CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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Cold Winds Blow Across 'Sunlit Uplands'

The EU-UK trade deal that was finally agreed on Christmas Eve has had little impact on sterling. EUR/GBP has traded in an 88.5-93p range since last May and has been confined to an even narrower 89-91p corridor since the deal was announced. One reason for this is that an agreement was widely expected by the markets.

Furthermore, it is a very limited or 'skinny' trade deal which does not include services, in particular financial services, and is far inferior to the EU Single Market. Thus, it can hardly be classed as a positive development for the UK economy, although it avoided a much worse outcome in the form of a no-deal Hard Brexit.

Overall, the UK's departure from the EU and its Customs Union and Single Market is viewed by many as lowering the potential growth rate of the economy over the medium term, via negative impacts on investment and trade. Indeed, Bank of England Governor Bailey stated that the deal will likely see a hit of 2% to UK GDP over the next three years, and endorsed forecasts from the Office of Budget Responsibility that this will rise to 3-4% over time.

Already, there are some signs of trade becoming far less frictionless, with business surprised at the complexity of new paperwork, retailers supply chains disrupted by rules of origin stipulations and the City of London losing business to the EU. There are expectations of greater disruptions to trade and delays at ports as trade volumes pick up from their very low levels at the start of the year.

Meanwhile, it is also the case that the recession caused by the Covid-19 pandemic has been much deeper in the UK than in other major economies, with the economy contracting by around 11% last year. Furthermore, the country has just entered a third lockdown which is likely to remain in force for much of the first quarter. As a result, UK growth forecasts for 2021 are being scaled back.

The deep recession has seen the UK budget deficit soar to close on 20% of GDP in FY2020/21, much higher than in other countries and another negative for the currency in an economy with a persistent balance of payments deficit. Meanwhile, given the headwinds facing the economy from both Covid-19 and Brexit, markets are pricing in a further 10 to 15bps in rate cuts from the Bank of England.

This could see the UK move to negative interest rates, which would hardly be positive news for the currency. Although we think that the BoE is likely to continue to eschew this option, especially with an economic rebound still in prospect over the second half of the year.

Taking all these factors into consideration, sterling seems likely to remain a relatively weak currency on a historic basis, trading in an 88-92p range against the euro in the months ahead. Meanwhile, it could trade close to $1.40 versus the dollar.

To put this into perspective, sterling hardly ever dipped below the $1.40 level throughout the whole period from the mid-1980s up until the Brexit Referendum in 2016, despite a number of serious crises over this time frame. The sterling market, then, does not seem to be anticipating that the UK economy is on its way to the promised post-Brexit 'sunlit uplands'.

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