One week after the UK Election: Scenarios for sterling and Brexit

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- Theresa May has pushed forward with EU negotiations despite it being widely expected that she will not last a full term in office
- The pound could fall even lower in the short-term, but we think that the downside is contained
- A 'softer' Brexit may be positive for sterling
- In the event that Britain leaves the EU without a deal, sterling could fall below 1.20 versus the dollar

One week on…

Theresa May has pushed forward with EU negotiations despite it being widely expected that she will not last a full term in office. Indeed, it has been a tough week for May's party following the election result and the devastating fire in London at Grenfell Tower. With the lack of an obvious successor, the Conservatives are uniting behind her, for now.

How far can sterling fall?

In the face of a very surprising election outcome, the market impact was relatively muted. Now, as Theresa May tries to **navigate Brexit negotiations** and the Conservative's weakened political position over the coming days and months, the changing fortunes will likely influence markets. We view geopolitical risks like this election and Brexit as an indicator for sentiment. In particular, sterling has been the barometer of the market's reading of political events.

Most likely scenario: Orderly and softer Brexit

Sterling initially fell by around 1.5% against the US dollar compared to its pre-election level.[1] The political uncertainty could drag the pound even lower in the short-term. While the downside for sterling is far from trivial, it is continuing to hover between 1.20 and 1.25 versus the US dollar. Once Brexit negotiations begin, short-term risks to sterling could recede further.

The pound has been stronger than justified by economic fundamentals since the election was called in mid-April. The interest rate differential between the US and UK would argue for a weaker sterling. On the other hand, valuation metrics offer some support to sterling and will help to limit the potential downside. Measures of the real effective exchange rate show sterling to be somewhat undervalued given the events of the last 12 months.

We think the pound will continue to trade between 1.20 and 1.30 to the dollar – the range it has occupied in the last eight months. In the longer term, it has the potential to eventually push higher once an orderly Brexit deal is agreed.

Risk scenario: Going out without a deal

Although negotiations are set to begin on Monday 19 June, there is still an outside risk of Britain leaving the EU without a deal at all.[2] The triggering of article 50 in March 2017 has left a two-year window to settle legal uncertainties for people and businesses before Britain formally leaves the EU. Given this tight deadline, it is very **possible that decisions and changes will not be made in time** which increases the risk of no deal. For example, should efforts to form a government fail, another general election could be called soon. If that election produces another inconclusive outcome, there will likely be further cause to delay negotiations…

The prospect of a disorderly departure from the EU could push the pound below 1.20 to the US dollar.

GBP to USD exchange rate

Source: Thomson Reuters Datastream as at 16/06/2017

UK Election: The Aftermath

Our investment process is designed to capture the – at times, divergent – signals that are being generated by analysis of the business cycle, market valuations, and prevailing sentiment. These are the fundamental underpinnings that drive our portfolio positioning. We anticipate continued volatility as the Brexit negotiations progress through to the March 2019 deadline. However, both scenarios will provide both risk and opportunity for investors.

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1 Source: Thomson Reuters Datastream, as at 16 June 2017

2 http://www.bbc.co.uk/news/uk-politics-40293260

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