

# Will Sterling Stay in the Sweet Spot?

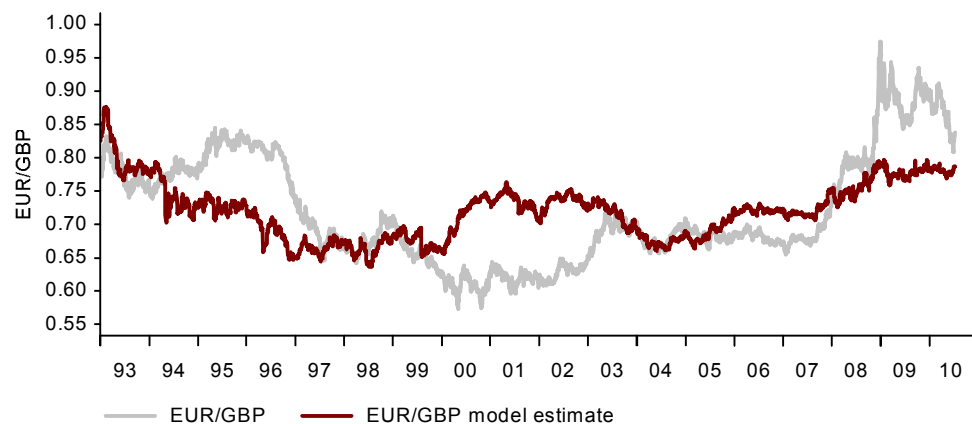
***Our baseline scenario for sterling is still for inflation to subside and for policy divergence to be no more than a minor driver. In this environment, valuation and positioning, and continued fiscal consolidation should be sufficient to maintain a favourable trend in the trade-weighted GBP. However, this view is dependent on a continued economic recovery (i.e. rising in tax revenues), and [eventual] policy normalization. If tax revenues drop with lower growth, then the UK's budget deficit would not easily be brought in line with forecasts, which in turn would lead to a fall in the value of the British unit. Moreover, stubbornly high inflation combined with the UK's fiscal position represent a risk for the pound, in particular if policy rates stay put because of soft economic activity.***

## Limited scope for normalization suggests policy divergence to take backseat

Money market curves are not pricing in any tightening in the US, Eurozone, UK and Japan over the next six months, and no more than one 25bp hike over the next 12 months. Little to no policy divergence between the majors is largely consistent with the view of the majority of central bank watchers and suggests that currency direction going forward will be less determined by policy, and more by the strength of the recovery and risk appetite, as well as fiscal consolidation, capital flows, etc.

However, before discussing other drivers it is useful to get a feel for where GBP currently is trading in an historical context, and in relation to policy expectations. Estimating EUR/GBP as a function of the futures spread (3<sup>rd</sup> pos) suggests that EUR/GBP around 0.78 would be more in line with the interest rate market. Repeating the same exercise for GBP/USD, again only using data post-September 1992 when the pound exited ERM2, suggests a rate of 1.64 (though rate spreads typically play a much smaller role in determining the direction in GBP/USD).

### EUR/GBP - 'rate estimate' vs. spot



Source: Deutsche Bank, Bloomberg

If anything this would indicate that GBP remains undervalued from a rates perspective. However, these 'valuation gaps' can be sustained for long periods of time. So the question now is: will GBP