3) **Absent rate support, sterling much more vulnerable to twin deficits and expensive valuation.** A robust recovery and high interest rates relative to European peers has helped to finance a very large deterioration in the UK's current account deficit since 2011. As we have previously argued, much of this is structural; a result of falling profitability in the UK's highly concentrated foreign direct investments dragging on the income balance. If rate support were to fade, slowing foreign capital inflows could see a sharp correction in sterling. Given the prospect of another four years of fiscal tightening, a weaker currency should also be beneficial to the UK's growth mix, which remains geared towards consumption. This makes valuations very unappealing. As my colleague George Saravelos has argued, the pound is now the most expensive currency in the world measured on an average of REER, BEER and FEER valuation metrics.

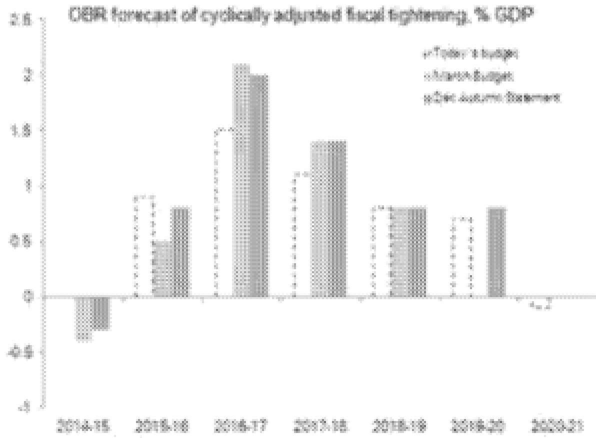
In sum, with a near-term hiking cycle off the table, the rationale for being long sterling has disappeared. Further analysis will need to be undertaken for the future outlook. In the meantime we recommend turning short GBP/USD, which should also benefit from our bearish EUR/USD call.

Our GBP/USD forecast for end-2016 and end-2017 is 1.27 and 1.15 respectively.

Figure 1: Monetary policy repricing suggests GBP/USD downside

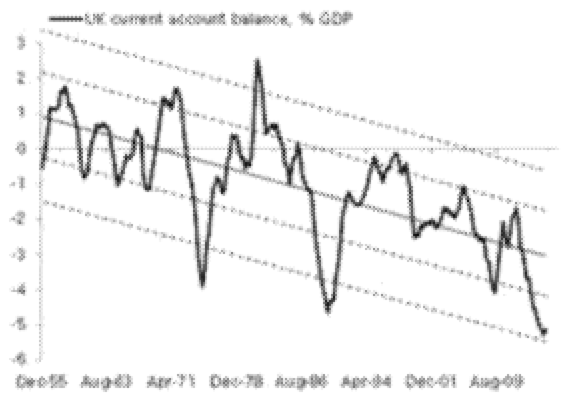
Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: Fiscal tightening will pick up sharply next year in the UK



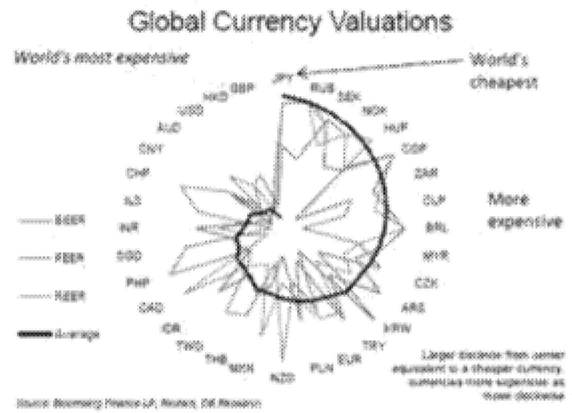
Source: Deutsche Bank, OBR

Figure 3: UK's very large current account deficit, even relative to trend, to become a problem



Source: Deutsche Bank, Bloomberg Finance LP

Figure 4: Sterling is world's most expensive currency



Source: Deutsche Bank