



Staying Bearish GBP

We've been bearish sterling since the start of the year and stick with the view, despite the last few months' squeeze. First, the recent run of positive UK data surprises versus the US and Euro-area appears to have reached extremes. Even if the run of positive UK data continues, it is difficult not seeing a greater catch-up from the country's two main trading partners.

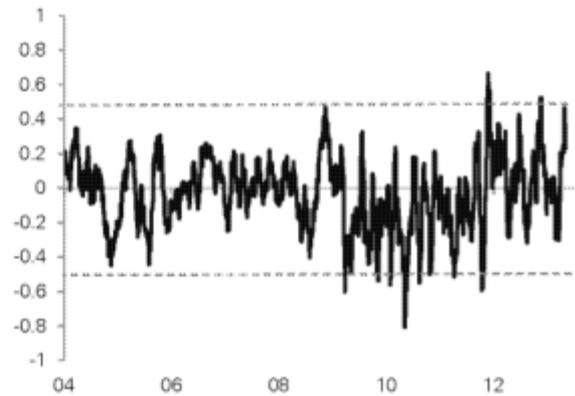
Second, outside of its recent potential to squeeze GBP shorts, we don't think the moderate improvement in the data outlook matters much anyway. Unlike the Fed, the BoE won't shift to less easing anytime this year, so the market can't price much in terms of relative monetary policy tightening. In contrast, GBP correlations with risk appetite (eg. the FTSE) have shifted to negative over the last two years. Improved risk appetite is associated with higher portfolio outflows from the UK given the extremely low level of real yields - the lowest in the world.

Third, we believe that flow, not data, will be the dominant driver behind GBP. On that front, we think it is fair to say that sterling has the worst flow dynamics in the world. Portfolio inflows remain exceptionally weak due to very negative real yields. The trade balance remains stuck in deficit due to the high share of services, the big rise in ULCs in recent years, as well as persistent negative J-curve effects. Perhaps even more worrying, the investment income balance is deteriorating rapidly. This, not trade, has been the biggest drag on the UK current account and has small potential to improve in coming months. For any EM country, this deterioration would flash warning lights on the sustainability of the external position. This is very negative in the UK and growing. On top of this, it stands in sharp contrast to the US. Even though both have current account deficits, the UK appears to be suffering from a more structural decline in the relative profitability of its foreign investments - pointing to a more permanent decline in the UK financial system's capacity to transform foreign "safe haven" inflows into higher-yielding foreign assets.

Finally, the risks are skewed towards higher "political" and "policy" premia on GBP. The continued dramatic decline in Eurozone risk premia should hurt GBP the most given that sterling has been one of the biggest beneficiaries of "safe haven" inflows from the Eurozone. On a more medium-term basis, the ongoing domestic political debate around an EU membership referendum on top of EU initiatives towards increasing regulatory burdens on the financial sector (financial transaction tax, among others), will do little to provide a medium-term uplift to UK structural competitiveness.

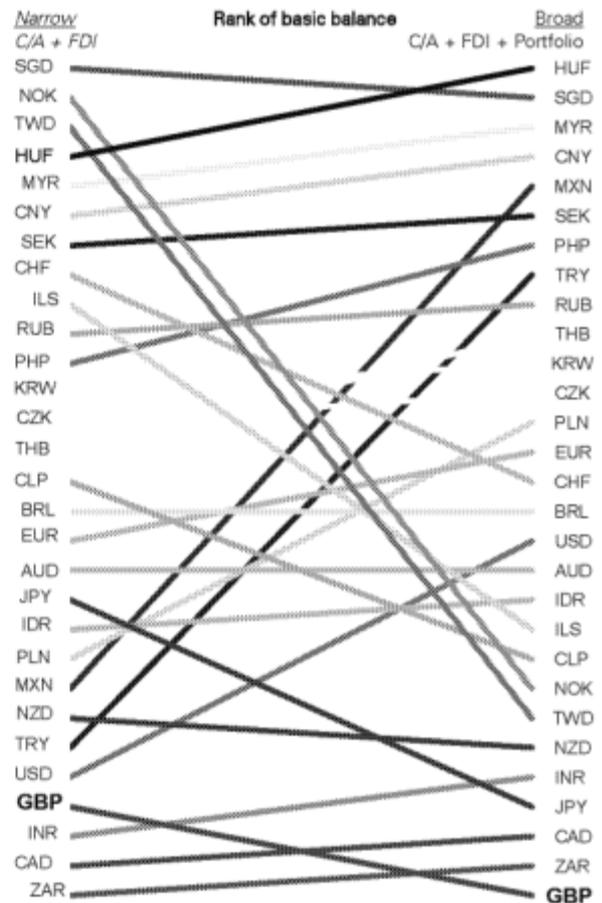
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UK vs Avrg US & Euro Data Surprises At Extremes



Source: Deutsche Bank

UK and Canada Have Worse Basic Balance in World



Source: Bloomberg Finance LP. *Average of 3M rolling correlations over the past 5 years.