

Subject: RE: Changing DB's view on GBP, turning very bearish [C]
From: Paul Morris <[REDACTED]>
Date: Thu, 05 Nov 2015 21:14:24 -0500
To: Daniel Sabba <[REDACTED]>, Vahe Stepanian <[REDACTED]>
Cc: Stewart Oldfield <[REDACTED]>

Thanks Daniel, let's try to catch up soon and if you could collaborate on future trade ideas before they go out would be great.

-----Original Message-----

From: Daniel Sabba
Sent: Thursday, November 05, 2015 01:25 PM Eastern Standard Time
To: 'jeffrey E.'
Cc: Paul Morris; Stewart Oldfield; Vahe Stepanian; Ariane Dwyer; 'Richard Kahn'
Subject: Changing DB's view on GBP, turning very bearish [C]

> Classification: Confidential

Jeffrey – please see below.

From: George Saravelos
Sent: Thursday, November 05, 2015 11:27 AM
Cc: Oliver Harvey
Subject: Changing our view on GBP, turning very bearish

From Oliver Harvey:

Today's November BoE inflation report marked a fundamental departure from recent Bank of England communication on the prospects of policy tightening.

First, the Bank explicitly validated dovish market repricing after the September period of risk aversion. The 2-year-ahead CPI forecast was essentially unchanged from August at just above 2%, but was based on a market yield curve implying the first rate hike in Q1 2017. Second, the risk to this forecast was seen as 'to the downside.' Third, the Bank talked up the impact of sterling strength on the CPI over the whole course of the forecast horizon, based on new work by bank staff.

In this sense, the BoE has clearly followed the lead of the ECB and not the Fed by prioritizing a weak external environment over domestic developments, and expressing intolerance of further FX appreciation. This changes our long-standing bullish GBP call held since September 2014. We take profit on our short EUR/GBP and long GBP/USD trade from the September Blueprint at a gain of 1.35%, and now see three reasons to turn outright bearish the pound:

1) Short-end rates now suggest GBP downside. Reacting to today's report, short-end rates have shifted hikes back into 2017. GBP/USD has closely tracked the relative timing of UK vs. US rate hikes and this mechanically implies the cross below 1.50. As well as the short term reaction, though, rate support may be undermined more broadly.

2) The window for policy exit may now close. Absent a remarkable volte-face, the MPC has now relinquished its optionality for a hike in H1 next year. The problem is that it may be too late after that for exit. Fiscal tightening is set to pick-up sharply in 2016, with the UK undergoing the largest fiscal consolidation of any G10 economy, at 1.5% of GDP. Growth has already slowed sharply from over 3% in late 2014 back towards trend. Autumn next year is also the most likely time for an in-out EU referendum. As we have recently written, the outcome appears to be becoming increasingly close, with an 'out' vote carrying huge political and economic consequences.

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.

{image004}

{image006}

George Saravelos
FX Research

Deutsche Bank AG, Filiale London
Winchester House, 1 Great Winchester reet, EC2N 2DB London, United Kingdom
Tel. [REDACTED]
Mobile + [REDACTED]
Email [REDACTED]