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UK UPDATE: STERLING-BREXIT, MAY VS CORBYN, BOE

Berenberg Macro Flash

WHAT THE RECENT STERLING MOVES SUGGEST

The most common question in the last few weeks from clients has been 'what do the recent cable (GBDPUSD) moves tell us about Brexit?' The answer has two parts: (1) The stronger sterling partly reflects the falling risk of a no-deal hard Brexit after the UK and the EU agreed the contentious divorce terms last December. We reduced our risk of a hard Brexit from 30% to 20%. (2) But the moves in cable exaggerate the extent to which this risk has fallen. The lowered hard Brexit risk is less than half of the story. The much bigger part is the dollar weakness which we wrote about last Friday, see 'Return to the mean: the currency story'. Looking at sterling on a trade-weighted basis and versus the euro gives a better perspective. While sterling has risen by c7.5% against the dollar since November, it has risen by c3.5% on a trade-weighted basis, and by c1.5% versus the euro.

Reuters report that UK and EU negotiators are planning a series of bi-weekly meetings for the coming weeks so that the framework for a transitional period until the end of 2020, in which the UK de facto remains inside the Single Market and Customs Union, can be informally agreed at the March 22-23 EU Summit. While any transitional deal could not be ratified by the EU27 until late 2019 along with the broader plans for post-Brexit trade ahead of Brexit in March 2019, markets would respond positively to the further progress. Sterling would likely make further gains over the course of 2018. Is sterling undervalued? Yes – as long as the UK avoids a hard Brexit. Currently, sterling embodies a range of potential outcomes for Brexit. That includes the risk of a hard Brexit. If the UK avoids this risk sterling is probably undervalued on real trade-weighted basis by between 5% and 10%.

THE CULT OF CORBYN IS NOT WHAT IT SEEMS

The leading Conservative Party is badly divided on the issue of Brexit. The public's confidence in its ability to make a success of Brexit has dwindled since Prime Minister Theresa May lost her party's slim majority in snap elections in June 2017. After last year's disappointing party conference and capitulation to the EU on the Brexit divorce terms, markets have wondered if May could resign, triggering early elections. We have consistently played down this risk. Despite the differences over Brexit within the Conservative party, the risk that far-left Jeremy Corbyn could end up in Number 10 has so far provided the glue that binds the opposing factions of government together.

Even though Labour are marginally ahead in the polls - c2 pts – polling on May vs Corbyn shows the prime minister well ahead. When voters are asked about who would make the best prime minister, the three polls taken this year put May ahead of Corbyn by 5%. May's lead against Corbyn has been stable since the election. This suggests two things: (1) The Conservatives have a strong incentive to keep May in No.10 if they want to minimise the Corbyn risk; and (2) that instead of being a plus for Labour, as is often assumed, Corbyn may actually be a negative. Would a more centrist leader be outperforming May in the polls in the current circumstances? Probably, yes. If the Conservatives avoid a hard Brexit and the risks that go with it, and continue with their policy of gradual fiscal rebalancing, the Conservatives can expect to be ahead come next election, if Corbyn is still Labour leader. We see only a 15% chance that Corbyn could become Prime Minister before the next scheduled general election in 2022.

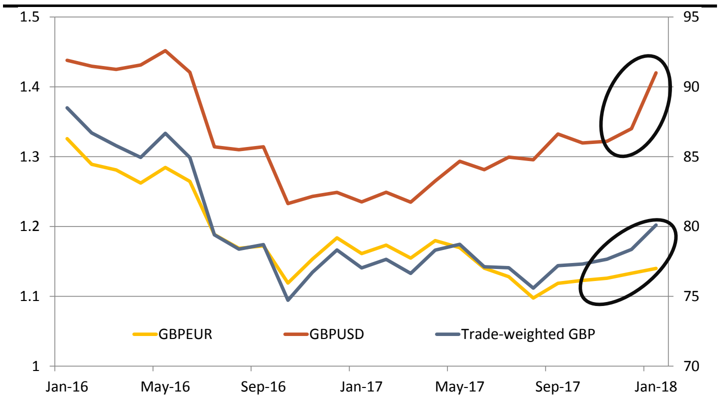
WILL MARK CARNEY SEND A SIGNAL FOR RATE HIKES THIS WEEK?
Bank of England (BoE) governor Mark Carney will speak before parliament's Economic Affairs Committee in London on Tuesday 30 January. In the past, BoE policy makers have used such occasions to strengthen or tune their forward guidance on the path of monetary policy. After last week's comments by Mr Carney that 'there is the prospect this year, as there is greater clarity about the relationship with Europe and subsequently with the rest of the word, for a recoupling……a conscious recoupling of the UK economy with the global economy' we need to watch his testimony careful for any signals that the BoE could make another policy change soon.

It is getting harder and harder for the BoE to justify its easy policy stance over time. Recent economic data suggest that the UK is at full employment. Meanwhile, wage growth is accelerating. Over time, higher pay will pull inflation up. The latest batch of GDP data showed that real GDP growth picked up over the course of 2018. As long as the UK avoids a cliff edge Brexit in 2019, GDP will probably expand in 2018 and 2019 at the 1.8-1.9% pace of the past two years. Risks to this outlook seem skewed to the upside. As Carney has acknowledged, the BoE's tolerance for above target inflation should be very low indeed. The BoE currently expects headline inflation to remain above its 2% target for the next three years.

After surprising markets with a rate hike in November last year, we expect the BoE to surprise markets again this year with another 25bps rate rise at the time of the May Inflation Report – market pricing suggests the hike will come late in the year. Mr Carney could use his Tuesday testimony to begin the process of preparing markets for another rate hike sooner.

Please see '[UK: 8 questions for 2018]' for a detailed overview of our key UK calls for 2018.

Chart 1: Sterling gains only partly due to falling Brexit risks



Monthly data. Source: Bank of England. January data taken from daily value on 28/1/2018.

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