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Market Update: 23rd January 2020

The Pound Strengthens on Improving Data

Despite market expectations for a cut to the UK base rate at the Bank of England's policy meeting next week, the threat of a rate cut seems no impediment to a stronger pound this week. Having recovered from a drop earlier this month to below $1.30 (for £1) after policymakers indicated there was room for more quantitative easing, the pound is currently trading around $1.31. As it stands, markets are pricing in a 60% chance of a January rate move, with the focus turning to Friday's manufacturing and services data for clues on what policy makers will announce on 30th Jan.

According to Bloomberg median estimates, sterling is expected to strengthen over 2020, ending the year around 3% stronger against the dollar. This expectation is based on a relatively smooth UK exit from the EU, drawing capital inflows into sterling assets, and resonates with the pound's turnaround from its recent decline after policy makers pointed to potential rate cuts. So far, the volatility experienced in the pound following the UK General Election is in line with our expectations, however although we see the pound strengthening further given improving economic data (to c. $1.35) while we could also see weakness in the dollar due to Fed stimulus measures, we see further volatility ahead for the pound, with risks weighted towards the second half of the year as the Government's progress towards securing a free trade deal with the EU faces increased scrutiny.

According to analysts, if the central bank does choose to cut rates next week, not only would it be a one-off move, but it could help the UK economy and in turn end up supporting the pound. After gaining on the back of the resounding Conservative victory in the election, the currency declined earlier this month after comments by policymakers calling for stimulus.

As shown in the chart below, the median forecast is for sterling to end at $1.35 by the end of the year, however some currency analysts forecast it will increase to $1.40. This will all depend on the outcome of negotiations with the EU as the UK officially leaves the EU at the end of the year.

The consensus is that if the Bank of England are to cut interest rates by the end of the month, it will be more of a risk-management exercise to attempt to solidify expectations for a rebound in growth. While a January cut could mean some near-term pressure on sterling, the currency isn't expected to significantly weaken, and Brexit risks are unlikely to flare back up anytime soon, indicating greater stability in the pound in the medium term.

Boris Gets a Green Light on Brexit Deal

The Prime Minister's Brexit deal cleared final hurdles in Parliament yesterday, paving the way for Britain to leave the EU in eight days' time. Ahead of the UK's exit at the end of the year, the next stage of Brexit negotiations is likely to prove challenging given the short window remaining to negotiate a free trade agreement. Risks remain over whether a substantial agreement can be made by then, and our base case expectations are that there will be an agreement in principle involving a long implementation period while details are ironed out. Given the history of EU-UK Brexit negotiations, however, there is a risk that this could run down to the wire before a last-minute agreement is reached, reducing hopes for a significant relief rally before the end of the year.

Supportive Data

The Monetary Policy Committee will have sought some reassurance from this week's economic data releases, calming market expectations of a January interest rate cut. Headline labour market indicators remained surprisingly resilient against a backdrop of weak economic growth. The UK labour market data for the three months to November showed sizeable increases in both employment and participation. Pay growth remained strong in real terms, and with a tight labour market likely to support more continued increases in pay while inflation remains subdued, UK consumers appear set to benefit from increased spending power in 2020. Additionally, this week's rebound in the main balances of the CBI Industrial Trends Survey offers further evidence that sentiment has taken an upward turn after the General Election. CBI Business optimism surged from -44 in October to +23 in January, the biggest quarterly change on record, giving a clear indication that companies are feeling much more upbeat after the general election. At the same time, with public borrowing looking like it will come in below the OBR's forecast this year, the government appears to have the room to loosen fiscal policy further to boost the economy.

With policymakers on high alert for further signs of weakness in the UK economy before backing a rate cut, the bright spots in the data which have appeared this week could dissuade some members of the MPC against a January rate movement. Without a critical need for lower rates, it appears unlikely that Governor Mark Carney will change policy direction in his last meeting at the helm of the BoE.

Outlook

Overall, it is our view that the outlook for sterling remains positive, with expectations for a gradual appreciation to $1.35 over the year. In the near term, we could see further weakness in the pound should the central bank cut rates, however our view is that the pound will continue to appreciate as the UK economy regains steam and uncertainty abates. Should the MPC resist calls for a rate cut this month, the likelihood of a loosening in fiscal policy in the March Budget (two weeks before the March MPC meeting) along with an expected recovery in the data suggests that the appetite for cuts will ease.

In terms of the UK outlook, we remain positive on the outlook for the first half of 2020, with recent data suggesting an improvement in the economic fundamentals in the UK economy. It is our view that the internationally exposed FTSE 100 carries more risks given elevated valuations and negative FX movements, however we see UK small and Mid cap companies being well positioned to benefit from a recovery in the UK economy combined with expectations for extra fiscal stimulus. In the second half, we may see some resurgence of Brexit related uncertainty, however the impact of this will depend on the strength of the UK economy and the progress towards recovery made over the first half of the year.

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