Trade Idea – Foreign Exchange
Persistent uncertainty to weigh on Sterling
11th February 2016

Bearish sentiment dominates

- The turn of the year has seen bearish sentiment prevail as concerns over tumbling oil prices and Chinese growth have sent global equity indices reeling. The uptick in volatility has had opposing effects for the GBP and the JPY, with the GBP/JPY currency pair falling 5.6% year to date (up to 11th Feb, Source: Bloomberg). Rhetoric from the Bank of England (BoE) and the Bank of Japan (BoJ) also suggests that respective policies promoting further interest rate divergence between the two nations are unlikely to materialise in coming months as unstable conditions warrant a more cautious approach. In the next month, we expect instability in the financial landscape and concerns over a “Brexit” to maintain the GBP/JPY exchange rate on its current downward trajectory, benefitting those investors with short exposure to the currency pair.

Figure 1

GBP/JPY follows stocks lower...

Volatility weighs on GBP...

Source: Bloomberg, ETF Securities

Volatility has opposite impacts

- Market volatility has historically had opposing impacts on the GBP and the JPY. The UK’s relatively large current account deficit of 4.7% and the importance of the financial sector has made it vulnerable to market instability (see Figure 1), while Japan’s 2.9% current account surplus has made it a traditional destination of safe haven cash flows. The current bout of market duress has proved these relationships still hold, with the GBP/JPY exchange rate mirroring the stock market’s move lower so far this year (see Figure 1).

Dovish MPC and “Brexit” concerns to pressure Sterling

- The BoE’s February inflation report and Monetary Policy Committee (MPC) meeting minutes both confirm the Bank’s view that current conditions are far from ideal for the UK to follow the US in raising rates. Despite healthy domestic demand, the deceleration of wage growth and a more pessimistic view of global trade have prompted the Bank to lower its growth and inflation forecasts for the years ahead. Accordingly, market pricing of an initial interest rate hike has shifted further out to Q4-2017, removing any near term support for the GBP from the prospect of higher interest rates.

- The recent revelation of a draft deal on the UK’s renegotiated position within the European Union (EU) brings the country ever closer to a June referendum. The terms of the deal have come under fire by Eurosceptic politicians, but nonetheless will form the basis for negotiations at the upcoming EU summit on February 18th-19th, where it will require approval from Britain’s 27 EU counterparts. With voting polls showing a 9% lead for those wishing to leave the union (see Figure 2), the EU summit...
will bring “Brexit” risks to the fore. Growing concerns over the potential impact of a “Brexit” scenario will act as yet another factor adding to investor concerns regarding market stability and likely weigh further on the GBP/JPY exchange rate in weeks to come.

**Figure 2**

![Support for "Brexit" grows...](image)

Source: YouGov, ETF Securities

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- ETFS 3x Long JPY Short USD (LJP3)
- ETFS 3x Short JPY Long USD (SJP3)

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