrary to expectations, the Tories just miss this majority, we wouldn't know any more than we did before. Since there are the parties from Northern Ireland in addition to the ones already mentioned, and since Welsh nationalists and possibly a number of independent parliamentarians could be elected to the House of Commons, there remains the risk of a stalemate in which nobody has control. In that case, the outcome of the Brexit drama would also be completely open again.

Tory election victory by far the likeliest outcome

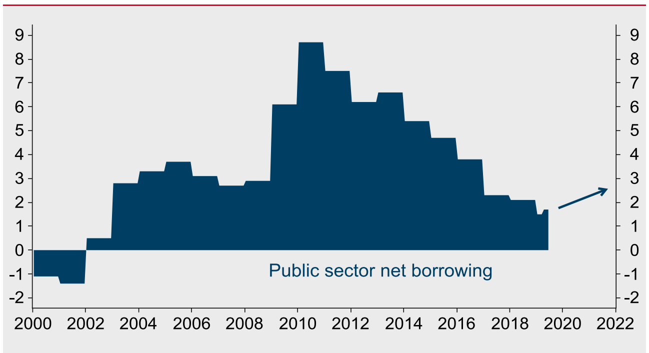
%, likelihood of possible election outcomes



Sources: Electoral Calculus, Helaba Research

Budget deficit will grow – no matter who wins

% of GDP, rolling 4 quarter average



Sources: Macrobond, Helaba Research

Conservatives: "Get Brexit done"

Prime Minister Johnson will presumably get his EU exit agreement through parliament with an election victory and complete the Brexit at the end of January 2020. Only a very small handful of Brexit hardliners will deny him the vote. It is hard to imagine him changing his mind and going through with a disorderly withdrawal instead. Following Brexit, Johnson then wants to quickly conclude an agreement on future relations with the EU, so that the transition phase will be finished already at the end of 2020. Apart from the Brexit issue, Conservatives are also showing themselves to be unusually generous. Expenditures for the health care system are supposed to rise significantly – as is the number of nursing staff by up to 50,000. Pensions and other social expenditure will also grow noticeably. Investments in infrastructure and internal security will be boosted. Income tax, VAT, and social security contributions are not to rise, and some cuts are planned. The current moderate budget deficit can therefore only go up. Carbon dioxide emissions are to be reduced to zero net by 2050.

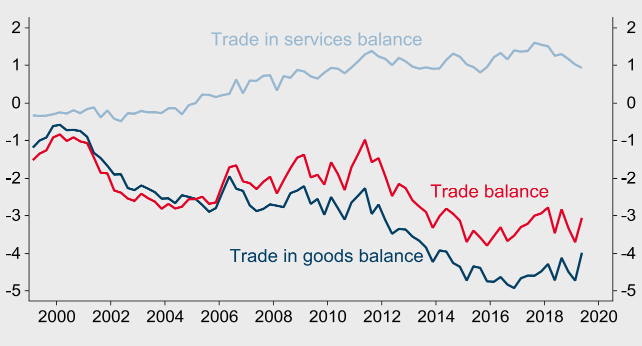
Difficult negotiations about the future

When it comes to the actual work of governing, however, negotiations on the future relationship to the EU 2020 will play the dominant role. In principle, the Conservative government wants to leave the single market and the customs union. It should be able to quickly agree with the EU on largely tariff-free trade in goods. In view of the trade surplus, the EU also has an interest in getting this done. Exceptions could be individual products, especially agricultural ones. However, product and regulatory standards are becoming more complicated. There is still uniformity here, though it is quite possible that the British would like to deviate from some of them. But the EU will press for fair conditions of competition ("level playing field"), i.e. it will not accept any significant relaxation of product, social, or environmental standards. Government subsidies for companies and public procurement will also become critical points. Negotiations are likely to be difficult here. The greater the deviations from EU rules, the more extensive customs controls would have to be, which in turn is undesirable.

With respect to services, Britain will leave the single market more clearly, especially as the EU has little interest in easy market access for the British given its trade deficit in this area. The main focus is on financial services. The British are demanding a broad principle of equivalence. British banks will lose their EU passports, but they could still do business in the EU if they recognize the regulatory standards. The EU's willingness to compromise can only be seen in the context of an entire negotiating package. The general free movement of workers in United Kingdom will be restricted, but the British might be prepared to allow certain additional quotas of EU foreigners into their country. Even British payments into EU coffers – beyond the "divorce bill" agreed in the withdrawal agreement – are conceivable.

British trade deficit on goods, surplus in services

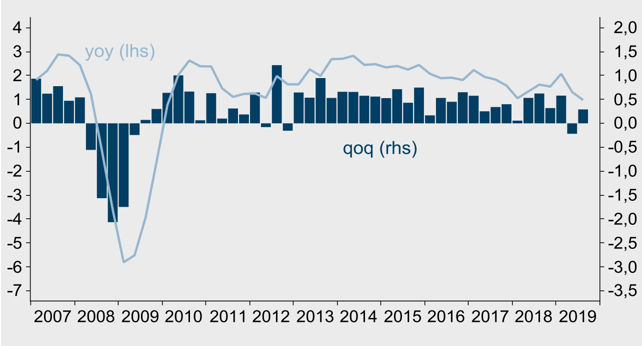
% of GDP, British external trade with the EU



Sources: Macrobond, Helaba Research

Moderate growth – not bad, considering…

% yoy | % quarter-on-quarter



Sources: Macrobond, Helaba Research

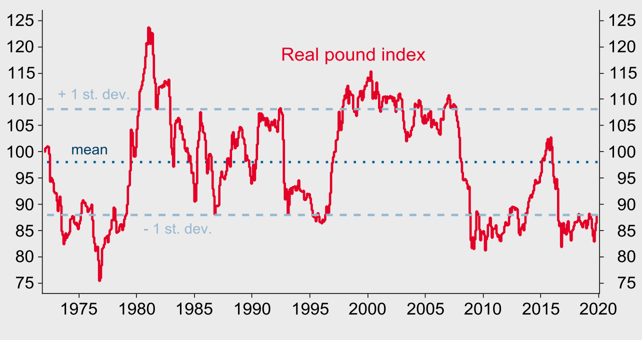
“Hard Brexit” at the end of 2020?

The time available for negotiations on the future relationship – i.e. in the course of 2020 – is far too short. An extension of the transition phase must be applied for by 1 July 2020, and it may last until the end of 2022. Johnson is reluctant to extend the deadline, but he has already changed his mind on more important points. Without a deadline extension, the time pressure for a negotiated solution by the end of 2020 will increase, especially as it still has to be ratified – probably in all EU member states. If no agreement is reached by then, customs controls could again be introduced overnight. Although there would still be time to prepare for such an eventuality, short-term economic distortions could hardly be avoided. However, even a Conservative government probably does not want this, so that such an indirect "hard Brexit" is not to be expected.

British growth was surprisingly good in the third quarter. However, the momentum is likely to slow somewhat in the short term. The economy is expected to grow by 1.3 % in 2019 as a whole. In 2020, growth is likely to be somewhat lower at 1.0 %, not least because special factors such as the unusually strong inventory build-up before the original Brexit date will not be repeated. Economic momentum will improve in the course of 2020 as political uncertainty gradually wanes and fiscal stimuli are added. The Bank of England will remain in its wait-and-see position. Inflation will suffer a setback in the short term, but inflation risks will remain balanced in the medium term. Moreover, the tenure of Bank of England Governor Mark Carney is coming to an end, the succession is still open and depends not least on the outcome of the election.

Pound undervalued

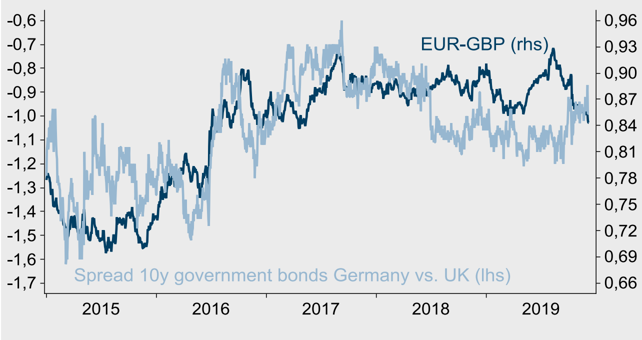
Index, real, trade-weighted



Sources: Macrobond, Helaba Research

Yield differences against the euro fits

% points GBP



Sources: Macrobond, Helaba Research

Johnson victory already priced in

The British pound has appreciated significantly since mid-August. At that time, there was still the threat of a "chaos" Brexit under Boris Johnson or an alternative government under Labour leader Corbyn. Meanwhile, a "no deal" is almost impossible in the short term. The probability of an absolute Labour majority is also very low. An orderly exit from the EU and a Conservative economic policy are currently the "best case" scenario from the pound's point of view, and that is exactly what looks like the likely case. However, this now seems to have been priced in, so that a clear Johnson victory should not give the pound any sustained momentum for the time being, at least against the euro. In principle, the British currency is undervalued – on the basis of adjusted purchasing power parities or real exchange rate indices. This also applies to interest rate differentials against the US dollar, but no longer against the euro. However, negotiations on the future relationship with the EU would need to go well for a further appreciation. In addition, improved growth and the prospect of higher interest rates in 2021 could help the pound. For the time being, however, the euro-pound exchange rate is likely to fluctuate around 0.85 and only fall towards 0.80 in the later course of 2020. By contrast, the British currency has more potential against the US dollar. The pound-dollar exchange rate could continue to rise significantly and climb from the most recent 1.31 to 1.40 and in the direction of 1.50. However, this also depends on whether the USA overtakes the United Kingdom in terms of political chaos in 2020.

Helaba Currency Forecasts

	Performance year to date	1 month	current*	Forecast horizon at end ... Q4/2019	Q1/2020	Q2/2020	Q3/2020
vs. Euro	(vs. Euro, %)						
US dollar	3,7	-0,1	1,11	1,15	1,15	1,20	1,20
Japanese yen	4,7	0,5	120	122	122	125	125
British pound	6,8	2,4	0,84	0,85	0,85	0,85	0,80
Swiss franc	2,8	0,4	1,10	1,10	1,10	1,10	1,15
Canadian dollar	6,7	-0,7	1,47	1,51	1,50	1,54	1,54
Australian dollar	0,6	-0,9	1,62	1,64	1,64	1,67	1,67
Swedish krona	-3,4	1,3	10,50	10,50	10,40	10,30	10,20
Norwegian krone	-1,9	-0,3	10,10	10,00	9,90	9,70	9,60
Chinese yuan	1,1	-0,9	7,78	8,05	8,05	8,28	8,28
vs. US-Dollar	(vs. USD, %)						
Japanese yen	1,0	0,6	109	106	106	104	104
Swiss franc	-0,9	0,4	0,99	0,96	0,96	0,92	0,96
Canadian dollar	2,9	-0,6	1,33	1,31	1,30	1,28	1,28
Swedish krona	-6,8	1,4	9,50	9,13	9,04	8,58	8,50
Norwegian krone	-5,4	-0,2	9,13	8,70	8,61	8,08	8,00
Chinese yuan	-2,2	-0,8	7,03	7,00	7,00	6,90	6,90
US-Dollar vs. ...	(vs. USD, %)						
British pound	3,0	2,5	1,31	1,35	1,35	1,41	1,50
Australian dollar	-3,0	-0,8	0,68	0,70	0,70	0,72	0,72

*06.12.2019

Sources: Bloomberg, Helaba Research ■