



Theme #3: – Home Counties trump Mounties

- Inflation risks and potential FDI inflows should keep sterling supported this year, but a widening current account deficit and stronger USD will constrain gains versus the euro and dollar. We are moderately bearish EUR/GBP and GBP/USD, forecasting 80p and 1.54 by end-year respectively.
- As an outright trade we prefer buying GBP versus CAD, on which we are more bearish. It remains vulnerable to an equally-large current account deficit, QE-flow unwinds and unwinding internal imbalances.

The UK domestic demand cycle has kicked in quicker, stronger and more sustainably than anticipated. We see inflation and FDI inflows as being the major source of upside risk for GBP next year.

Inflation, not deflation to be theme in 2014

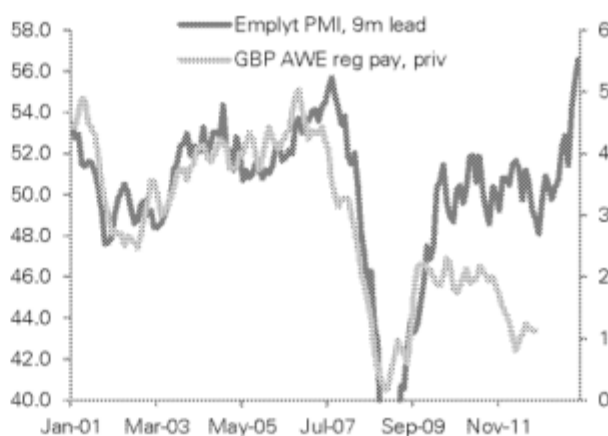
Last year was all about UK growth expectations. This year, the risk is attention turns to prices. First, even though recent inflation prints have surprised to the downside, pipeline pressure is building. Productivity is not recovering as quickly as the BoE is expecting, leading to a much faster than expected drop in the unemployment rate. In turn, wage inflation could accelerate sharply in 2014 (chart 1). Second, the starting point of inflation is much higher in the UK than the rest of G10. Any turn in the trend will focus minds much more quickly than elsewhere. With the first BoE rate hike still only priced for mid-2015 (a bit earlier than the Fed), there is plenty of potential for near-term yield support as price pressure builds.

Outside of monetary policy, FDI is another source of support. Excluding the Verizon-Vodafone deal, UK inbound M&A has been muted by pre-crisis standards. But UK deal-flow is pro-cyclical, tracking the broad trends in equities and global M&A transactions well. Our equity analysts are positive on both this year. Add to that the UK government’s increasing dedication to attracting foreign investment – particularly into the publicly-owned banks – (chart 2) and FDI stands out as a potential additional source of support for GBP in 2014.

Current Account Deficit Will Constrain Gains vs. EUR

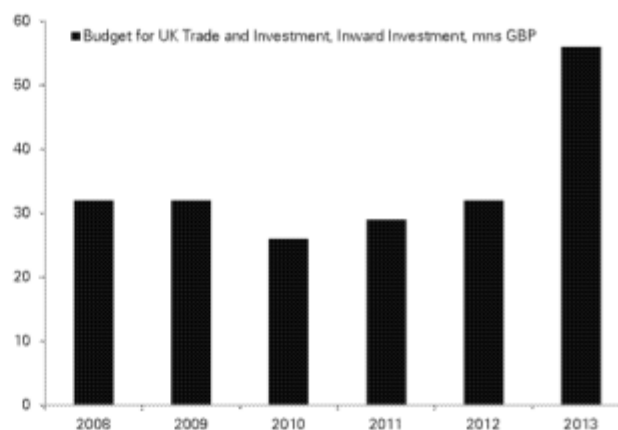
On the flipside, the UK recovery is happening for the “wrong” reasons. Domestic demand, not exports are driving the cycle. The current account deficit is deteriorating and stands in contrast to the US and Euro-area. This goes a long way to explain the lag in EUR/GBP versus cyclical indicators (chart 3). This is reflected in our conservative EUR/GBP forecasts: we see a slow grind lower to 0.80 by the end of the year, with GBP/USD revisiting the low 1.50s on the back of a strong USD.

Inflation Could Be Here Sooner Than Market Expects



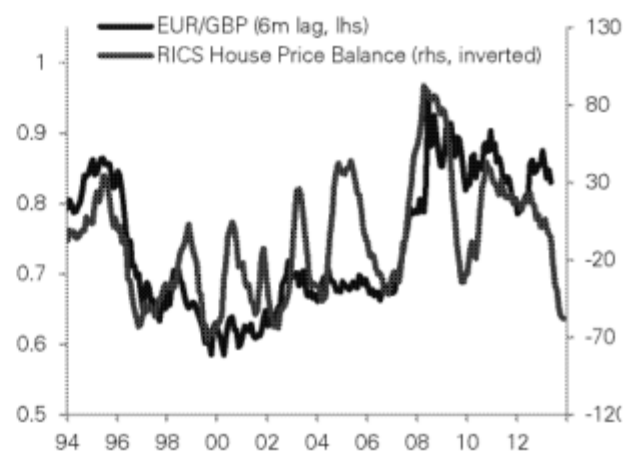
Source: Global Markets Research, IMF

FDI Upside Risk To GBP Next Year



Source: Deutsche Bank, Bloomberg Finance LLP

EUR/GBP Holding Up Better on Back of Flow



Source: Deutsche Bank, Bloomberg Finance LLP