The case for sterling

September 2013
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Introduction

In its simplest form, the reality with currencies is that what goes up eventually comes down. This cyclical nature is relatively simple to understand. Investor sentiment, the quest for profit and the deployment of leverage tend to culminate in many a market move becoming ever more detached from reality at cyclical peaks and troughs. Global investors tend to become blinkered in their views: all news is good news in the bull markets; all news is bad news in the bear phase.

Currency values, unlike most other asset classes, are not driven by “absolute” economic credentials. It is what is happening in a country “relative” to others and how these developments compare with market expectations that act as the primary drivers of FX rates. With such enormous degrees of leveraged and borrowed money being employed in today’s markets, greed and fear clearly dominate and however stretched a market may seem, speculators will push and squeeze every market move to the nth degree, irrespective of logic or basic measures of value.

Ultimately, however, any persistent and excessive misalignment in a currency’s value will have self-correcting effects on its underlying economy, sowing the seeds of self-destruction for those with excessively overvalued currencies and nurturing the green shoots of growth, demand and opportunity for those with currencies that are disproportionately oversold and undervalued. It is merely a matter of time. In breaking up these cycles, we can see that bull markets are born amid dire pessimism, they thrive amid scepticism (climbing a “wall of worry”), they tire amid optimism (as all the fruits of tomorrow are progressively factored into today’s prices) and they crash amid euphoria (just when it is perceived that nothing could possibly go wrong).

History shows us, again and again, that there simply are no one-way bets, however good the story-line.

For six years following the devastating chain reaction of events that started in 2007, sterling became the worst performing major currency, bar none. To maintain such a basket case status and continue to depreciate across the board, two things need to happen:

1. Economic and financial conditions in the UK need to keep deteriorating “relative” to other major economic areas; and
2. Investment opportunities and returns in other countries need to continue to surpass those available in the UK.

“History shows us, again and again, that there simply are no one-way bets”

Continued...
It is our contention that neither of these conditions is the case any longer. More importantly, nor will either one be so for a very long time to come. In the absence of (1), and given the extent to which sterling is undervalued on almost any econometric model, sterling’s general value against a basket of other currencies is unlikely to depreciate further. In the absence of (1) and (2), it is realistic to expect sterling to migrate to a more natural buoyancy level based on neutral econometric measures of fair value.

Based upon our Median Fair Value Model for G8 currencies (which utilises twelve different and accepted valuation methodologies across five categories), sterling is undervalued by some 8% on a Trade-Weighted Index basis. Against the euro, for instance, sterling’s undervaluation is nearer 12.5%. Clearly, therefore, a reversion back to a median fair value would translate into a fairly significant appreciation in sterling.

This should, however, not be confused with that which one might forecast for sterling were (1) and (2) not only not to apply, but for the economic performance in the UK to actually improve (rather than flat-line or deteriorate) at the same time as the deterioration of other major economies’ performance. In such a scenario, we would expect sterling not only to recoup its deficit against fair value but, if sustained, it is likely (as we have seen repeatedly in the past) that sterling would extend the recovery cycle comfortably into overvalued territory.

As is the UK’s style and history, when it rains, it pours and when conditions are good, they can become extremely good and self-sustaining for an extended period. For now, though, we shall remain focussed upon the most acute levels of misalignment and be content with the steady convergence in these targeted areas which has already begun.
1987-2007: **Policy Errors**

For reasons that will become apparent later in this document, in analysing the future prospects for sterling, it is appropriate first to remind ourselves how the UK and sterling fell from grace and to look for similar warning signs in other economies that may help us in identifying systemic risk in other countries today, for these are capable of having a material impact on currency developments going forward.

It is, perhaps, a perennial occupational hazard of financial markets to place global policy makers on too high a pedestal and, perhaps, to attribute too much faith in their intellect and ability to manage their economies appropriately and prudently. The reality is that a catalogue of policy errors helped set the stage for the “Perfect Storm” for the UK and sterling.

However, as one might expect in a world that had become entwined by a relentless drive towards ever greater globalisation, not all these policy errors were home grown. Despite almost universal god-like status, Alan Greenspan (who presided over the Federal Reserve from 1987 to 2006) seemed to have learned little from the root causes of market crises under his tenure (notably the Stock Market Crash of 1987 and the collapse of Long Term Capital Management in 1998). Instead, he contributed, through excessively lax monetary policy, to the mother of all US housing bubbles that, as indeed all bubbles do, burst. His hands-off regulatory philosophy and his fervent belief that banks’ ability to assess risk and their self-interest would protect them from excesses were key catalysts for the financial crisis.

Keeping short-term interest rates too low for too long, whilst focusing erroneously on core inflation rather than seeking to predict underlying headline inflation in the medium term, the Fed failed to appreciate the long term consequences of its actions, both at home and abroad. Furthermore, Greenspan failed to consider properly the downside risks of the rapid securitisation of mortgages during the 2000-2005 period and, instead, acted as a cheerleader for its perceived virtues.

Greenspan also displayed a naïve and wholly misguided faith in the self-regulating properties of financial markets and private financial institutions. Compounding this error, by enabling the rescue of Long Term Capital Management in 1998, he acted as a moral hazard incubator, sending out a clear signal that excessive risk taking was a case of “heads you win, tails you get bailed out”.

The failure of the Fed to press, before or after LTCM, for a special insolvency resolution regime with prompt corrective action features for highly-leveraged private financial institutions that were likely to be deemed “too big to fail”, demonstrated poor judgement that set the stage for an unadulterated binge on credit and leverage over ensuing years. Like a cancer, this perilous culture of risk taking spread across the Atlantic, where UK banks perfected the art in ever greater proportions under the noses of UK policy makers and regulators who, collectively, failed miserably in their oversight.

"Poor judgement... set the stage for an unadulterated binge on credit and leverage"
As we know, ultimately, all bubbles burst. The first shoe to drop in the UK was Northern Rock in September, 2007. This was the first run on a British bank in 150 years (since Overend Gurney crashed in the 1860s) and yet, due to the reallocation of banking supervision away from the Bank of England and the Treasury to the FSA, the established protocols for dealing with a run on a British bank were not invoked. Instead, amid a total lack of clarity as to who was ultimately responsible for taking the lead in such a situation, the ensuing radio silence and delay ended up with pictures of hordes of people queueing to get their money out being flashed all over the world.

Although Alistair Darling’s decision to support Northern Rock (and later the other major high street banks) came in the end, the damage was already done. Confidence in the UK banking system started to evaporate. The next shoe to drop was in the US, where it all started. Lehman Brothers was in deep trouble and none of the major US banks were willing to get involved unless they had appropriate guarantees. Nonetheless, Barclays were on the brink of buying Lehman before a phone call from Alistair Darling to US Treasury Secretary, Hank Paulson, made it clear that this would not be allowed to happen. By the end of the weekend Lehman filed for bankruptcy, proving to be the straw that broke the camel’s back. The rest, as they say, is history.

The point is that major policy errors helped to create a scenario where banks and other institutions had, in effect, become too big to fail, an error that was further compounded by letting Lehman go to the wall. A tsunami of wealth destruction and economic implosion ensued on a scale not seen since 1929.

The overall fallout for the UK – and sterling – since 2007 has been particularly acute, falling by some 35% to 60% from its prior peak levels against all currencies (except the Icelandic krona). There is no doubt, just as sterling commanded a premium to fair value “generally” during the financial excesses prior to the autumn of 2007, when the US subprime mortgage crisis crossed the pond, sterling’s ensuing and precipitous fall left it significantly undervalued.

The sentiment towards sterling over the ensuing five years remained resolutely bearish. With the convergence of global interest rates and UK rates hitting almost zero, the weak financial, economic and political backdrop in the UK, together with a misguided policy bias towards talking down the currency, sterling became unloved and unwanted.

2007-2008: The Perfect Storm

“A tsunami of wealth destruction and economic implosion ensued on a scale not seen since 1929”
2009-2012: Licking Wounds

The “sell Britain” mentality that emanated from the UK Government and the BoE’s implied weak currency policy (in the blind belief that a weaker sterling would answer all our problems) was, ironically, a persistent contributory factor in the UK’s inability to generate any meaningful form of economic recovery. The persistent weakness in sterling contributed to UK inflation remaining stubbornly well above target for some 44 months in a row. Therefore, with pensioners’ savings being eroded in real terms with interest rates down at 0.5% for this entire period, incomes subdued, taxes up, benefits down and household bills, weekly food and drink spend, travel costs, insurance – in fact almost anything and everything you can imagine (except bank lending) up – it is hardly surprising that a domestic led recovery remained totally elusive during this period.

There can be little doubt now how corrosive an impact this misguided bias/inference/steer/policy for sterling weakness had on household wealth, disposable incomes, purchasing power and investor sentiment. Indeed, it is no wonder that economic green shoots struggled for so long to gain any traction. With global aggregate demand dropping everywhere, being cheaper on something that no one really wanted to buy anyway did not help. In any case, for the goods and services that UK companies are really good at, in all probability, they would get this trade anyway (if people want a Bentley, Range Rover or Aston Martin – they are going to get one, regardless of price). All that the talking down of the pound did was to eradicate any chances of a domestic-led recovery by importing inflation on essential goods that permeated through the entire economy and, in so doing, dulling the appetite for any meaningful foreign investment in Britain. Add to this the fact that half our export market (equating to about 15% of GDP) was exposed to the eurozone, an economic area in crisis (with demand falling off a cliff in many parts), and you had a pretty hostile backdrop.

The UK export sector in goods and services was comprehensively hammered by the crisis. Our most successful export, the financial services sector (which ran a trade surplus of £41bn in 2008) went out of fashion, accounting for about two-thirds of the UK’s overall surplus in services. Since then, financial services exports have dropped 16 per cent. The country also faced another big misfortune as the North Sea supply fell off a cliff at the precisely the wrong moment. The UK’s oil and gas production, already in long-term decline, plunged 40 per cent in volume terms between 2008 and 2012 thanks to technical problems on North Sea rigs. This, together with an implosion in crude oil prices since 2008, had a direct and material impact on the trade deficit. This was further compounded by energy-hungry manufacturers being forced to rely more on imports. By comparison, the US shale revolution has been a boon to its UK competitors across the Atlantic.

Although time is generally a good healer, this on-going and comprehensively bearish sentiment became so entrenched that it created a self-fulfilling degenerative spiral – prompting credit rating agencies to cut the UK’s credit rating. Until global investors could see the UK as being in a recovery mode, or at least some bold and decisive steps being taken to shake the UK out of this negative psychology, there was little incentive for them to buy sterling – especially given they were not being paid (by way of a higher interest rate) for the risk.
After several years of stubbornly miserable economic data, there developed a broad consensus that the UK was permanently mired in a severe demand shortfall, and that none of the usual levers – monetary policy, fiscal policy or weaker sterling – were ready or able to remedy the problem.

The announcement, therefore, of Mark Carney’s appointment as the next Governor of the Bank of England marked a pronounced change in sentiment. All of a sudden, UK plc had something to look forward to. Sometimes a change is as good as a rest and a wave of pent up hope could be felt rippling its way through the country.

The notion of having a no-nonsense and proven central banker with high credibility and experience and a mandate to do “whatever it takes” to get the economy going, acted like a cattle prod for UK business sentiment. In fairness to Mervyn King, we were already at a juncture where we needed a continual stream of bad news to keep sterling down.

Additionally, with currency being a “relative” game, not an “absolute” one, it was actually developments elsewhere that most likely helped sterling to find a floor. As discussed, unlike property, bonds, equities and commodities (which can all go up or all go down together), this is not how currencies work. It did not necessarily require the UK outlook to improve for sterling to recover some lost ground against some of its rivals – one just needed to see (a) the UK economic backdrop stop declining further and/or (b) the outlook for other currencies to start deteriorating. In actuality, we had both.

**Another BRIC in the wall**

On 15th November, Xi Jinping was confirmed as the man to lead China for the next decade. Xi Jinping replaced Hu Jintao, under whose leadership China had seen a decade of extraordinary growth (fuelled, in the main, by a massive credit bubble) and Li Keqiang was appointed the man set to succeed Premier Wen Jiabao. China’s off-balance sheet bank lending and local government deficits had become out-of-control under the former administration’s prescribed policies. Under this new leadership, a new message was being transmitted to differentiate the new from the old. High on the agenda now was taking a hard line on corruption, dealing with a colossal shadow banking system and credit bubble, improving education, creating affordable housing and cleaning up the environment.

The inference for sterling and other currencies was that, with the era of double-digit growth in China likely to be over for the foreseeable future (as a prolonged period of consolidation amid major social, economic and financial reform unfolded), the prior and relentless appetite by UK (and other) investment managers to pour money into the Chinese growth story had run its course. Indeed, it was not only China that was facing major challenges resulting from a mountain of cheap credit (courtesy of US, UK and, by then, Japanese QE policies), it was clear that much of the emerging market sector had become gripped by bubble mania.

"a wave of pent up hope could be felt rippling its way through the country."
China’s inexorable growth over so many years had a major reverberating knock-on effect into other markets, underpinning the appeal of both their currencies and their underlying asset markets. The wall of money into the so-called “Brics” had been overwhelming over the years, as investors chased higher yields than those achievable elsewhere in the developed world.

However, as we have warned persistently over the past year, these massive capital flows into Emerging Markets since 2008 were simply too big to be efficiently absorbed by the recipient countries. With the global liquidity tide in these markets at a wholly unprecedented high level, cracks in this Bric wall started to appear. As we have also warned, repeatedly, the exit strategy as this inevitable dam bursts, notably in the bond markets, would be both uncompromising, indiscriminate and brutal.

Against this backdrop, capital flows from UK fund managers into these markets (and their currencies) were likely not only to dry up but, in time, reverse. More worryingly, this was likely to happen, as in the past, with a degree of panic as investors all head to the exit at once. Another tick in the box for arresting sterling weakness.

**The Three Arrows**

On 17th December 2012, Shinzo Abe was elected to become Japan’s 7th Prime Minister in six years, with a bold and decisive plan to drag Japan out of a twenty-one year economic malaise. His aim was to revive the sluggish economy with “three arrows”: a massive fiscal stimulus, more aggressive monetary easing from the Bank of Japan, and structural reforms to boost Japan’s competitiveness.

By the end of February this year, the measures had resulted in a dramatic weakening of the yen and a 22 per cent rise in the Topix stock market index since Abe’s election win, underpinned by his newly-appointed central bank governor (the former Asian Development Bank President, Haruhiko Kuroda) agreeing to set an inflation target of 2 per cent. For the first time in a very long time, the market had another currency of choice to sell and/or borrow in *(other than sterling)*. Another tick in the box for sterling, as bloated short speculative positions in sterling against the Japanese yen were caught short and reversed.

"much of the emerging market sector was firmly gripped by bubble mania"
So, back to the present: where exactly are we in the UK? Although pessimism dies hard in the UK, the startling rise in sentiment in UK business surveys in recent months surely calls for a serious rethink of the downbeat view of the British economy which prevailed almost everywhere at the start of 2013. After a long period of stagnation, it is clear that Britain’s economy has finally started to recover and, moreover, more in line with normal rebounds after recessions. More relevantly to the currency markets, and as noted by the Organisation for Economic Cooperation and Development (OECD), it is doing so faster than most of its peers. Manufacturing, construction and business surveys on prospects for both services and investment have all picked up. Unlike previous “dead cat bounces” in individual sectors, the current backdrop shows an economy having troughed comprehensively across all sectors. Whilst re-stocking may explain part of the bounce, confidence is clearly rising again underpinned by consistently better-than-expected retail sales and labour trends.

Against this backdrop, interest rate expectations at the long end of the curve are changing. This doesn’t yet mean the Bank of England is close to raising rates. Indeed, the new BoE Governor, Mark Carney, has said, with caveats, that he will keep policy rates low until the unemployment rate reaches 7%, something which BoE officials do not expect to happen before Q4 2016. However, even if 7% is still a way off, it won’t stop markets anticipating that the BoE could soon follow the Fed in putting some clear water between QE and prospective monetary policy.

Despite the Fed’s potentially hazardous foot-dragging on tapering QE (given US equities have been propelled into new all-time high ground), we believe that we shall nevertheless arrive at a genuine inflection point for US monetary policy before too long. In the UK, further QE is no longer warranted. The UK housing market is now recovering courtesy (partly) to the Government’s “Help to Buy” scheme. The market is now even recovering outside the London hotspots as bank lending, finally, begins to open up. BoE officials appear somewhat in denial on the state of the recovery and have been doing their best to talk down the positive outlook, expressly dismissing the notion of any potential bubble forming in the housing market. The reality is, however, that the datapoints are both strong and improving. In any event, continued “super easy” monetary policy will simply broaden out and strengthen UK economic prospects further, so “denial” is fine. Interestingly, it is clear that markets do not go with Carney on his “forward guidance” directions and have chosen to price in earlier interest rate moves than his guidance prescribes.

As for sterling’s prospects, housing has always been a key driver of growth in the UK, given the associated spillover into the wider domestic economy across the country. Interest rate differentials with sterling have, throughout history, also been a major driver of foreign exchange rate trends and so, with the UK 10 year gilt yield rising to 3.0% and, more relevantly, the spread over German bunds reaching 100bps (1%), the technical base in sterling’s value “generally” is looking, this time, to be built on more than sand. As we mark the 6th anniversary of Northern Rock crisis, household and bank balance sheets are now in considerably better shape, after years of enforced deleveraging.

2013: Reasons to be Cheerful: Parts 1, 2 & 3

“Britain’s economy has finally started to recover... faster than most of its peers”
2013: Reasons to be Cheerful: Parts 1, 2 & 3 continued

As the UK economy appears to strengthen, particularly relative to the eurozone, the market’s short position on sterling is likely to unwind. Our belief is that there is a good chance of a short, but possibly quite considerable, upward move in sterling at this juncture, particularly against the euro, but quite possibly against a comprehensive number of other currencies too. This will not be welcome news to the BoE clan that, we suspect, still extol the virtues of a weaker currency (a flawed concept in our view, given the dynamics and composition of today’s UK economy), and it will be interesting to see whether Carney will do anything beyond forward guidance, which, to our way of thinking, is a pretty weak reed in any event.

While long-term sceptics may be right to warn about the lack of rebalancing, the UK’s structural trade imbalance, weak export initiatives and political risks, the cyclical outlook should support sterling, especially in view of: 1 the creeping disaffection with emerging markets and their currencies; 2 the knock-on consequences of a slowdown in Chinese and emerging market growth for commodity prices over the medium term and for commodity currencies; and 3 the likelihood that the German elections will not change the outlook for European macro adjustment or banking union for the better.

Analysing the Data

In an update to its near-term economic forecasts before the Group of 20 meeting earlier this month, the OECD raised its 2013 growth forecast from 0.8% to 1.5% and predicted that growth would accelerate in the second half of the year, with the economy expanding by 1.7% between June and December. A separate report by NSIER has the UK growing at the fastest rate for more than three years with GDP is now predicted to grow by 3.5% annualised in H2 2013. Credibility for this is heightened by private expectations that Q3 alone could see GDP rising by up to 1pct. If that pace of expansion continues into 2014, the recovery would begin to resemble a normal upswing rather than the slowest recovery from recession that it has endured since 2010. In its latest outlook, the OECD, concurring with what we have been saying for nine months now, sees the pendulum of contribution to economic growth swinging from emerging to developed nations for the time being, with the UK in pole position. Presenting the biggest upward forecast revision for the UK among the Group of Seven, Jørgen Elmeskov, deputy chief economist at the OECD, said the optimism reflected improved sentiment and data, justifying their decision to elevate UK growth numbers ‘more than a tad higher’.

Job prospects for the final quarter of this year look their brightest for six years, with finance and business services leading the way. Employers expect to increase staff in every sector except construction, according to a quarterly survey of 2,100 companies by Manpower, a leading recruitment company. Interestingly, the strongest hiring plans were in northwest and eastern England.

“The data points are both strong and improving”
Seasonally adjusted production and manufacturing

Markit UK composite PMI

NIESR UK GDP growth estimates
Quarter on quarter % change (rolling 3-month averages)

UK Retail Sales by volume
% change on the previous year

Source: ONS

Source: NIESR

Source: ONS

Source: Markit via Thomson Reuters
The OECD’s growth forecasts for the second half of the year are more than twice those from the Office for Budget Responsibility, suggesting that the official fiscal watchdog will substantially revise upwards its 2013 and 2014 forecasts in the Autumn Statement towards the end of November.

The forecast expansion is also substantially higher than the BoE’s central predictions, even from last month, which suggested growth would rise to annual rates of about 2.5 per cent, a percentage point below the growth rates suggested to be possible by the OECD.

Over the summer, business surveys have risen to multi-year highs and have been backed by strong data on real growth in the second quarter, business investment, the labour market and retail spending. There are signs that the BoE’s Funding for Lending scheme, effectively offering banks cheap funds to encourage extra lending, is at last beginning to normalise the supply of credit, even in the small company sector which has been entirely frozen out of credit on all levels over the past five years.

The construction PMI index has now risen to its highest level since 2007, leading us to believe that the construction industry (the only sector yet to show intentions to increase jobs) will soon burst into a hiring spree. The Bank of England reported that mortgage approvals for house purchases in July increased to 60,624 from 58,238 the previous month. This figure is the highest since March 2008, in part engineered by the Government’s housing programmes announced earlier this year. These have solicited much debate about wisdom and relevance of such initiatives but they are, nonetheless, likely to keep the sector bubbling through until the next election. BoE data also pointed to a thawing in credit conditions more broadly, with net lending expanding by £4.6bn – its largest amount since March 2010. Separately, the latest figures published by Nationwide showed house prices climbed 3.5% in the year to August. Prices have risen 1.4% in the past three months, the fastest pace in three years.

On many different indices, house prices are now rising and, although price-to-income ratios remain very high, there are strong grounds for believing that prices may have been structurally underpinned by long-term factors such as the lack of land supply for new building, and by unprecedentedly low “real” interest rates.

In manufacturing, output levels are now at their highest for a year with gains spread across a number of sectors, including food, electronics and transport. The manufacturing purchasing managers’ index for August rose to a two-and-a-half year high of 57.2, the fifth consecutive month that manufacturing activity has expanded. In services, the latest services purchasing managers’ index hit 60.5, its highest level since 2006.

According to Markit, the combined PMI (manufacturing and construction, as well as services) reached 60.7, the highest level since the surveys were first compiled in 1998.

“Business surveys have risen to multi-year highs and have been backed by strong data on real growth in Q2″
Surprisingly, perhaps, UK export orders have been rising almost as fast as domestic orders, giving some hope that, at last, the trade deficit may start to narrow. This recovery is supported by another study stating that investment intentions among British companies are at a six-year high. Indeed, Nissan will spend £250m on expanding its UK factory and increasing its workforce, amid resurgence in the car sector as manufacturing shows growing signs of recovery. The Japanese carmaker’s Sunderland plant, the UK’s biggest by output, will create an additional 1,000 new jobs and be the first in Europe to produce its luxury Infiniti models. This news comes amid a quite astonishing renaissance for UK car manufacturers. Jaguar Land Rover, for instance, has increased its factory workforce by more than half over the past two years. Other car manufacturers, including Toyota and BMW, have invested in high-tech innovation, design and manufacturing in the UK, revitalising what was considered a dying industry.

The British position is in stark contrast to European rivals such as France and Italy, where national car making champions are bleeding cash from unproductive factories building mid-range vehicles. It appears that the UK, in recognising that it simply cannot manufacture some products as cheaply as other countries, has evolved successfully by using technologies to manufacture efficiently, focussing on quality and innovation. In any event, the result is that UK has posted its first trade surplus in cars since the mid-1970s. Given a backdrop of the worst European sales slump in 20 years, this is by no means a small achievement.

Likewise, in the UK private sector, there are multiple grounds for believing that the dark clouds may also be finally lifting. If so, the economy will be much better placed to absorb the significant fiscal tightening which will surely come in the next few years. Add to this the possibility of a stable (or a strengthening) currency, and this stands to increase disposable household incomes as the dis-inflationary knock-on impact that a strengthening currency has on energy costs and other goods and services. Previously, the relentless slide in sterling had caused a perpetual cycle of domestic belt-tightening as the inflationary impact of a weakening currency ate into disposable incomes. As history has shown us before, the sudden and abrupt change in sentiment and momentum in the UK economy that these developments can bring should not be underestimated.

Perhaps the only blot on the landscape has been in the government’s persistent lack of success in cutting spending. The data from the ONS show that spending was £575.8 billion in the financial year before the coalition took office and £630.3 billion last year. The trend has continued this year with spending in the first four months of this tax year amounting to £217.4 billion, compared with £208.4 billion in the same period of 2012. That the deficit has fallen can be attributed to a cut in investment spending (the wrong thing to reduce, since it probably has the biggest multiplier effect) and a rise in taxes. However, this will always be a lagging data print and recent developments in the economy as a whole can make significant inroads here if the current upward momentum continues, as indeed, we believe it will.

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2013-2015: The Swing of the Pendulum

"there are multiple grounds for believing that the dark clouds may be finally lifting"
Whatever the sceptics may say, the reality is that the UK economy is growing faster than most of its peers and the persistent stream of positive data of late represents the most consistent run of above-expectation data that most can ever remember. However, in fact, this is reminiscent of the backdrop that prevailed through the back end of 1995 and the beginning of 1996 (which heralded then the start of a considerable recovery in sterling’s fortunes). The relevant factor for the currency markets is that the reality of these data points and emerging trends are not currently reflected in sterling’s value. Nor, indeed, has the improving position in the UK particularly altered global investor sentiment towards sterling .... yet.

The latest data gleaned from the CFTC Commitment of Traders report shows short positions at over twice those of open long positions and that net short positions (of 38,166 contracts) currently represent an 87th percentile reading (traditionally, therefore, still at extreme levels), also ranking sterling at a commensurately low Sentiment Index reading of 30.4. Clearly, there is the potential, therefore, for a sea change in market positioning as these emerging trends gain traction. After all, the majority of speculative positions have been short sterling on the grounds that the UK was fundamentally weak, combining a high public sector deficit with a large current account deficit. That stance is no longer justified, particularly in light of developments elsewhere. The UK is now growing faster than other advanced economies, so rates and yields will tend to become higher here earlier than in, say, the Eurozone or Japan, and will likely move pretty much in tandem with the US. Bearing in mind that currency movements are triggered by relative performance of one country against another, we feel that we are running into a sweet spot for sterling as, against this rather stable outlook in the UK, there are significant (and growing) imbalances elsewhere – in the Eurozone (especially between Germany and the Euro periphery), in China, the rest of the BRIC’s and much of the Emerging Market sector. We remain bearish on EM currencies over the longer term and believe that events here will have a negative spillover effect on commodity currencies.

However, perhaps the starkest alignment of both technical and fundamental inputs at this juncture remains with EUR/GBP. As we have said for some time, the Eurozone is a disaster – economically, politically and socially. Notwithstanding some signs of better data in the Eurozone too (mainly in Germany), the reality is that much of of the Eurozone remains stifled by cumbersome administrative regulations, rigid labour markets and high operating costs. The economies of Greece, Portugal, Ireland, Cyprus, Spain and Italy have collapsed, and are mostly still contracting. Unemployment is at record levels, and rising; it is now 22 per cent in Greece, 24 per cent in Spain, 18 per cent in Portugal, 15 per cent in Ireland and 10 per cent in Italy. Amongst the young, these numbers are too horrendous for words. This is in stark contrast to the UK (where the number is 7.7% and falling), and the US (7.3%). In short, it is an insurmountable mess and, ultimately, we have little doubt that the structure and constituents within the Eurozone, as we know it, will not last indefinitely.
It is a political dream, based on theoretical ideology, which has virtually no chance of survival in practice. Fixed exchange rates in history have an appalling track record at the best of times, and we doubt that this one will be any different. Had the Eurozone architects undertaken proper financial, economic, political, fiscal and welfare reforms over the past 15 years and disciplined themselves to a strict convergence timetable towards a level playing field on all levels, then maybe there might have been a slight chance that this project could have worked for an extended period of time. As it is, this hasn’t happened and we feel that in some cases already, we have reached the point of no return. Official forecasters have been pretending for the past four years that the turnaround is just around the corner. They have been wrong each year. And they will be wrong again. The reality is that some economies are simply too far gone to be able to recover before this crisis rotates from a financial, economic and sovereign debt one into a political and then a “social” one, which is where, in a democracy, it all ends.

The major flaw in any political dream is that politicians are only there for as long as “the people” are prepared to tolerate them or (the consequences of) their policies. In political terms, “the swing of the pendulum” is beginning to swing hard against austerity, against enforced erosion of cultural heritage and against “the one size fits all”. Not everyone in Europe wants to become a German – economically or socially. The cultural divisions in Europe are simply enormous and, as a consequence of not starting as they meant to go on (15 years ago) and the total neglect over the ensuing years to move to a level playing field, bitterness and resentment has built up on all sides. Much too late in the day, policy makers are trying to put the genie back in the bottle amidst a fractious blame game. It’s simply too late.

Strenuous and ever more ingenious (and desperate) efforts have, so far, papered each crack as it has appeared but real damage has been done and the cracks behind the paper are now gaping and ever-widening crevasses. At this juncture, the only way to perhaps save the Eurozone in its present form is for the introduction of Eurobonds and an absolute commitment to a ‘one for all and all for one’. Whilst this would not deal with the deep rooted cultural differences or economic divergences between Germany and the periphery, it would at least put an end to market pressures which, otherwise, will keep coming back again and again. Although European policy makers have, thus far, managed to kick this can a long way down the road, they will eventually run out of road. Simply put, if a policy or situation is unsustainable, this means that it shall not be sustained. However, any agreement on eurobonds is extremely unlikely as we do not see the Germans will ever go for this. Without it, however, the Eurozone project is doomed to failure. The numbers just don’t stack up.

Accordingly, whilst the UK gets on with its domestic-led recovery (and perhaps becomes the European outsourcing country of choice for many a foreign firm), we envisage a progressively unstable Eurozone, teetering from one crisis to another. In the long run, this is not a viable or safe investment proposition in anyone’s book, and we see the euro falling considerably as the economic, financial, political and social divergence expands over time. Against sterling, we anticipate EUR/GBP will retrace significant ground back towards 0.75 (some 11%) over the next two years but, in the event that we do actually start to see a real break up in the Eurozone, we would expect to see EUR/GBP drop precipitously and much more extensively. Even without a break up, we would still expect to see EUR/GBP settle back to somewhere between 0.72 (14%) and 0.68 (19%) by 2018.

"Much too late in the day, policy makers are trying to put the genie back in the bottle"
The steady improvement in UK banks’ balance sheets and Government initiatives are finally translating into a recovery in mortgage approvals. Given the close correlation these have with the fortunes of sterling, we anticipate that this backdrop will continue to underpin sterling’s recovery.
Chart 2: Employment

The gap widens as European “one size fits all” policy continues to erode confidence and jobs.
The gap widens as austerity measures in the Eurozone take their toll on domestic demand.
The fallout from the 2007/2008 financial crisis saw the euro surge 50% against sterling over a two-year period.

As the Eurozone has lurched from one crisis to the next, the EUR/GBP has been ratcheting lower in a very wide channel.

Having ridden the last leg of this channel last year (average entry of 0.8402; average exit of 0.7865), we have now rebuilt our short EUR/GBP strategy once again (average entry of 0.8532), and we are now anticipating a move, in fits and starts, down towards 0.7500.

Source: Bloomberg
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1. A managed margin FX account is only suitable for sophisticated investors. A client must ensure that they fully understand the additional risks involved in margin trading.

2. A client should be aware that their bank will require additional margin to be paid on demand and will have the right to close any open positions if this additional margin is not promptly paid.

3. As with all margined products it is possible to incur significant losses and to lose more than the margin in the account at any one time.
Managed multi-currency mortgages

1. At no stage should a client be exposed to the high risks of foreign currency borrowings if they are unable to afford the potential losses that could result from adverse currency movements and the higher interest costs that would arise from having a larger loan.

2. A client's lender will not tolerate an increase in the GBP value of a client's loan above a predetermined level as a result of currency losses. The lender will agree a "Conversion Limit" with the client before a client takes out an ECU managed multi-currency loan. If the loan reaches or breaches its "Conversion Limit", the lender may exercise its right, but not its obligation, to convert the loan back into GBP. However, a loan may be converted back into GBP at a worse level than the agreed Conversion Limit. This would mean that a client's loan would increase by more than it would if it had been converted at the agreed Conversion Limit. Converting a loan back into GBP may result in a permanent increase in the GBP value of a client's loan and the associated GBP interest costs.

3. The FCA risk warning is "Your home may be repossessed if you do not keep up repayments on a mortgage".

Managed multi-currency loans

1. At no stage should a client be exposed to the high risks of foreign currency borrowings if they are unable to afford the potential losses that could result from adverse currency movements and the higher interest costs that would arise from having a larger loan.

2. A client should be aware that their lender may not tolerate an increase in the base currency value of a loan if it exceeds a certain level and will have the right to convert the loan back into the base-currency.

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