



Theme #2: Brussels sprouts – sell GBP vs USD & SEK

- Stretched valuation, unsustainably large capital inflows and renewed political risks spell the end for the sterling uptrend.
- Stay short GBP/USD as Fed and Bank of England policy diverges. Short GBP/SEK also makes sense from a relative value perspective.

Sterling has far outshone its peers since the start of the dollar uptrend in April 2011. The pound has fallen just 7% against the greenback versus a 30% move in the broad USD TWI (figure 1), with only the Korean won doing better among floating rate currencies. There are now plenty of reasons to think outperformance is over.

The pound is expensive

First, sterling is expensive on several metrics. Two year rate spreads suggest cable closer to the low 1.40s. The cross has also closely tracked the relative number of months between a US and UK tightening cycle, which also imply downside based on current market pricing. Using a medium run valuation framework, the currency is the most expensive among all the majors on a combined PPP, BEER and FEER basis.

Record capital inflows may not be sustained

Second, it is doubtful whether the huge capital inflows the UK has generated and seen the current account deficit widen to the largest in history can be sustained. As figure 3 shows, these have been very sensitive to the UK's relative growth rank with other developed economies. Britain has fallen from the top of the pack back in 2014 to number four today, and will drop to number six if the softer growth momentum implied by GDP revisions in Q3 December endures.

Drilling down into flows, robust net direct investment was boosted by record M&A inflows last year. This may be difficult to repeat given rising US interest rates and renewed focus by US authorities on tax inversion deals. Most of the inflows, though, have been portfolio, broadly balanced between equity and debt. For the former, EFPR data suggests that healthy inflows in Q2 and Q3 have turned. On the latter, fixed income inflows have been highly sensitive to relative monetary policy stances, with the UK one of the largest beneficiaries of the compression of term premia from ECB QE. But monetary policy divergence may have peaked, with the prospects of more ECB easing seemingly off the table for the first half of next year, while the Bank of England has become much more cautious about tightening.

Fiscal and monetary tightening may prove a challenge. Growth risks appear skewed to the downside too. The UK is set to undergo renewed austerity next year. At 1.3% GDP, fiscal tightening is less than previously forecast, yet will still be the largest of major developed economies. A sharp increase in fiscal tightening may be the 'hidden' reason growth has slowed this year and a further pick-up could put rate hikes on ice indefinitely.

GBP has outperformed almost every other currency since the start of the USD uptrend



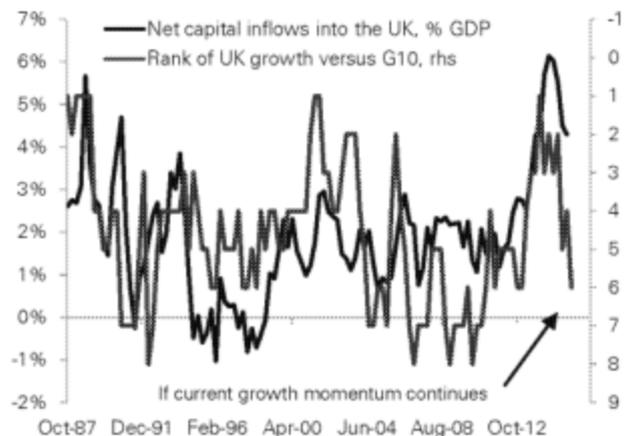
Source: Global Markets Research; Bloomberg Finance LP

The pound already looks expensive to rate spreads



Source: Deutsche Bank; Bloomberg Finance LP

Debt inflows mean reverting appear to have peaked



Source: Deutsche Bank; Bloomberg Finance LP