



FX Daily

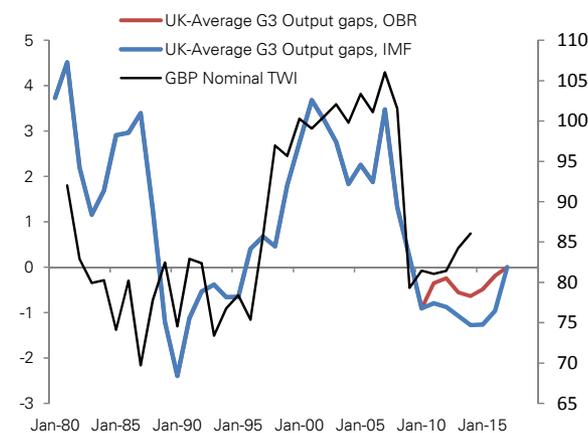
Don't fear Carney creep, follow the flow

Arguments over spare capacity and productivity may seem arcane, but they are important for currencies. Relative output gaps have done a good job of explaining sterling performance against the majors over the last two decades.

Today, the Bank of England will reassess its views of spare capacity in the UK economy. Even if the central bank abandons the dramatically falling unemployment rate as its real activity indicator for forward guidance, as expected, we think those hoping for a dovish outcome may be disappointed. First, rates market pricing has retraced to close to November Inflation Report levels. Then, the first hike was being priced 'in line' with the Bank's assessment of the probability of the unemployment rate falling below 7% (around mid-2015). This suggests the market already anticipates a replacement for the unemployment rate as a tool to keep rates expectations on hold until the middle of next year. Second, pricing remains dovish. Our fixed income strategist has noted that both the pace of hikes and terminal rates already imply a very cautious Bank of England relative to history.*

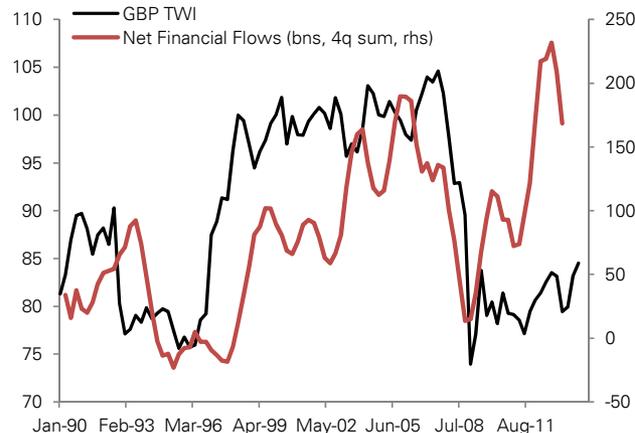
Looking ahead, however, we don't see economic data as the key driver of sterling strength, as last year. To be sure, indicators remain exceptionally strong, but most have stabilized or declined in recent weeks, and the pound has correlated more with the change than the level of data in the past. Instead, we would argue that it will be capital flows rather than growth that help GBP. One source is FDI. While M&A inflows have so far failed to materialize, the cheapest equity valuations in G10 and a strong cycle should see this change. We therefore like to play sterling against currencies with weak flow dynamics (such as CAD), but would be more cautious against the EUR and USD, where the current account and FDI respectively mean flows are also supportive.

Relative output gaps explain pound performance



Source: Deutsche Bank, Bloomberg Finance LP, IMF, OBR

Financial flows already supportive of higher GBP



Source: Deutsche Bank

*See UK Fixed Income Weekly, Soniya Sadeesh, *Waiting For Guidance*, 7th February 2014