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EUROPEAN MARKET COMMENTARY

CAN STERLING REGAIN ITS LUSTER?

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Can Sterling Regain Its Luster?

"If you wanted a currency that has a stable effective exchange rate, you couldn't do better than to look at sterling."—Bank of England Governor Mervyn King, November 14, 2007.

"The probability of a real sterling crisis is around one in three, and the probability of major tax hikes and cuts in [U.K.] public spending is roughly one in one."—Niall Ferguson, British financial historian, June 30, 2009.

Introduction

When we last examined the pound sterling in detail in March 2007, our sanguinity came with a substantial caveat: "… it seems logical to expect the pound to continue appreciating at a modest pace against the U.S. dollar and Japanese yen, *provided* the global economy and financial markets remain more or less quiescent. An event that caused large-scale unwinding of carry trades, on the other hand (e.g., some sort of financial crisis, or simply a sharp and sustained increase in volatility), could render such forecasts moot and send the pound plunging, at least temporarily."[1] Well, the period since then has been about as far from quiescent as we hope to see in our investment lifetimes!

Sterling has been buffeted not only by the factors we mentioned—a global financial crisis, the massive unwinding of carry trades, and a sharp rise in volatility—but also by the United Kingdom's first recession since 1991. The pound has not weathered the storm well; it fell 30.5% from July 2007 through December 30, 2008. Notwithstanding a rally in 2009, sterling remains (as of October 13) 27.6% down from its July 2007 level on a trade-weighted basis (Tables A1 and A2).[2]

What is next for sterling? While we do not opine on near-term prospects of currencies, there is no getting around the fact that based on fundamentals the medium- and long-term negatives for the pound seem much more numerous than the positives. At the same time, there is some support for the idea that these negatives are more than fully reflected in current valuations, suggesting that sterling could easily surprise on the upside going forward.

Sterling's Fall

While the pound, like the U.S. dollar, is worth much less on a relative basis than it was when Bretton Woods was scrapped, most, if not all, of the adjustment took place before 1994. Sterling appreciated steadily thereafter against all the currencies we track, peaking in late January 2007 at its highest level since the 1970s (Tables A-1 and B). By the following August, after the onset of the financial crisis, sterling began a steep and steady decline.

[1] Please see our March 2007 Market Commentary *Implications of a Rising Pound*. We were expressing our concern the very same month in *It's Getting Late—Risks Are Rising* "about the possibility of a severe decline that catches most investors overexposed and underprepared."
[2] We use the broad rather than the narrow trade-weighted sterling for purposes of all calculations in this Commentary.

Sterling's history since the end of World War II, when the U.S. dollar clearly became ascendant, has been marked by periodic crises. These include devaluations in 1949 and 1967 (30% and 14.3%, respectively), a massive 24.9% depreciation that occurred over 20 months in 1975–76 (when the United Kingdom received a $2.3 billion bailout from the International Monetary Fund), and a 15.1% depreciation that occurred in just six months in 1992 amid Britain's withdrawal from the exchange rate mechanism (ERM).[3] The 30.5% trade-weighted decline in less than 17 months in 2007–08 exceeded these previous tumbles.[4]

Indeed, since the beginning of the crisis the pound has been by far the worst performer among currencies of the G10 countries. Performance against emerging markets currencies has been nearly as bad (Tables B and C). By December 30, 2008, sterling's trade-weighted value had fallen to its lowest level since 1993 (Table A-1).

The pound rallied during the first seven months of 2009, rising 11.9% on a trade-weighted basis. By comparison, sterling rose 4.9% and 4.0% (using monthly composite averages) in the seven months following the currency crises of 1976 and 1992, respectively. Volatility remains much greater than in the pre-crisis period, although not nearly as high as it was in the second half of 2008; however, this is certainly not unique to the pound (Table D).

Where Are We Today?

Sterling managed to hold steady in May 2009 when Standard & Poor's revised its outlook on U.K. sovereign debt to negative from stable for the first time ever.[5] However, since August 5, sterling has again taken a turn for the worse on news of continued U.K. economic weakness, the Bank of England's (BOE) £50 billion expansion of its quantitative easing program to £175 billion ($277 billion) and its August inflation report (which raised fears of *deflation*), and a September 2009 report by Moody's suggesting potential future bank loan losses of £130 billion on top of the £110 billion that has already been recognized.[6] On September 24, meanwhile, Mervyn King suggested that sterling weakness was helpful to the long-term rebalancing of the British economy, which he believes should include "a shift of resources into exports." The pound has since dropped 2.0% and was at late-1996 levels as of October 13.

Factors Behind Sterling's Weakness

More than most other nations, the U.K. economy was supported in recent years by positive conditions in the financial sector, high levels of consumer spending (aided and abetted by the housing boom), and the availability of cheap financing. Sterling experienced a sharp and rapid decline as conditions turned, investors took flight from risk, and the United Kingdom fell into a deep recession. Sterling has been further

[3] This was the occasion on which George Soros was said to have "broken" the Bank of England.
[4] However, it should be noted that we have understated the "maximum" depreciation in the 1975–76 and 1992 sterling crises due to our lack of daily trade-weighted numbers for the period before 1994 (we used composite monthly averages instead).
[5] Standard & Poor's began analyzing U.K. sovereign debt in 1978.
[6] Bridgewater Associates, meanwhile, estimates that U.K. banks still need to recognize another $512 billion (£323 billion) in losses.

pressured by Britain's loose fiscal and monetary policy. The government has enacted a large stimulus package and the 2009 budget deficit is projected to be between 12.4% and 15%, the highest among the G20 countries. Credit default swap protection against a default on gilts jumped from 17 basis points (bps) in August 2008 (and only 5 bps in November 2007) to 175 bps in mid-February 2009, although it had declined to 46 bps as of October 13 (Table E).

Beginning in 2008 the U.K. government intervened massively in the banking industry by, among other things, nationalizing Northern Rock and Bradford and Bingley, recapitalizing other firms (including Royal Bank of Scotland and Lloyds Banking Group, pursuant to which the government took 70% and 43% stakes, respectively[7]), and insuring banks against possible losses on their riskiest assets. Such support is a major reason for rating agency and investor concern; as the *Financial Times*' Willem Buiter wrote late last year, the "UK authorities have effectively underwritten the balance sheet of the over-sized UK banking sector. ... Without the banking crisis, the government would not find itself exposed to a possibly unsustainable fiscal liability." The close relationship since last fall between the cost of protection against the failure of major U.K. banks and that of the country as a whole makes this amply clear (Table E).

Britain's increased budget deficit and scale of potential government liabilities exacerbate its public debt problem. The country's current account has been negative since 1986 (with the exception of third quarter 1997, where the account was 0.01% positive) (Table F). Government debt outstanding of £734 billion in *2008* was 45.8% greater than in 2006 and equivalent to 50.9% of GDP.[8] JPMorgan Chase projects that U.K. public debt will reach 103.2% in 2013, the highest of any G10 country save Japan.[9] Inflation, 1.1% in September, is higher than in other developed countries—as are inflation expectations for the United Kingdom (Table G).

To fund these deficits the United Kingdom is being forced to vastly expand its gilt issuance. Net gilt issuance more than quadrupled in fiscal year 2008 and is expected in fiscal year 2009 to be £203 billion ($322 billion), *seven times* its 2007 level. Net (and gross) issuance in fiscal years 2010 and 2011 is expected to remain well above 2008 levels. Will there be sufficient demand for gilts, particularly in light of the expected heavy issuance of sovereign debt by the United States and other major economies? In March 2009 an auction of nominal gilts actually failed for the first time in seven years.

Although the BOE cut policy rates to record lows, its actions came long after the Fed had acted (Table H); this delay may have contributed to pound weakness, with the market interpreting (initially) higher U.K. rates not as an indication of underlying economic strength but as an indication that the BOE was not moving quickly enough to ease credit. As a result of its asset purchase programs, the BOE's balance sheet expanded by 60.7% in the 12 months ended September 2009. The BOE now owns 16% of outstanding gilts, a figure that is expected to increase to 21% by late 2009, which should be worrying to inflation watchers.

[7] Under terms agreed to in March 2009, the government's 43% stake in Lloyds will increase to 62% in connection with the government's insurance of the bank's assets; Lloyds is now apparently seeking to pull out of this program, however.
[8] This includes financial sector intervention expenditures.
[9] Note that JPMorgan Chase's estimate of a 57.0% public debt ratio for 2008 is 6 percentage points higher than that of the Office for National Statistics.

The pound has also suffered due to the severity of Britain's recession, its first since 1991. From April 2008 through June 2009, U.K. GDP fell 5.7%, with the decline during the last four quarters sharper than during any such period in 60 years. The number of unemployed is the highest since 1995. Mervyn King warned in September that economic recovery will be "slow and protracted." Weak economic growth is expected to force the BOE to keep rates low and perhaps expand its quantitative easing program even more. Capital Economics believes that the combination of falling public spending and "deep cuts in public sector employment and wage growth" could reduce annual real GDP growth by up to 2% compared with rates experienced during the boom earlier this decade.

Is There Any Hope for Sterling?

Despite this litany of negatives, there are some reasons to believe that sterling may rebound. For starters, it is certainly possible that the market has discounted bad news about sterling to such an extent that a surprise on the upside is much more likely than one on the downside. Indeed, the British economy appears to have grown in the third quarter[10] and consumer confidence has risen. Higher growth could improve the deficit outlook and lead the BOE to raise interest rates more quickly than anticipated, which could bolster the pound, since many believe that the BOE will lag the other major central banks in raising rates. Meanwhile, the chronically negative current account deficit has narrowed slightly since 2007 and might be expected to compress further given the weaker pound (Table F).

If Britain's current condition is as dire as most believe, this may force the government to meet its problems head on, which would be a long-term plus for sterling. Britain appears less able than other major countries to muddle its way through current difficulties. Already, Prime Minister Gordon Brown has indicated that public spending cuts are imminent, notwithstanding trade union threats of possible riots and upcoming elections (which must be held by June 2010). The opposition Conservative Party, meanwhile, has discussed freezing public sector pay, cutting welfare, and raising the age at which beneficiaries are eligible to receive state pensions. Likewise, the precariousness of Britain's situation could lead to other extreme measures, even a decision by the BOE to pay, like the Swedish Riksbank, a negative interest rate on excess bank reserves in order to force money back into the economy. Barclays believes such a measure would probably bolster sterling in the long run, although its short-term effect would likely be negative.[11]

Before writing off sterling, investors should also consider that the currency has bounced back from crises that were at least as severe. Indeed, sterling appears undervalued against its major competitors on a purchasing power parity (PPP) basis. Based on the Organisation for Economic Co-operation and Development's (OECD) PPP estimates, as of October 14, 2009, sterling was 4.4% overvalued against the U.S. dollar but 18% and 20% undervalued against the euro and yen, respectively.[12] In our view, however, PPP is inconclusive, and *at best* useful only in considering currency movements over long periods. For

[10] As we went to publication, the Office for National Statistics released a preliminary estimate of a 0.4% decline in growth in the third quarter.
[11] The Swedish krona actually has appreciated by 8.6% on a trade-weighted basis since the Riksbank imposed a negative rate in July 2009.
[12] Based on its PPP for GDP measure, the OECD considers the pound to be worth $1.53, ¥178, and €1.31.

example, PPP calculations vary significantly (e.g., Ned Davis Research shows the pound as *undervalued* versus the U.S. dollar).

In general, analysts consider sterling somewhat undervalued. JPMorgan Chase wrote on September 18 that it "has been very cheap relative to its long-term fundamentals since the beginning of 2008 and remains so at 12.8% below its real fair value." Writing at the same time, Barclays foresaw double-digit sterling gains against both the U.S. dollar and the euro over the next year while Morgan Stanley also estimated sterling appreciation, though on a smaller scale and on a more delayed basis. However, based on forward pricing, the market has low expectations for the pound relative to the other major currencies. While little change is expected over the next year, forward pricing indicates sterling will decline by 0.4%, 0.6%, and 2.7% against the U.S. dollar, euro, and yen, respectively, over the next two years and by 1.4%, 2.9%, and 12.0% over the next five years.

Despite its struggles and the fact that the United Kingdom now accounts for only 4.8% of the GDP of countries represented in the MSCI All Country World Index (ACWI), sterling remains an important currency. This is due not only the legacy of empire but also to London's continued importance in the world of global finance. Indeed, by one important metric sterling's influence has been increasing since the mid-1990s. Data from the International Monetary Fund's Currency Composition of Official Foreign Exchange Reserves database shows that the percentage of global foreign exchange reserves held in sterling almost doubled as a percentage of declared reserves from 2.1% in 1995 to an estimated 4.0% in first quarter 2009.[13] Interestingly, emerging countries are more enamored of the U.K. pound than are developed countries (Table I).

Sterling's status as an alternative currency may thus be a tailwind as the dollar confronts its own obstacles in the years ahead. The greenback has benefited from its status as a haven in a risky environment, but it seems hard to envisage a long-term scenario in which the dollar maintains the same level of predominance it has enjoyed for many years. While emerging markets currencies, most prominently the Chinese *renminbi*, will likely gain more clout in the future, sterling may also prove to be a beneficiary.

As easy as it is to be a sterling bear, currency strength/weakness is, after all, a *relative* measurement. The United States, Europe, and Japan all face their own major short- and long-term economic challenges, creating significant headwinds for the dollar, euro, and yen.[14] It is very possible that the bad news has been discounted less for these other currencies than for sterling. For example, while inflation (and expected inflation) is higher in the United Kingdom than in the United States and other countries—which would normally indicate further weakness—inflation remains under the BOE's 2% target and concerns about *deflation* could cause the United States to continue policies that eventually lead to extremely high U.S. inflation rates.

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[13] The percentage actually rose to 4.7% in third quarter 2007 and remained at that level through second quarter 2008. It fell thereafter, primarily because of the drop in the value of sterling.

[14] Please see our August 2009 Market Commentary *Uncharted Waters: The U.S. Policy Response to the Financial and Economic Crisis*, our April 2009 Market Commentary *Breaking Up Is Hard to Do*, and our forthcoming Market Commentary on Japan. It is worth noting that while the dollar has fallen 13.8% on a trade-weighted basis since March 2009, it is still down only 3.7% since mid-2007.

Conclusion

Arguably, the pound was due for a fall in 2007 because its fortunes were dependent on a global model of high leverage and perceived low risk that could not last. This model had helped sterling steadily appreciate for well over a decade, to the point where the currency appeared overvalued on a PPP basis against its major competitors. Sterling's fall was exacerbated by the fact that the financial crisis was accompanied by (and tied to) a banking crisis and extreme economic woes. Unlike the dollar, meanwhile, sterling lacked the benefit of being the major reserve currency and was therefore hurt rather than helped by the flight to safety.

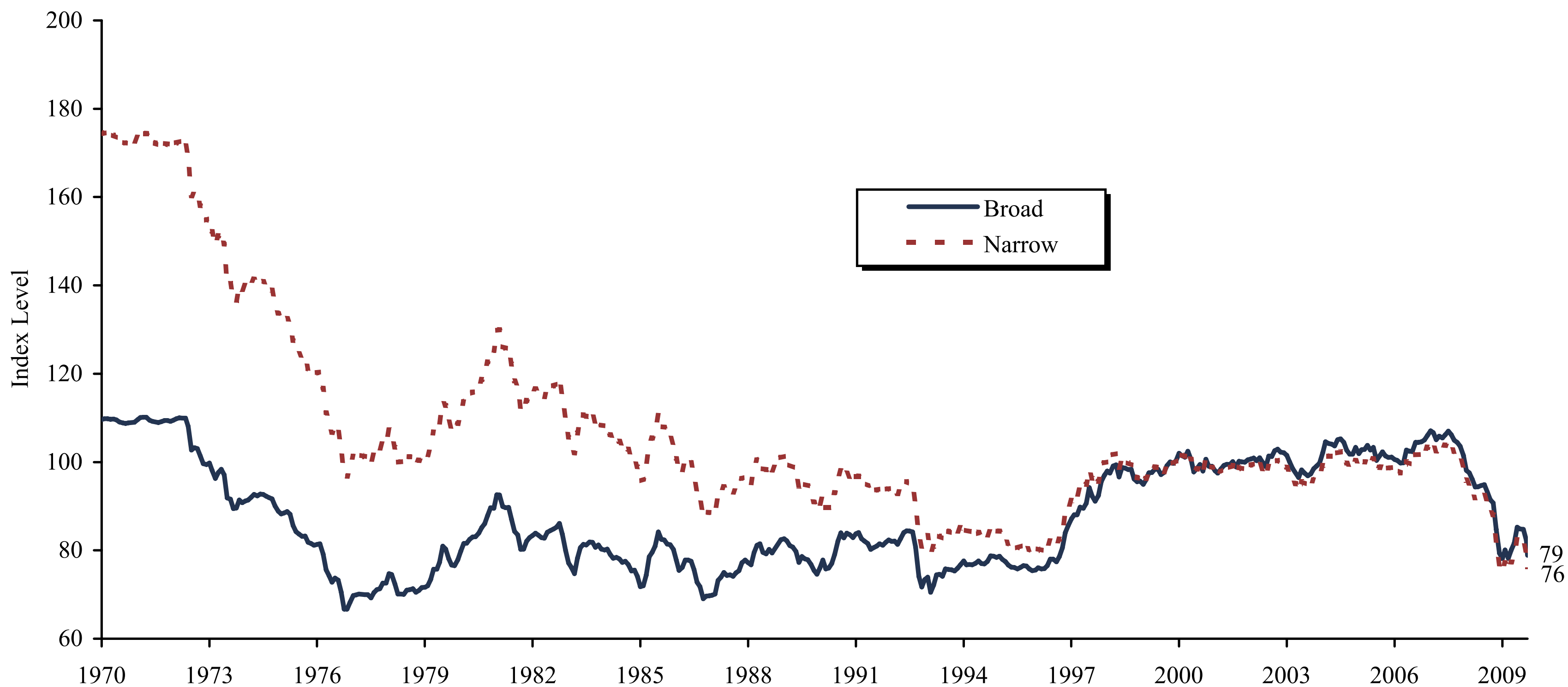
Going forward, sterling continues to face strong headwinds in the form of Britain's weak economy, large budget deficit, and public debt level, which is expected to worsen substantially in the years ahead. The government's support of the troubled banking sector places an added burden on sterling. The other side of the ledger is less full but expectations for sterling are so low that there may be more latitude for surprise on the upside. In particular, while the pound has borne the brunt of investor concern during the downturn, the other major currencies are all likely to confront significant issues in the years ahead. The dollar, for example, will face pressure as U.S. deficits increase and the desire of some governments for greater diversification in their foreign reserve holdings (and perhaps a less powerful dollar) grows. Those betting against an eventual sterling comeback would also seem to be betting against history—the currency has weathered earlier crises that were even worse by certain measures, often rebounding quickly.

Investors will need to keep a close eye on U.K. fiscal and monetary policy. Will the British government make substantial budget cuts? Will the BOE be able to wind down its quantitative easing program? Might it consider unconventional measures that could bolster the currency? Will the lower pound drive export growth, helping Britain to rebalance its economy, as occurred in the 1990s following the exit from the ERM? Sterling, like other developed markets currencies, will likely decline over the long term against the currencies of major emerging economies. It is by no means clear, however, that the pound will continue to suffer against its developed market counterparts. The key issue is whether real reform and a sustainable economic recovery (the two are tied together) take place; if so, there is plenty of reason to believe sterling could regain some, if not all, of its luster. In any event, investors should be prepared for a continuation of high sterling volatility as foreign exchange markets adapt to a world in which the U.S. dollar becomes less important.

Table A-1

NOMINAL TRADE-WEIGHTED STERLING INDEX

31 January 1970 – 13 October 2009



Source: Thomson Datastream.

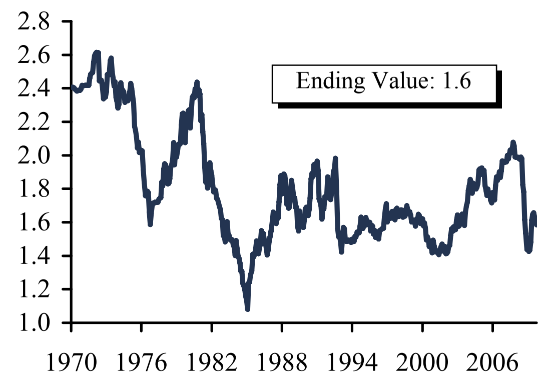
Notes: Graph uses average monthly rates. The Narrow Index includes only OECD currencies while the Broad Index also includes currencies of emerging markets in Asia, Europe, and Latin America.

Table A-2

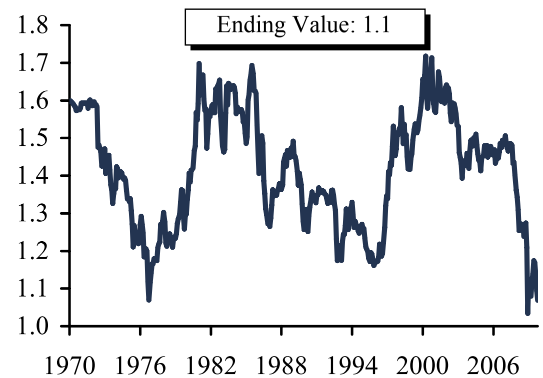
EXCHANGE RATE MOVEMENTS

31 January 1970 – 13 October 2009

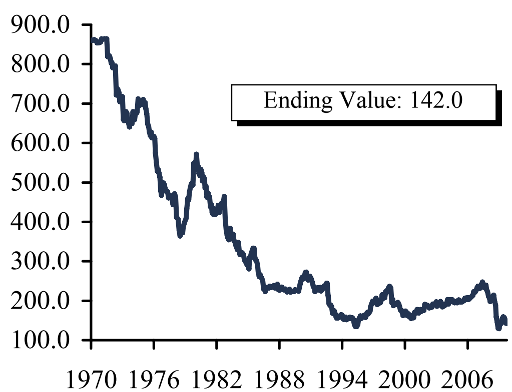
GBP/USD



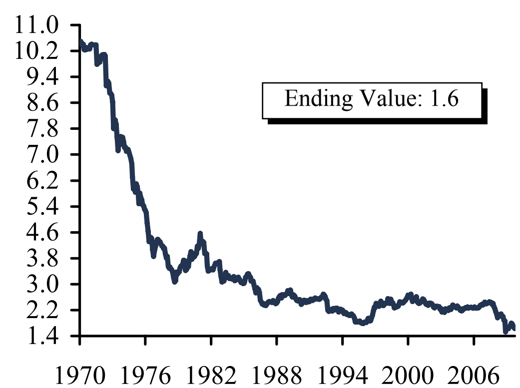
GBP/EUR



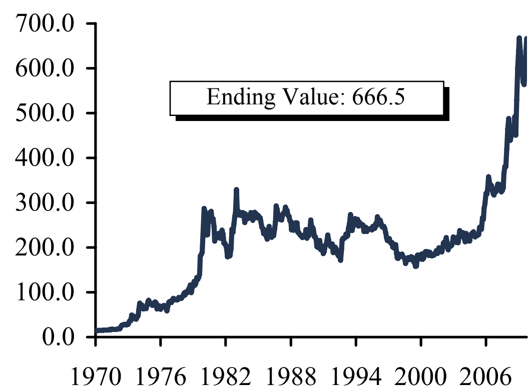
GBP/JPY



GBP/CHF



Gold/GBP



Sources: J.P. Morgan Securities, Inc. and Thomson Datastream.

Notes: Graphs are based on monthly data including a daily end point as of October 13. These data represent what one British pound is worth in other currencies. The final graph represents how many British pounds are required to purchase one troy ounce of gold.

Table B

COMPARATIVE CURRENCY PERFORMANCE VS THE U.K. STERLING

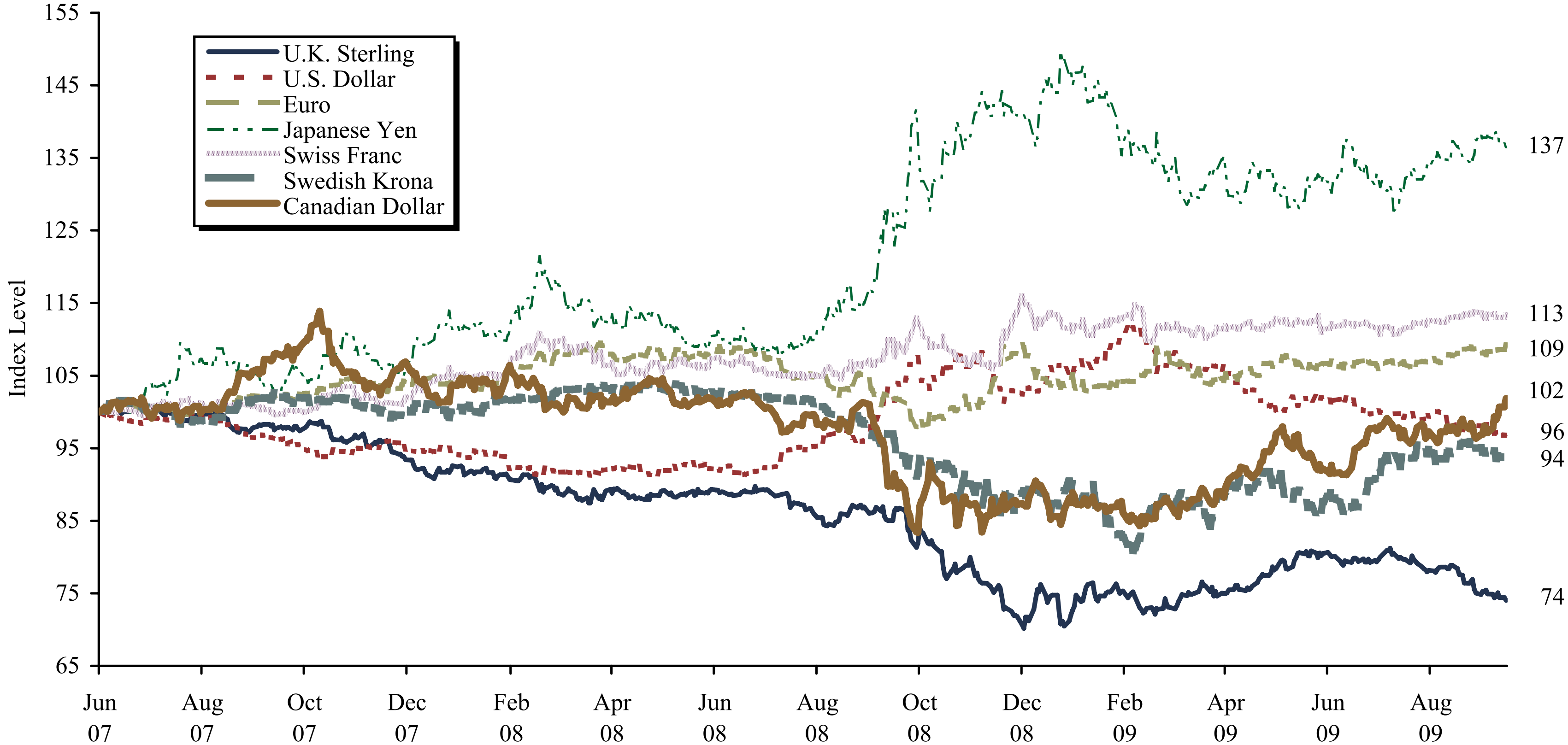
	31/12/1993 – 13/10/2009	31/12/1993 – 30/6/2007	30/6/2007 – 13/10/2009
Swiss Franc	35.3	-10.6	51.4
Euro	24.1	-10.7	39.0
Australian Dollar	24.6	-7.8	35.2
Japanese Yen	16.2	-33.4	74.4
Canadian Dollar	19.8	-8.2	30.5
Swedish Krona	11.4	-10.4	24.3
Singapore Dollar	7.4	-22.4	38.5
U.S. Dollar	-6.6	-26.3	26.6
Hong Kong Dollar	-6.9	-27.1	27.7
Chinese Renminbi	-20.7	-43.8	41.2
Taiwanese Dollar	-23.0	-40.3	28.8
Thai Baht	-28.4	-45.4	31.3
South Korean Won	-35.6	-35.6	0.0
Indian Rupee	-37.0	-43.2	10.9
Philippine Peso	-44.5	-55.9	26.0
Argentine Peso	-75.7	-76.2	2.2
Mexican Peso	-78.0	-78.8	3.7
Indonesian Rupiah	-79.1	-82.8	21.0
Brazilian Real	-93.7	-95.5	40.7
Venezuelan Bolivar	-95.4	-96.4	26.6
Russian Ruble	-96.1	-96.4	10.4

Source: Thomson Datastream.

Table C

PERFORMANCE OF CURRENCIES OF THE G10

30 June 2007 – 13 October 2009



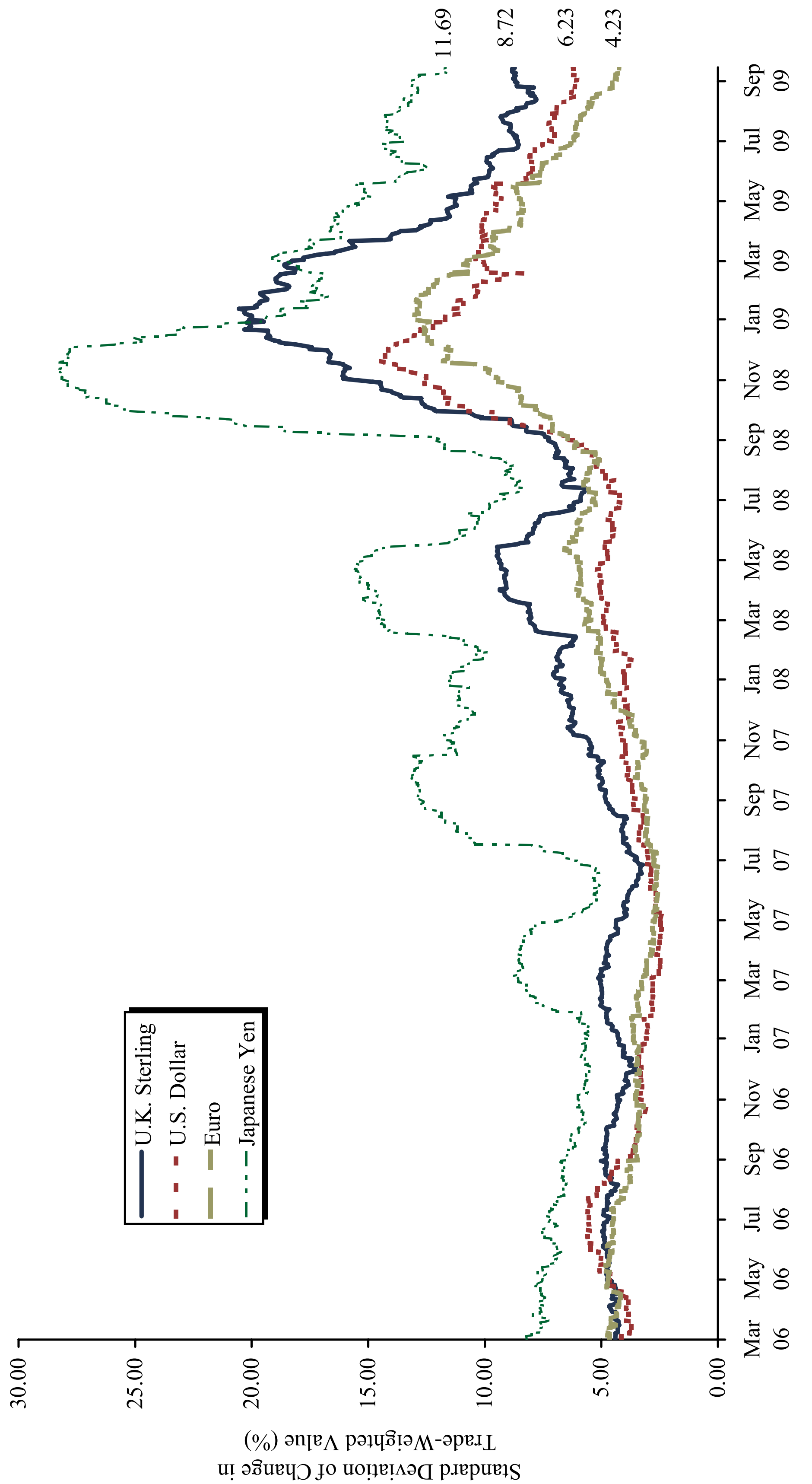
Source: Thomson Datastream.

Notes: Each trade-weighted currency index is rebased to 100 as of 30 June 2007. The G10 comprises Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. The euro is used by Belgium, France, Germany, Italy, and the Netherlands.

Table D

ANNUALIZED 65-DAY ROLLING VOLATILITY OF VARIOUS TRADE-WEIGHTED CURRENCY INDICES

31 March 2006 – 13 October 2009

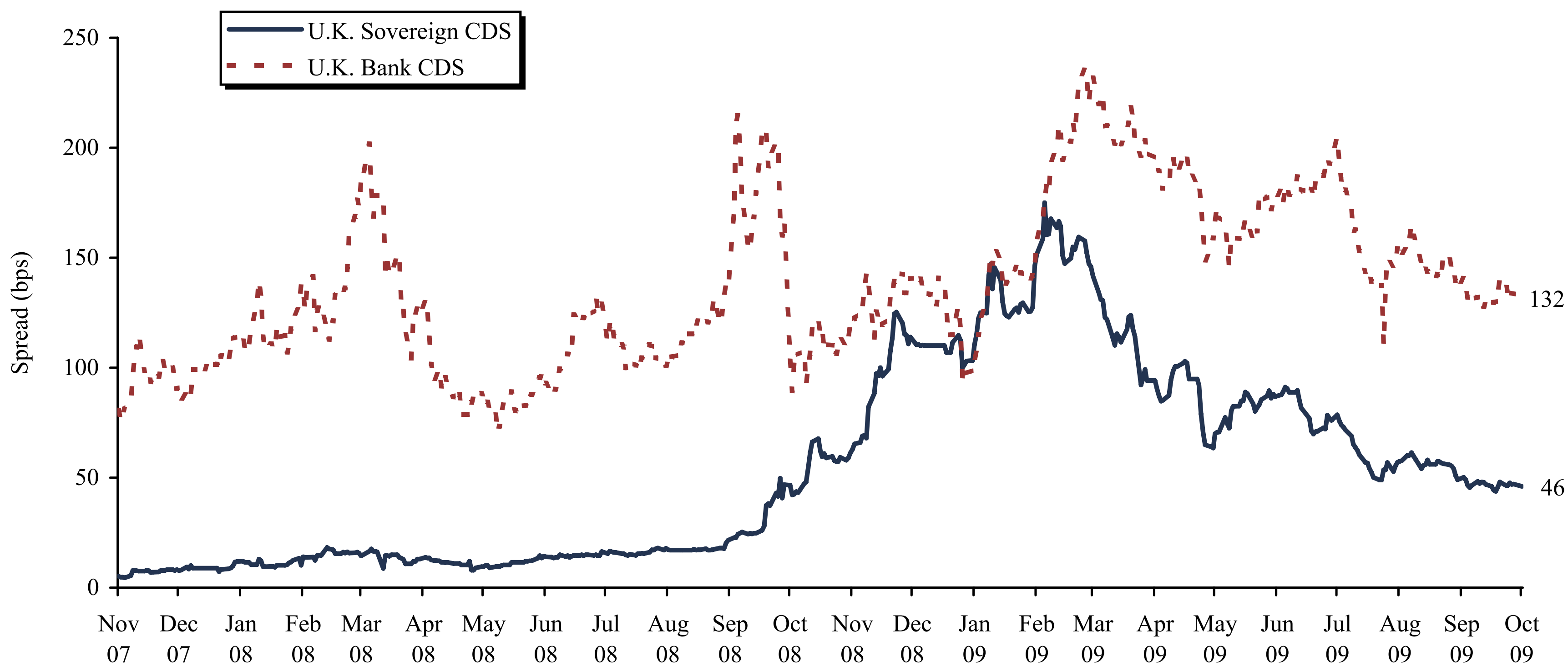


Source: Thomson Datastream.

Table E

SPREADS ON FIVE-YEAR U.K. SOVEREIGN AND BANK CREDIT DEFAULT SWAPS

13 November 2007 – 13 October 2009



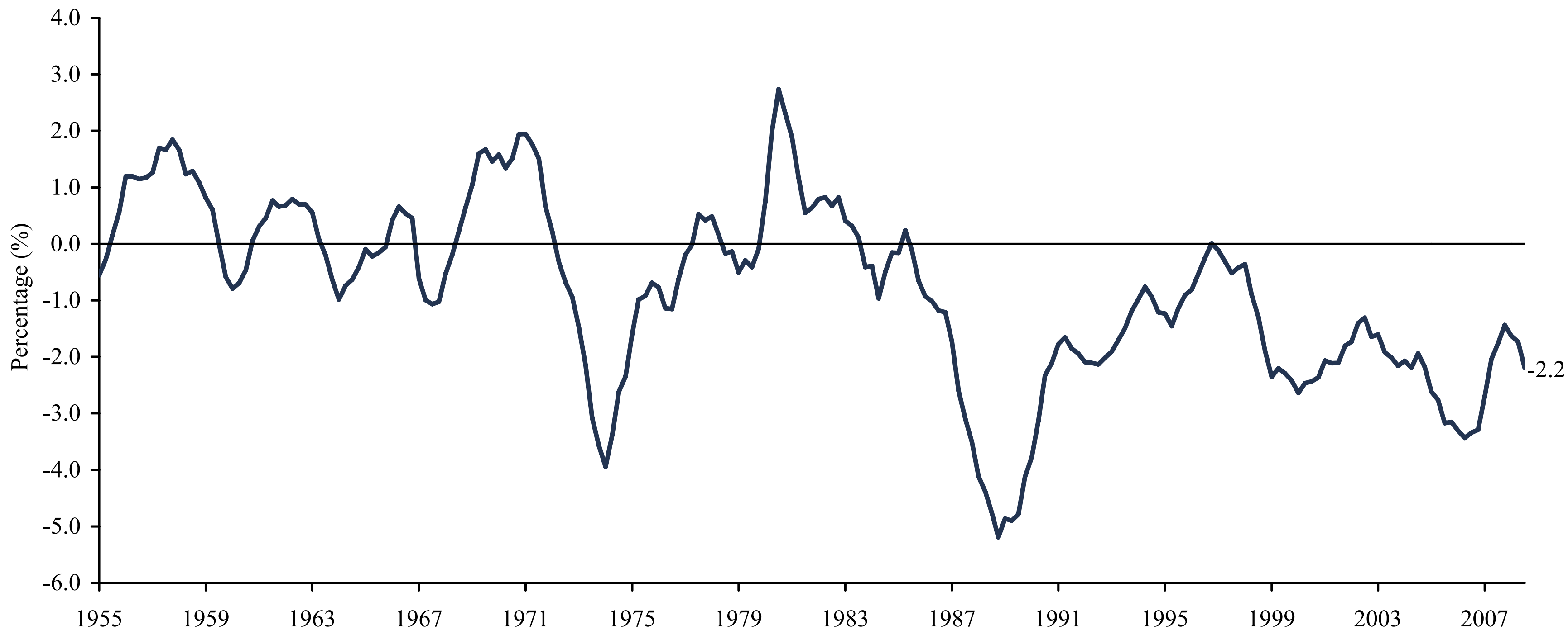
Source: Thomson Datastream.

Note: The U.K. Bank CDS spreads are the average mid-spread on five-year credit default swaps for six (previously seven) major U.K. banks.

Table F

U.K. CURRENT ACCOUNT AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT

31 December 1955 – 30 June 2009



Source: Thomson Datastream.

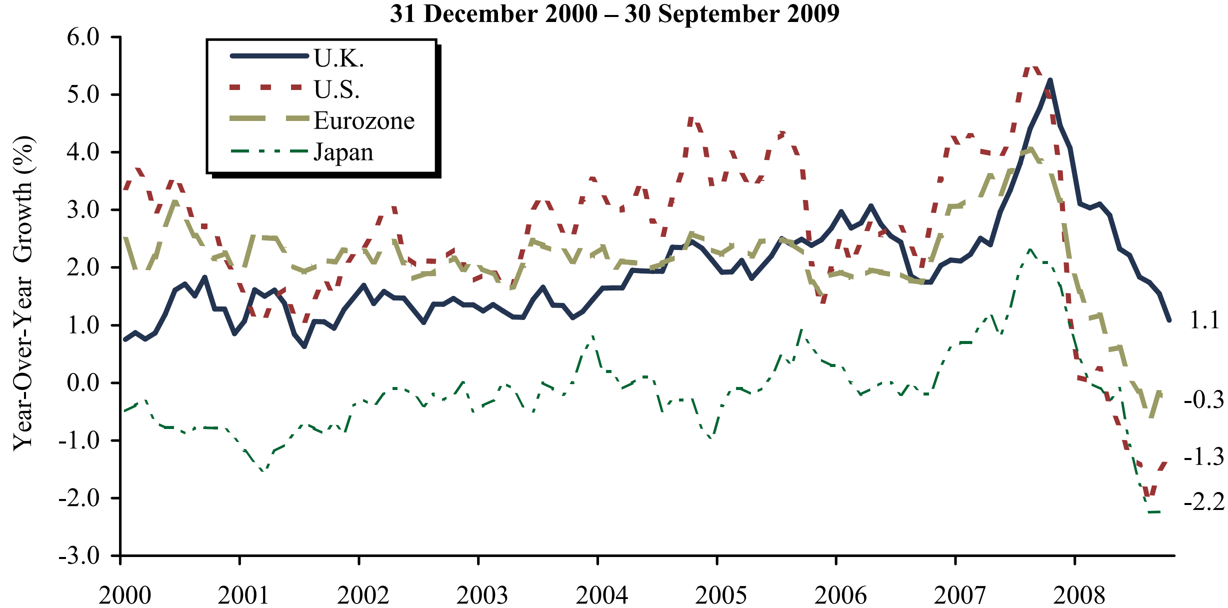
Note: Data for U.K. current account balance are based on the previous rolling four quarters relative to nominal GDP.

Table G

HISTORICAL AND IMPLIED INFLATION

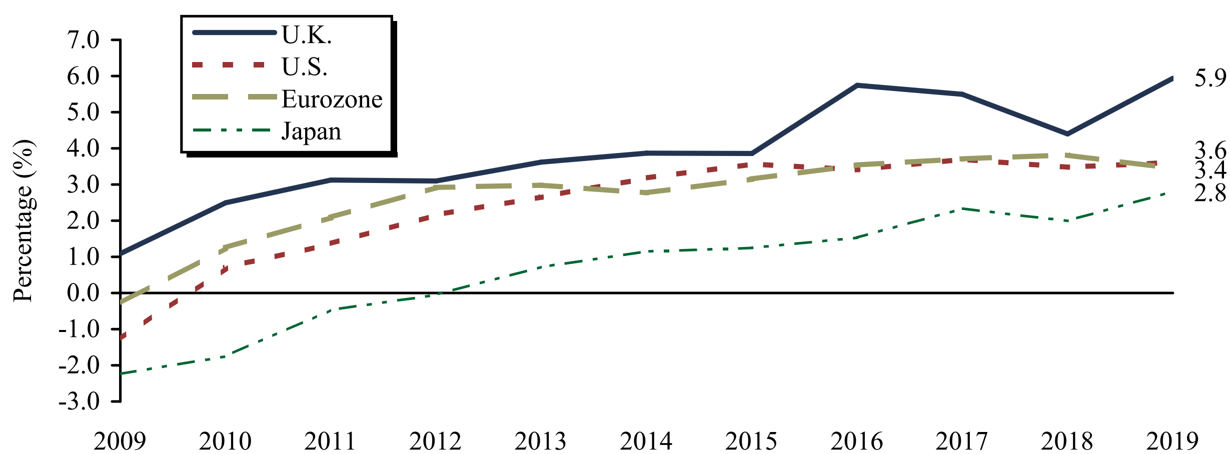
Consumer Price Index

31 December 2000 – 30 September 2009



Inflation Expectations

13 October 2009



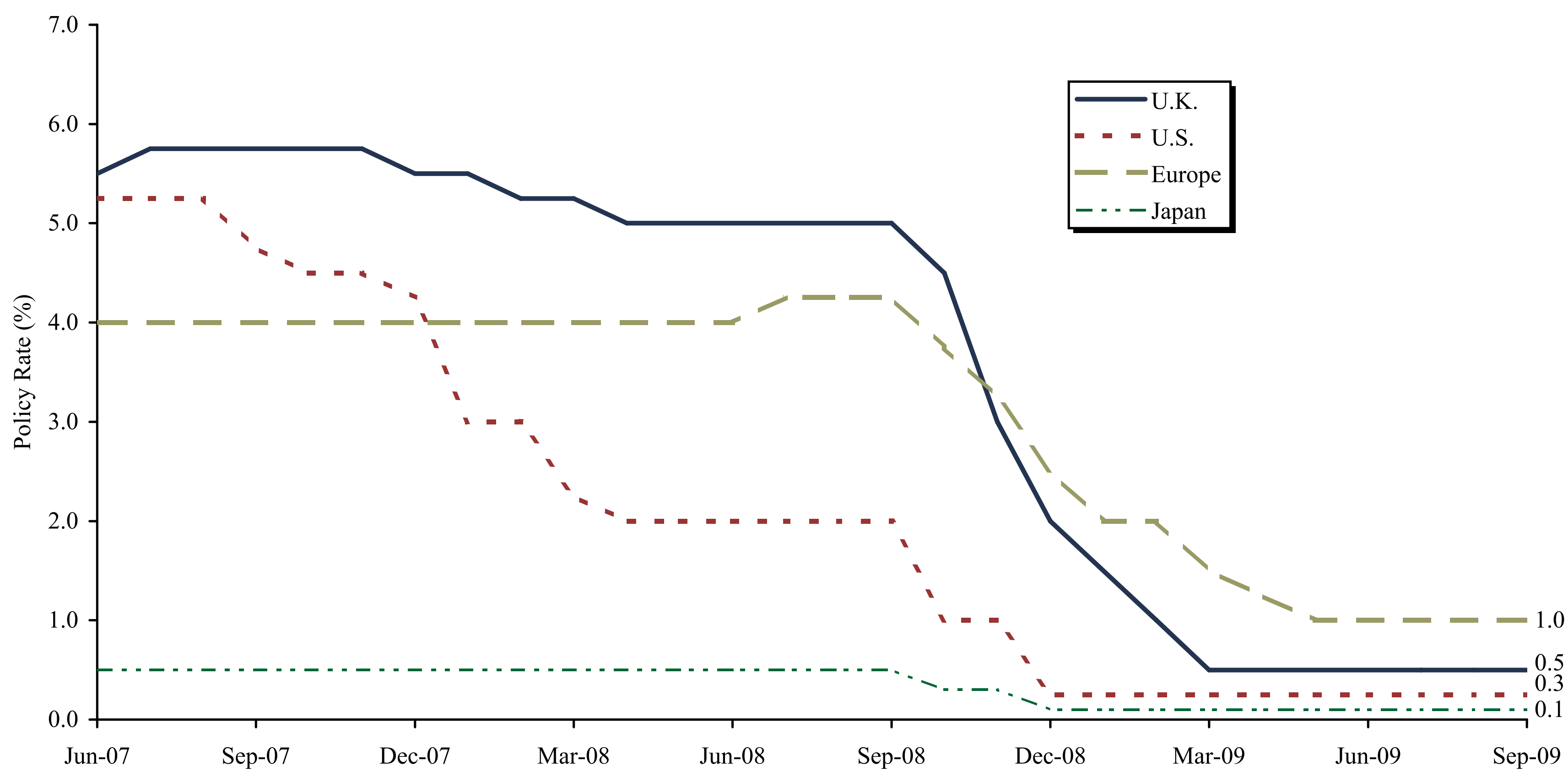
Sources: Bloomberg L.P., Thomson Datastream, and U.S. Department of Labor - Bureau of Labor Statistics.

Notes: Top graph represents monthly data. Data for Japan CPI are as of August 2009. Inflation expectations data are linearly interpolated from annual zero coupon inflation swap rates as of 13 October 2009.

Table H

CENTRAL BANK POLICY RATES

30 June 2007 – 30 September 2009

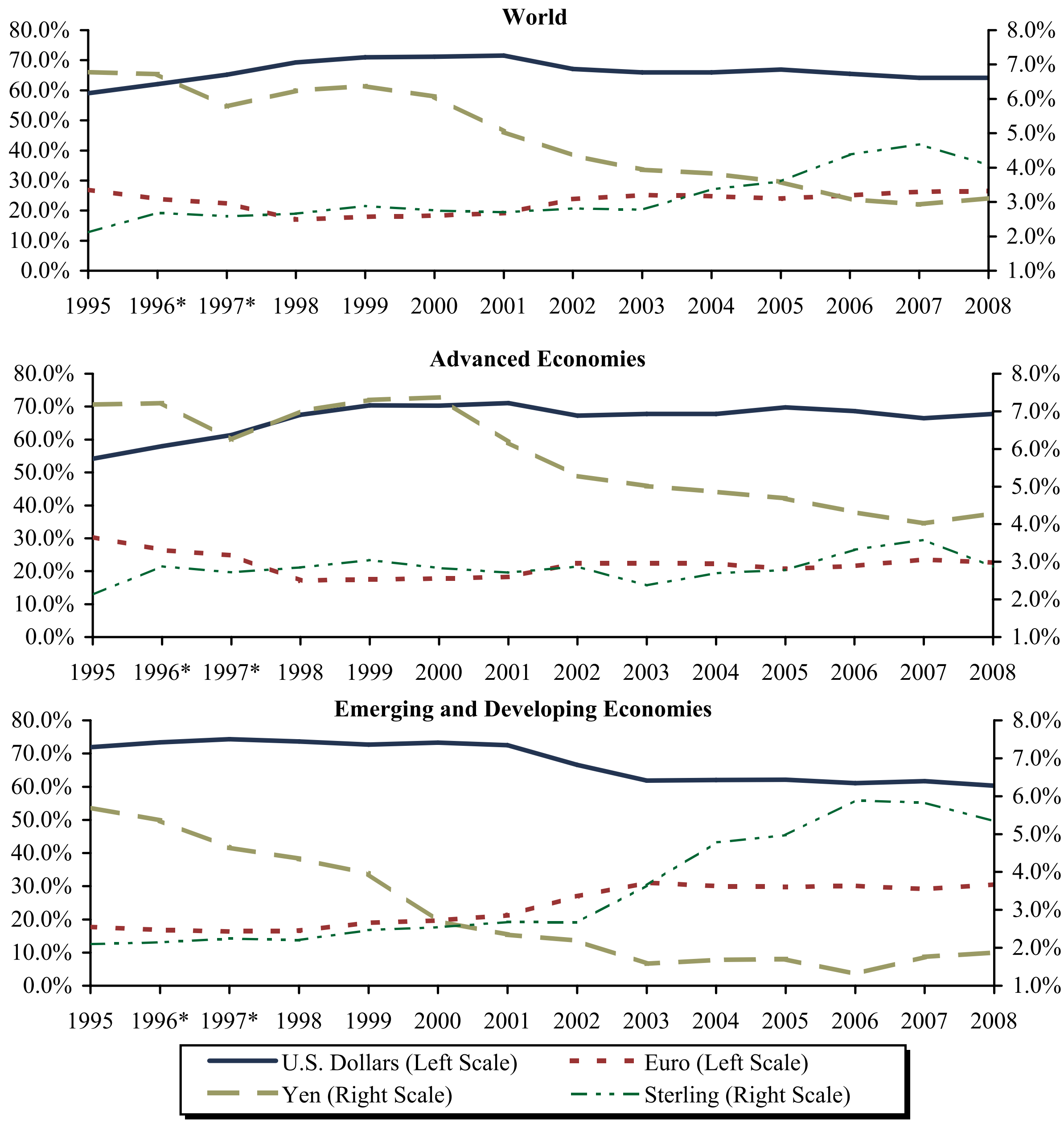


Source: Thomson Datastream.

Table I

SHARE OF GLOBAL FOREIGN RESERVES HELD BY FOUR MAJOR CURRENCIES

1995–2008



Source: International Monetary Fund - COFER.

Notes: Data for 2008 are preliminary. Prior to 1999, European currency data is composed of Deutsche marks, ECUs, French francs, and Netherlands guilders. Euros are used thereafter. Other currencies in which foreign exchange reserves are held are not included. Data cover only countries that declare the composition of their local currency reserve holdings.

* Denotes years in which countries with sizable reserves either joined (began reporting) the sample or left (stopped reporting) the sample.