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MARKETS

Investors Betting Against the British Pound Fear a Reversal

U.K. Prime Minister Boris Johnson's recent Brexit talks prompted a rally in the currency

The pound's rally from its lows in recent days is forcing some investors to exit short positions on it, or even wager on a further rally. **PHOTO:** DOMINIC LIPINSKI/ZUMA PRESS

By Anna Isaac

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Some investors are betting that the biggest risk to the British pound isn't that the turmoil around Brexit causes it to plunge further against the dollar, but that it stages an unexpected rally.

The pound was hovering at $1.2250 on Tuesday, just above its August low, according to FactSet. Still, sterling is down about 17% in value against the U.S. dollar since the Brexit referendum of June 2016. The currency is being weighed down in part by hedge funds and other speculative investors, who reached their highest net short positions—bets that the pound will drop further—this month since April 2017, according to data from CME Group .

The pound's rally from its lows in recent days is forcing some investors to exit short positions on it, or even wager on a further rally. Driving the rally: a perceived softening in attitudes toward a compromise Brexit deal following U.K. Prime Minister Boris Johnson 's meetings with French President Emmanuel Macron, German Chancellor Angela Merkel and other EU leaders in recent days.

Some speculate that Mr. Johnson might secure a smooth transition out of the EU, ending over three years of political uncertainty and economic turmoil.

“Volatility is too high in the short term to stay short,” said Yujiro Goto, a currency strategist at Nomura Holdings Inc. “We’ve had a lot of headlines around Prime Minister Johnson’s meeting with Macron and Merkel. The market reacted quite positively at the suggestion that there could be a compromise.”

His firm’s strategy has shifted from shorting the pound’s value against the euro to a more neutral stance. There hasn’t been a breakthrough yet, Mr. Goto said, but if there were one, he forecasts that the pound might strengthen to $1.30.

Nomura isn’t the only firm seeing risks ahead for the pound. Investors have been expecting its value to drop further if the country quits the European Union on Oct. 31 without a trade deal in place, disrupting the flow of goods and people between the U.K. and its largest trading partner. Earlier this month, it fell to $1.2057, its lowest since 1985.

In its latest quarterly inflation report, the Bank of England said market participants believe the pound could trade as much as 9% higher if a deal is reached. The central bank modeled the risk of sterling being 5% to 10% stronger on an exchange rate-index basis in its inflation projections in the case of a smooth transition out of the EU.

For any U.K. investor with foreign-currency exposure in their portfolio, a stronger pound would be “quite painful” said Willem Klijnstra, a currency strategist at Legal & General Investment Management. His firm is betting that sterling will rise, as even just an extension to the Brexit deadline could trigger a meaningful rally in the pound, Mr. Klijnstra said.

If the Brexit process was resolved in a way that proved to be minimally disruptive to businesses, “then all of a sudden we have an economy that’s doing relatively well versus the rest of Europe,” Mr. Klijnstra said. “If the cliff edge is removed, things look a lot better for sterling than the euro at the moment.”

The sterling is currently worth about 1.10 euros, having dropped 16% since the referendum.

The U.K. Parliament’s return from summer vacation in early September will shed light on how the country’s lawmakers might try and combat a no-deal exit.

There is a risk that the currency may strengthen, but that is only a small possibility, according to Van Luu, head of currency and fixed income research at Russell Investments, who has a short position on the pound. The recent appreciation in the sterling was about more than a potential Brexit compromise, he said.

"Some investors we've been speaking to, who are short the pound, have closed out that position to lock in profits," Mr. Luu said. "That explains how pronounced the movement was when there was a little bit of positive news."

Ultimately, the risk presented by a no-deal Brexit is so great that shorting the pound remains essential for companies who feel the need to hedge. A sharp fall in the pound, for instance, would hurt the profits of non-British companies with U.K. based operations.

"Corporate clients will need to stay cautious; there's a possibility of parity [with the dollar] in a hard Brexit scenario," Mr. Goto said. However, investors "will need to watch the upside,'' he added.

Write to Anna Isaac at anna.isaac@wsj.com