Trade Idea – Foreign Exchange
Domestic inflationary pressures build
22<sup>nd</sup> October 2015

**Deflation to subside**

- Last week a report from the Office of National Statistics (ONS) showing that consumer prices fell by 0.1% pushed market expectations for a UK rate hike out beyond 2016 and exerted downward pressure on the GBP against the EUR. We believe that such dovish expectations are unwarranted and will be subject to revision as soon as the deflationary impact of energy prices subsides towards the end of the year. Furthermore, domestic inflationary pressures should also help inflation return to more normal levels and indirectly support the GBP. Therefore, we believe for those investors with a medium to long term time horizon, now is an ideal time to build long exposure to the GBP against the Euro.

**Tightening labour market to support prices**

- While broad consumer inflation dropped in September, core inflation, which removes the impact of energy and food, remained unchanged at 1% (Source: ONS). Domestic cost pressures have built from higher wages, which in coming months should see inflation return to more normal levels (see Figure 1). The Bank of England (BoE) has cited for some time that inflation should normalise when the impact of plunging energy prices “wash” out of annual inflation figures. Although still not likely to reach the BoE’s 2% target, stronger levels of inflation should encourage the Monetary Policy Committee (MPC) to vote more hawkishly in upcoming meetings and eventually raise rates in the first half of 2016. We believe this will lend support to the GBP against the Euro, as the European Central Bank (ECB) remains firmly in easing mode.

**Figure 1: Labour costs rise**

Data is 4-quarter average. Source: Bloomberg, ONS, ETF Securities
**Top of recent range**

- The EURGBP has consolidated between 0.7-0.74 since February (Source: Bloomberg) and is currently at the upper end of this range. From a technical perspective, current levels are an attractive point to enter into a long GBP and short EUR position and exploit supportive fundamentals (see Figure 2).

![EURGBP Spot exchange rate](chart)

**Figure 2: EURGBP expensive**

Source: Bloomberg, ONS, ETF Securities

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