Deal or No Deal?

How Brexit could impact the Pound

WORLDFIRST

What were you doing on March, 29th 2018?

Unless it happened to be a significant personal anniversary like one of your children's birthdays or the day you moved house, the chances are you've no idea. It is highly likely, however, that in years to come you'll remember the same date in 2019.

That's because at the end of March the UK will – by one means or another – leave the European Union. What happens after that largely depends on the terms of the deal the two sides strike or, of course, the deal they're not able to strike.

At the time of writing, around 8 possible outcomes – or 'deals' – are still possible, to which we can also add the infamous 'no deal' scenario too. Write them all down and you get a list that looks like the sort of cocktail menu you find in those cool urban bars that used to be a Post Office or a public toilet.

The possible outcomes include:

— **The Blind Brexit**
— **The Customs Union Brexit**
— **The Article 50 extension (to allow more negotiating time)**
— **The Fudge (just extend the transition period)**
— **The Norway**
— **The Second Referendum**
— **The Canada**
— **The Chequers**
— **No Deal**

It is not the purpose of this paper to discuss the merits and shortcomings of each scenario – your local library can probably suggest a book for that. Our job here is to look at all the facts (as they stand today) and ask one very specific question: **what does this all mean for sterling?**

The starting point:
No-one likes uncertainty

Ever since the referendum result back in June 2016, the pound has had a pretty rough ride; it's what happens to a currency when it is forced to swim against a constant tide of political uncertainty.

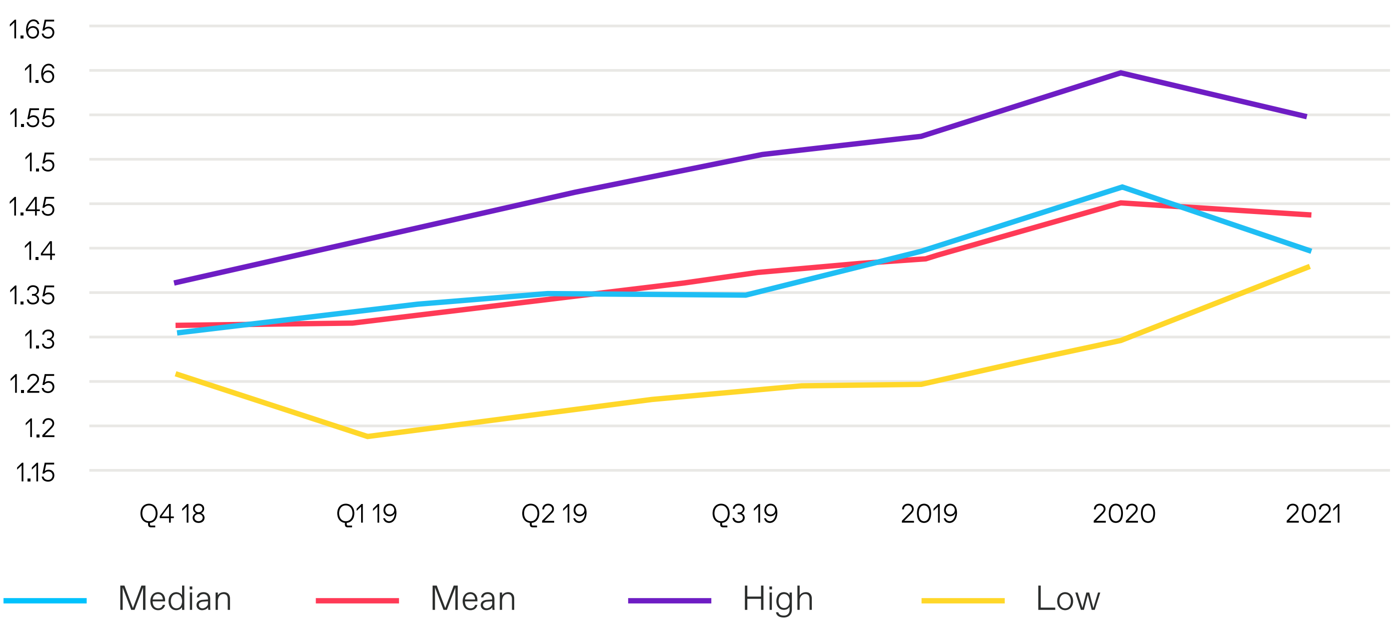
Poor old sterling, it must be knackered.

But, as we head closer to shore in negotiating terms, could some certainty be coming? Could sterling finally find a port in a storm? What will happen after March 2019? Are some 'deals' better than others for sterling?

Over the next few pages we'll outline what we see as the best and worst case scenarios, not for the country, but for sterling. We'll give you our view as to how likely each scenario is too. But before we get going, it's worth remembering that there is still quite some distance left to run in the Brexit negotiations. And that means that the outcome is far from certain. You only need to look at the current High-Mean-Low predictions from leading market analysts on the path of sterling for the next two years to see how such uncertainty manifests itself.

Today, there is a variance of more than 20% in terms of where some leading experts think sterling could be by Q1 2019 against the USD.

Top 90 banks predictions in GBPUSD show 20% spread



Source: Bloomberg, LLP – 29th October 2018

And the effect of such uncertainty can also be seen below; right now there is just over a 70% chance that GBPUSD will in the 1.2008 and 1.3837 range at the end of next March.

	Date	Price Range	Probability
1W	12/06/18	1.2562 — 1.2972	72.4%
1M	12/31/18	1.2264 — 1.3306	71.3%
Q4 18	12/31/18	1.2264 — 1.3306	71.2%
2M	01/31/19	1.2087 — 1.3524	71.7%
3M	02/28/19	1.1984 — 1.3661	72.2%
Q1 19	03/31/19	1.1899 — 1.3785	72.3%
6M	05/30/19	1.1760 — 1.4002	72.7%
Q2 19	06/30/19	1.1704 — 1.4097	72.7%
9M	08/30/19	1.1599 — 1.4283	73.0%
Q3 19	09/30/19	1.1599 — 1.4361	72.9%
1Y	11/29/19	1.1478 — 1.4524	72.9%
2019	12/31/19	1.1434 — 1.4610	72.8%
2Y	12/01/20	1.1041 — 1.5424	72.2%
2020	12/31/20	1.1008 — 1.5495	72.1%
2021	12/31/21	1.0670 — 1.6249	71.6%

Source: Bloomberg, LLP – 29th October 2018

The 'best' case scenario

UK retains membership of the Single Market

Looking at this solely from the perspective of the outcome that would be interpreted most favourably by markets for sterling, any deal that allowed the UK to remain a member of the Single Market would be extremely positive. The big fears for markets are all around trade dislocation, upheaval to supply chains and the prospect of both tariff and non-tariff barriers.

The UKs issue with the Single Market is that membership is absolutely conditional on it continuing to support and accept the free movement of people, something that the Leave camp campaigned hard on and something that the Prime Minister has already said to be out of the question. This does appear to be one issue where there is a clear negotiating line and for that reason we see it as highly unlikely that the UK will wake up to this 'best' case scenario come the 30th March 2019.

UK back to polls for second referendum

Despite 700,000 people marching through the streets of London and several high-profile supporters – in both politics and popular culture – the likelihood of a second referendum, or even a vote on the terms of any deal, look remote. The truth is that it would be a bold move to challenge the outcome of an already democratic process in this way and, in any case, referenda can take a long time to organise (even if it doesn't look that way from the outside).

That's not to say that we have heard the end of the second referendum as a sub-plot in Brexit debate and discussions, far from it. It is also likely that idle referendum chat – or even a manifesto pledge from Labour for example – will breathe life into sterling from time to time, but, in the long-run, we just don't think it's likely.

Best case impact on sterling

So how high could sterling get in this best case scenario? We think it could be possible for sterling to regain the 1.40/1.42 against the USD and towards €1.19 against EUR should either of these outcomes come to pass. However, and crucially, we assign just a 10% probability of this scenario becoming reality.

Scenario likelihood	Potential GBP-USD range	Potential GBP-EUR range
~10%	**$1.40 — 1.42**	**€1.19 — 1.22**

The ‘worst’ case scenario

‘No deal is... just a bad deal’

Midnight on Brexit Day – March 29th 2019 – without a deal is the nightmare scenario for many, not least any UK business that trades internationally. Overnight, years of established trade rules would disappear and the UK would immediately default to World Trade Organisation (WTO) rules, and that means customs checks and additional tariffs. No one is quite sure how this would play out in practice but many are predicting that progress through air and sea ports could slow to a crawl. A border between Northern Ireland and the Irish republic would also become necessary.

Away from the ports, expect some investors to start to withdraw capital from the city, concerned about their ability to do so further down the line. In such circumstances, inflation could rise as tariffs are levied and supply chains cut. Expect growth to slow to a crawl.

Worst case impact on sterling

Remember what happened to sterling after the result became clear? It fell 13% against the USD and 10% against the EUR almost immediately. And back then most commentators still actually believed that the UK would leave with membership of the Single Market in tact and with broad equivalence of regulations in place. We now know that’s not how this ends and most people seem to agree that what follows from a no deal scenario is not good, especially for the pound.

So how low could sterling go in this worst case scenario? We think that we would see an immediate decline in sterling beyond the recent lows of 1.17 against the USD and a move towards parity in GBPEUR – and that hasn’t happened since 2008.

We believe this is unlikely however and ascribe a 25% chance of a no-deal Brexit.

Scenario likelihood	Potential GBP-USD range	Potential GBP-EUR range
~25%	**$1.15 — 1.17**	**€1.00 — 1.02**

The central expectation

Less a matter of if than when

Our central scenario is that a deal will be agreed between the UK and the EU which will be voted upon – and passed – by all necessary parliaments. It is possible, however, that this will not follow the timeline currently in place and that in itself may be problematic for sterling.

The deal as it currently stands would keep the UK as part of the Customs Union into the transitional period, keeping trade a lot more frictionless than a no-deal scenario.

Will it pass parliament?

It has too. Whether this is on the first vote or the second, it has to pass the UK parliament or we are back to talking about a no-deal. We think that the government loses the first vote – if only because the opposition will want to put as much pressure on what is seen is as a weak government – but enough cosmetic changes are extracted from the EU to allow the opposition to rally around the need for a deal.

Sterling volatility is all but assured within this time frame; politicians and sterling aren't suddenly about to get along.

A bit-like Canada

As for what the future relationship looks like, we think that it will most closely mirror the Canada Free Trade Agreement that the EU signed last year, however, that still leaves the not inconsiderable issue of how services businesses can still trade with the wider EU. That's one to tick off during the transitional period.

As for sterling, in the short term, any form of a deal is a positive and GBPUSD would likely break into the mid/late $1.30s as a result of the pricing out of any no-deal concerns. This is our central scenario and therefore we assign a 65% probability of this scenario becoming reality.

Scenario likelihood	Potential GBP-USD range	Potential GBP-EUR range
~65%	**$1.36 — 1.38**	**€1.16 — 1.18**

How our predictions compare with the Bank of England assessment

At the end of November, the Bank of England outlined its own post-Brexit scenarios for the economy. It offered four eventualities based upon the current mooted agreement and on a possible 'no deal' situation, which included sterling predictions:

	GBP — USD	% Change as per 30/11/18 ($1.28)
"Economic Partnership, Close"	$1.34	+5%
"Economic Partnership, Less Close"	$1.31	+2%
"No Deal Transition, Disruptive"	$1.09	-15%
"No Deal Transition, Disorderly"	$0.96	-25%

The Bank's outline for a "disorderly" no deal eventuality naturally stole the headlines with predictions of a truly cataclysmic drop in sterling to below USD parity. Beyond even our worst nightmare, this is something the Old Lady herself admitted was an unlikely scenario.

But, the Bank's more sanguine scenarios put the pound in and around $1.30 - $1.34, which broadly reflects our most likely outcome.

What can businesses do in the meantime?

"Prepare for the worst, hope for the best"

Markets are not the only ones to dislike uncertainty – owners and managers of businesses trading overseas are not big fans either. If that includes you, you'll no doubt be wondering what your strategy should be to see you through the next few months, especially with sterling likely to react so differently to the possible outcomes.

If there's some solace here, it's that you're not alone. WorldFirst's most recent Global Trade Barometer highlighted one of the stranger juxtapositions in the operations of UK SMEs ahead of the end of the Article 50 period.

Nearly half (48%) of UK SMEs – that's around 2.7 million businesses – believe the value of sterling will decrease after the UK leaves (with a third predicting a fall of over 10%) to the EU and yet nearly two thirds are doing nothing to protect themselves against that risk.

It is almost like the majority of British SMEs have heard the storm warnings and seen the dark clouds gathering but still need to see the first drops of rain to believe it's coming their way.

This winter, don't forget your SCARF

To borrow a well-known phrase 'winter is coming' and we think that British SMEs would do well to remember their 'SCARF' to secure their businesses against the ill winds that may be on their way.

S **Set Budget rates —** Set a budget rate that guarantees currency moves will not hurt your profitability

C **Certainty of terms —** Talk to suppliers and customers now to avoid confusion caused by Brexit uncertainty later.

A **Access to markets —** Put in place back-up plans with global conveyors to ensure supply chains remain flexible and stockpile if necessary

R **Regulatory assurance —** Compare regulatory environments for similar products from non-single market competitors

F **Funding plans —** Arrange facilities with alternative finance providers should banks be unwilling to help

Conclusion

We have a little less than four months to go until the Article 50 period ends and while there is a deal on the table now, passing parliament is the last acid test. Until it does, UK SMEs and the pound are in as much uncertainty as before but with less time on the clock.

Are you ready?

Talk to a WorldFirst currency expert today on **020 7801 1050** and make sure Brexit doesn't catch out your business.

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