Running with the bull

The true value of sterling

As views and opinion on the current position of sterling change, Cormac Naughten assesses its future chances in a bear market

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2008 was truly an annus horribilis for sterling, with the pound seeing its worst decline on a trade weighted basis in recent memory. Worse than its decline after the Exchange Rate Mechanism (ERM) exit in 1992 and worse even than in 1976 when the then Chancellor Dennis Healey had to go cap in hand to the International Monetary Fund. Some pundits even stated it was the worst decline for sterling since 1931 when the UK came off the gold standard amidst the wreckage of the Great Depression.

Sterling's problem

The UK had been viewed as particularly susceptible to the global economic malaise, due to its perceived dependence on a boom in the housing and financial services sector as a root cause of its previously strong economic performance. With the burst in both these bubbles the pound suffered accordingly. It then fell to historical lows against the euro in December 2008, almost reaching parity and to all-time lows against the Japanese yen in January 2009. That month saw financial commentators comparing the UK to Iceland or "Reykjavik-on-Thames". Some went further, speculating that there could even be a UK sovereign default crisis in which sterling would collapse, necessitating another humiliating trip to the IMF. This extreme in sentiment was exemplified by the comments of Jim Rogers, who co-founded the Quantum fund with George Soros, telling Bloomberg, "I would urge you to sell any sterling you might have. It's finished."

Green shoots?

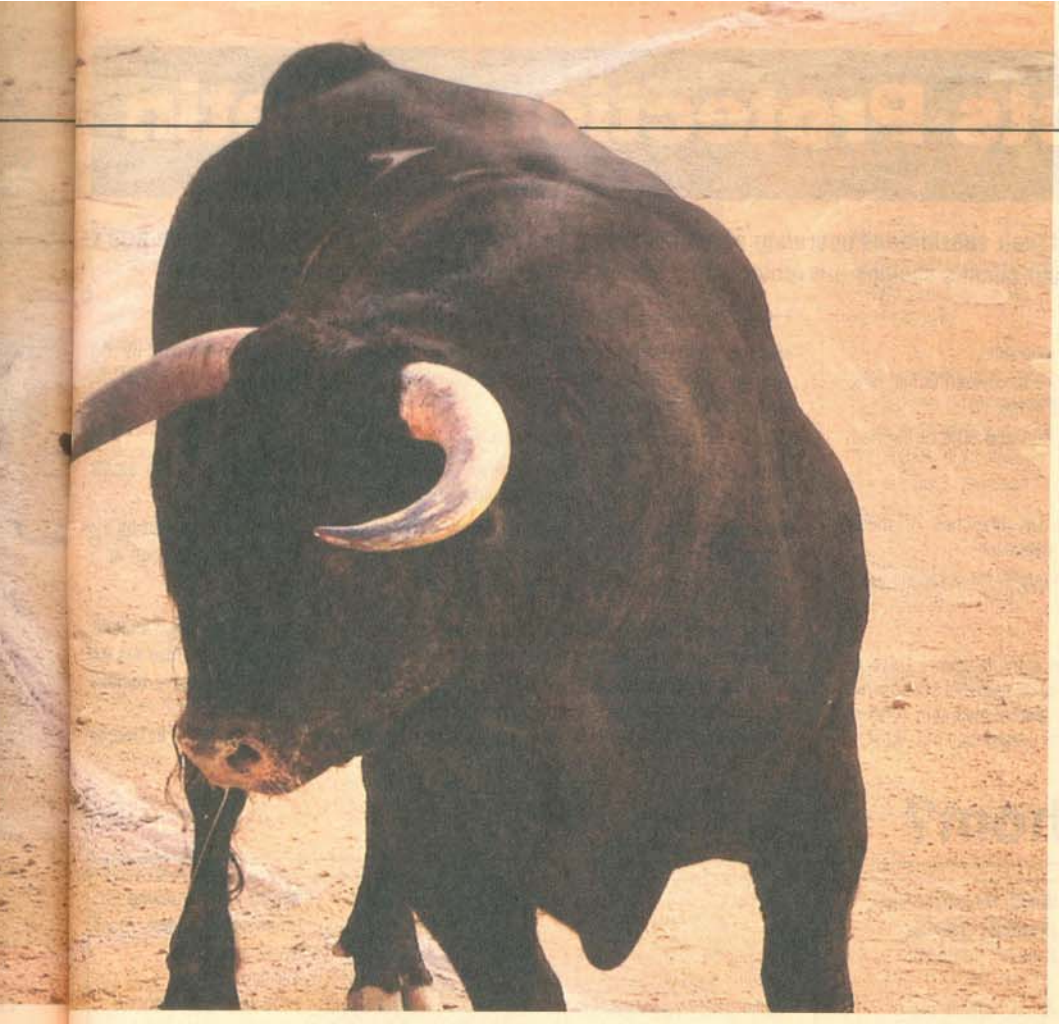
Strong stuff indeed but fast forward three months to the end of April and market sentiment towards the pound now feels slightly different. A few tentative signs of recovery for the UK housing market – green shoots - and speculation that the pound may have seen its lows have encouraged some to believe that sterling is rallying. Nothing spectacular certainly but the euro is down to 0.89 from 2008 highs at 0.98 and sterling has bounced from its all time lows against the yen, from sub 120 to the 140s.

The debate has now moved on to the sustainability of these supposed green shoots of recovery - whether for the UK or US economies. Sentiment towards sterling has also shifted from a simple equation of good economic news equals a stronger currency to consideration of the idea of sterling as a proxy of global financial risk. That means that when risk appetite goes up so does the pound. Is this a turning point for the pound and should we be looking forward to its recovery?

Danger of further disappointment to come?

Nationwide data showing UK house prices up 0.9% in March, a pick up in mortgage approvals, together with Royal Institution of Chartered Surveyors' figures that buyer enquiries increased at the fastest pace since September 2003 and that the number of properties actually being sold by estate agents increased for the first time since November 2007 have all given heart to those who feel the UK housing market may be about to turn. This positive UK housing data whilst welcome is not yet indicative of a definitive turning point. Even those looking to accentuate the positive concede that the housing market is still in a fragile state and suggest that there may be more signs of stabilisation in coming months or that housing market activity may have passed its worst point. This is very different to a substantive turning point.

Furthermore the housing data itself is hardly conclusive. For example, Halifax data released the day after Nationwide's announced that over the same month house prices fell by 1.9%. It does not reflect the wider economy or employment which is still rising. The Chancellor's Budget revealed public borrowing surging to £175 billion this year – even higher than previously estimated. If



sterling is increasingly viewed as a proxy for global financial risk then one must also look outside the UK to the global economy and financial crisis and to the US in particular for confirmation of these green shoots.

The global picture and its implications

Yet many commentators remain sceptical that either the financial crisis or the contraction of the global real economy is over. For them the green shoots are no more than weeds. Whilst they may concede that things may be getting worse at a slower rate, they also stress that this is not the same as a turning point. Some such as ex-Monetary Policy Committee member Willem Buiter point to the risks of a U-shaped recovery with a long, flat segment of stagnancy.

Others such as Richard Koo of Nomura would also accept that whilst there are tentative indications of a deceleration in the pace of economic decline, especially for the US and UK economies, much of this is related to a potential turnaround in the manufacturing inventory cycle. Namely that a sharp rundown in US inventories had been a key feature of declining US GDP data at the end of 2008 and that a restocking could generate better GDP numbers in Q1 and Q2 2009. This does not mean that the US economy is about to embark on a durable cyclical upturn as this would require evidence that the consumer is recovering. Instead, US employment data looks pretty grim, adding to the problem of a bad dent in household wealth which makes increases in consumer spending less likely.

This argument states that the current global economic situation is a balance sheet recession, one that emerges after the bursting of a nationwide asset bubble that leaves private sector balance sheets with more liabilities than assets. To repair balance sheets requires deleveraging and the paying down of debt. This is likely to be a drawn-out process in which hopes of a durable broad based recovery are likely to disappoint in the short to medium term.

In the short term equity markets have rallied with the S&P 500 index having its best month in March since 1933. The recent equity market rally is viewed by many as just a bear market rally with further disappointment expected to be seen before a durable recovery in asset prices. Were this to happen, it would reflect a return to greater risk aversion which could cause the pound to suffer.

The Bank of England

Up until the end of March the Bank of England (BoE) had voiced a preference for a weaker pound to aid exports. At a time when world trade and exports were slumping, this seemed strange to many market commentators as in these circumstances a weaker currency was deemed unlikely to have real impact in the short to medium term. Instead for a deficit economy it ran the risk of scaring away much-needed foreign investors. Who would wish to continue to buy sterling denominated assets or UK government debt if our own central bank wanted a weaker currency?

Mervyn King, the Bank of England Governor commented in his Treasury testimony at the end of March that there was now no reason for the pound to go lower. This was an important signal for FX traders and investors in our view and is similar to Mr Bernanke's Damascene moment on the US dollar on 3 June last year when he recognised that a weaker dollar - rather than helping US competitiveness – was pushing commodity prices higher and hurting world economic prospects. He might also have been reacting to calls from the Chinese – the biggest holder of world US dollar FX reserves – to stabilise the dollar. Note that the euro:dollar rate peaked at just over 1.60 last year and that since then the dollar had appreciated considerably back to the 1.20s earlier this year.

As outlined above, Britain has already had a significant devaluation in its currency and a deficit country like the UK cannot pursue such a strategy for long, as foreign investors will have little incentive to buy UK financial assets and fund the UK budget deficit. There are signs that sterling is stabilising, aided by tentative evidence that the worst of shocks in housing and financials may be behind us, even if neither sector has yet turned into positive territory. The UK needs foreign investors and in this context the BoE Governor's recent comment that the pound has fallen far enough were important.

Bull or bear market for the pound?

Jim Rogers' prediction of sterling's imminent demise now seems to mark the nadir of sterling bearishness. Talk of green shoots pointing to a sustainable recovery in either UK housing or the US economy may still be moot but there has certainly been a deceleration in the pace of economic decline especially for the US and UK economies and the falls in the UK housing market. The pound has recovered from its recent lows of December 2008 and January 2009 and whilst it is still in a bear market, some investment banks have noted that sterling has been at its most undervalued against the euro since 1995.

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Although one cannot rule out further shocks, much of the bad news for the UK and the pound appears to be out there in the market already. Sterling has also started to demonstrate its capacity to benefit from an increase in global risk appetite - independent of UK news - as a proxy for global risk. In this sense then, sterling's future prospects may have less to do with the UK's economic prospects than some think. Whether this marks a turning point only time will tell but sterling is not yet in a bull market. ■

This article has made use of material produced by Neil Mackinnon, ECU Group's chief economist and former chief currency strategist at Citigroup. Some of the themes contained in the article can be explored in greater depth in Neil's daily blog at www.ecugroup.com/resources/MarketCommentary.cfm