Daily Note

SCHRODINGER'S BREXIT

Oliver Brennan

- **We expect BINO to be the final outcome of the Brexit negotiations; until then the currency market discounts all risks**
- **GBP currently mid-range; we examine the bull and bear cases**
- **UK financials likely to respond temporarily to GBP repricing, but fundamentals matter more for index investors**

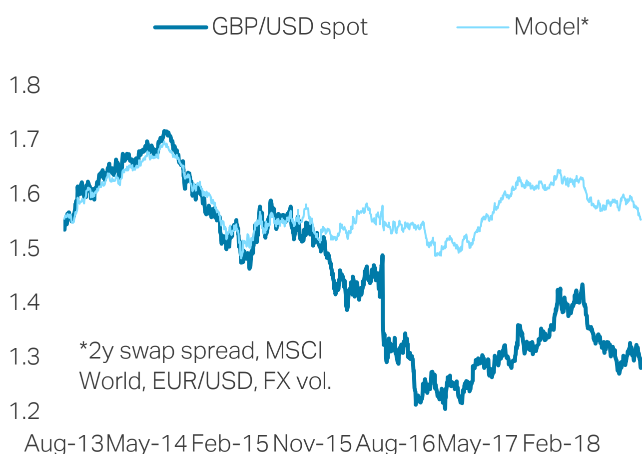
Actually, our title may be a misnomer. When Erwin Schrodinger opened his hypothetical box the cat was either alive or dead, not a mixture of both. Following Brexit day, the UK-EU relationship may be no clearer than it was before.

GBP is simultaneously high and low. The current price of sterling on your screens can be characterised as the superposition of all possible Brexit end states. For ease of calculation in this note, we analyse two states: "BINO" and hard Brexit (no transition period deal, no FTA).

When the box is opened, we expect to find BINO. After all is said and done, we expect the UK government and the EU will agree to a transition deal with minimal change in the relationship between the two countries (i.e. Brexit in name only, or BINO). Therefore we expect GBP to decompose to its 'high' state once BINO is announced. But what is the 'high' state? Valuations can help us deduce the current Brexit risk discount and handicap expectations post-Brexit.

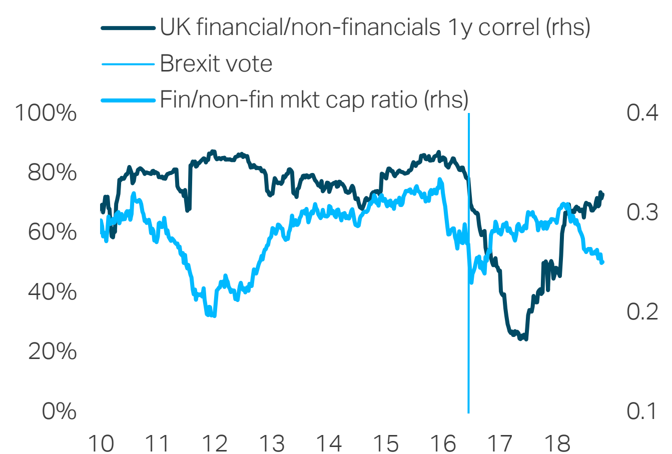
The valuation anchor (1). First, GBP valuation measures help us to understand where the pound would drift to if no other factors were at play. Both the IMF's FEER and long-term REER

GBP at 15% discount to pre-Brexit model level



Source: Bloomberg, TS Lombard

UK financial sector also hit, but damage faded



Source: MSCI, Bloomberg, TS Lombard

deviation have GBP around 15% cheap. Sterling is being compared in both cases mainly to its pre-Brexit range, so the degree to which GBP could rise is probably overstated because it fails to account for increased trade friction, uncertainty over the UK's post-transition status and electoral risks. But GBP is trading well below fair value; we can be confident of a BINO rally.

The valuation anchor (2). Applying a pre-Brexit sample period regression to post-Brexit moves implies that, if there had been no EU vote, GBP/USD might be closer to 1.50 (+15%) and EUR/GBP closer to 77c (-14%). Again, these figures do not account for other risks. Together these anchors suggest GBP/USD at 1.40 and EUR/GBP at 0.80c are reasonable GBP targets GBP under an outcome of the closest possible EU-UK trading relationship after Brexit. Both imply a rise of around 10% from current levels – a retracement of roughly half the initial post-referendum rout.

Hard Brexit vapour trails. Estimating the downside risk is more art than quantum physics. First, the sharp sell-offs in GBP over the last couple of years give an idea of the market's assessment of sterling as a value opportunity (GBP/USD at 1.20 and EUR/GBP at 93c, around 6% below current spot levels). Second, the magnitude of the GBP discount to the pre-Brexit regression estimate incorporates changes in other conditions. The maximum discount has been around 18%, i.e. about 4% more than the regression model.

By these measures GBP presently has more upside than downside risk. But the currency could easily fall further if a no-deal outcome becomes likely or if the government fails to plan for the worst-case scenario. Even in the event of BINO, a rising risk premium due to heightened political uncertainty may limit sterling's gains. We are waiting for a further dip in GBP before we buy it in our Macro Strategy portfolio.

Sterling contagion to other assets. The UK has experienced roughly one political risk event a year since 2014: the Scottish referendum, the general election, the EU vote, another general election. These political risks have tended to raise UK intra-asset correlations, to the extent that the 2016 Brexit referendum triggered a near-10% intraday fall in the FTSE-100 large-cap index and a 14% fall over two days in the FTSE-250 smaller-cap index.

Financials the key sector. The reason for the immediate slump was the decoupling from the rest of the equity market of the financial sector, which fell by 10% in the week after the referendum (vs a +4% rise in MSCI UK). Financials regained strength by the end of the year (shown by the market cap ratio above), and correlation is almost back to the pre-Brexit level.

But to get a measure of the UK share index, look to energy and global stocks. For the UK index, global stocks and energy prices are more important drivers than Brexit. The key to future equity returns lies in the outlook for energy (we reckon Brent prices are toppish at $85) and global stocks (for which prospects are currently murky: trade war and liquidity headwinds remain).

GBP liable to exhibit a large move; echo in stocks likely to fade. All this means that the primary vehicle for expressing a view on the Brexit negotiations is the currency. At the current GBP level we reckon there is slightly more upside on BINO than downside on a hard Brexit, but we prefer to wait for a better BINO discount before trading it. And although financial stocks are likely to rally or sell off in sympathy, history suggests the move in GBP will be more persistent than the one in stocks.

Schrodinger's cat was simultaneously alive and dead in the box. Although the UK sometimes appears to be rather on the weak side of the EU negotiations, we still expect Brexit in name only. There is still life in the UK, too.