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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

IMPLICATIONS OF A RISING POUND

March 2007

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Implications of a Rising Pound

Over the past few years, unhedged sterling-based cross-border investors have seen strong global equity returns eaten away by the persistent strength of the pound (Tables A and B). Most market observers, meanwhile, expect the pound to continue appreciating over the next year or so, particularly against the US$ and Japanese yen, due to expectations that the US$ will continue to weaken thanks to the United States' current account and trade deficits, while the carry trade (borrowing in yen to invest in high-yielding currencies such as the pound) will continue until interest rate differentials narrow significantly. Further pound strength would, of course, continue to exert a drag on cross-border investors; however, it would be unlikely to undermine corporate profitability given that US$ and Japanese yen weakness have been large contributors to the global economic boom of the past few years.

The Trouble with Relativity

Last July, we suggested that strength in the euro owed more to US$ and Japanese yen weakness than to fundamental strength in the common currency.[1] We believe a similar logic applies to the recent upward movement of the pound. In short, while a strong U.K. economy and recent rate hikes by the Bank of England have no doubt played a role in the pound's rise, these have likely been relatively small factors compared with the structural deficits that will weigh on the US$ for the foreseeable future, and the growing influence of carry traders who borrow in yen and buy pounds with the proceeds. In essence, many investors appear to view the pound as one of the better houses (i.e., currencies) in a bad neighborhood (i.e., fiat currency world in which most countries are seeking to devalue their own currency). Indeed, it is worth noting that while the pound has strengthened by 20%, 18.5%, and 6.5% against the US$, yen, and euro, respectively, since May 2003, its value relative to gold has *fallen* by 35% (Table C).

Not surprisingly, unhedged sterling-based cross-border investors have felt the most pain from the rising pound. Since the pound bottomed on a trade-weighted basis in May 2003, for example, the MSCI World ex U.K. Index has returned 83.9% (average annual compound return [AACR] of 17.2%) in local currency terms, but only 57.2% (AACR of 12.5%) in pounds. Relative to the United States, performance has been even worse. The MSCI U.S. Index has returned 62.3% (AACR of 13.5%) in US$, and 32.4% (AACR of 7.6%) in pounds. Thus, while global equity markets have continued to make new highs, unhedged U.K. investors have not fully participated in this advance.

U.K. corporate profits, on the other hand, have remained strong despite the rising pound (Table D), in large part due to rampant global liquidity that has boosted global economic growth over the past several years. In other words, the extraordinarily low interest rates hewed to by the U.S. and Japanese central banks from late 2001 through mid-2005[2] not only boosted the value of the pound, but, somewhat paradoxically, also insulated U.K. profits from the negative effects of a strong currency by stimulating economic growth. Further, the U.K. market has a large percentage of global enterprises—the energy and financial sectors, for

[1] July 2006 European Market Commentary: *Should Equity Investors Fret Over the Strong Euro?*
[2] While the Federal Reserve has since raised rates, Japanese policy rates remain at extremely low levels.

example, make up nearly half the market cap of the FTSE All-Share—that use sophisticated hedging techniques to manage the impact of currency fluctuations.[3] Going forward, therefore, continued pound strength would *not* necessarily presage weak corporate profits, but might simply indicate that liquidity remained rampant and was continuing to drive global economic growth.

Where to From Here?

Most observers expect the pound to strengthen a bit versus the US$ and Japanese yen over the next 12 months, while remaining more or less flat versus the euro. J.P. Morgan, for example, expects the pound to breach the $2.00 level later this year (which would represent a 26-year high on a monthly-close basis), while Barclay's Capital says the pound/yen exchange rate is now 2 standard deviations below fair value (in other words, the pound is cheap versus the yen). While the pound does look expensive on a purchasing power parity (PPP) basis—according to the OECD, the pound's PPP is only $1.62, compared to an exchange rate of $1.97 as of March 27—PPP measures tend to be relatively poor predictors of currency movements.

Analysts' biggest disagreement is over the pound/yen exchange rate, mostly due to the unknowns surrounding the carry trade. Indeed, if anything the significance of the carry trade in boosting the pound seems a bit underappreciated. For example, while most of the press regarding the late February weakness in equity markets focused on the yen's rally versus the New Zealand dollar and Australian dollar (as well as the Brazilian *real* and Turkish *lira*), the pound fell nearly as sharply as all these currencies during the sell-off, a strong indication that traders were using the high-yielding pound as a vehicle to boost returns. As *The Economist* put it, during the sell-off the pound behaved "more like those racy high-yielders than a stable reserve currency." Thus, while most analysts expect the pound to strengthen versus the yen, further market turmoil that caused (or was caused by) an unwinding of carry trades would almost certainly put additional pressure on the pound. However, given the murky nature of carry trades it is impossible to calculate this with any level of specificity.

Conclusion

We do not, as a matter of policy, make currency forecasts. That said, current market expectations for a continued rise in the pound seem about right, although the unbalanced state of the world economy, as well as questions about the size and pervasiveness of the yen/pound carry trade, create significant uncertainties. Said a slightly different way, it seems logical to expect the pound to continue appreciating at a modest pace against the US$ 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. Corporate profits, meanwhile, are likely to depend more on global economic growth than on currency fluctuations. In short, insofar as pound strength is synonymous

[3] In other words, the relationship between a strong pound and weak profits is not linear, as would be the case with an economy that relied primarily on goods exports.

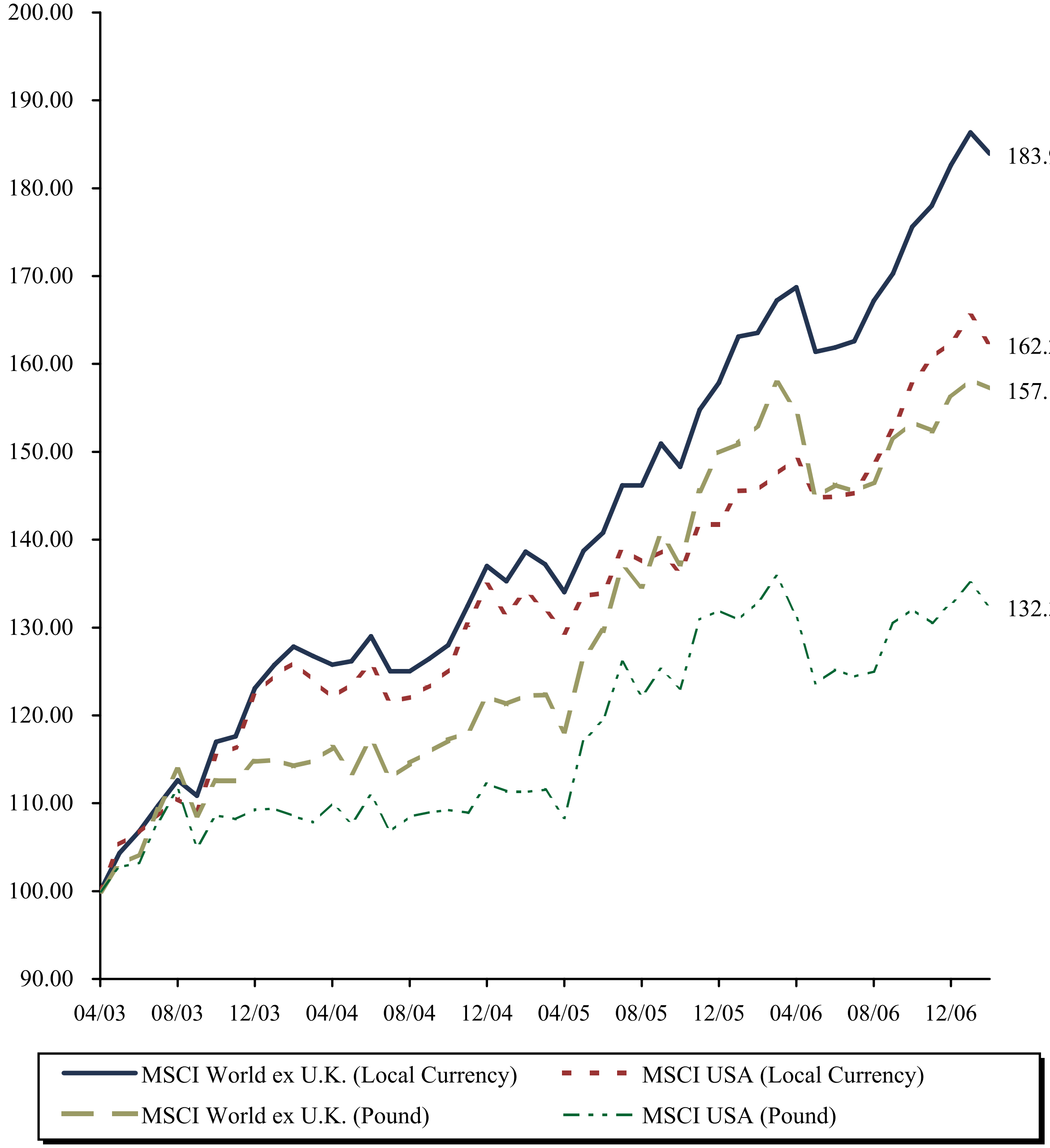
with rampant global liquidity, we would expect a rising pound to go hand-in-hand with strong corporate profits, while pound weakness (at least against the yen) would likely imply ebbing liquidity, and thus slower economic growth and weaker profits.

Table A

CUMULATIVE WEALTH OF THE MSCI WORLD EX U.K. AND USA INDICES IN LOCAL CURRENCY AND POUNDS

May 1, 2003 - February 28, 2007

Cumulative Wealth Index
(April 30, 2003 = 100)

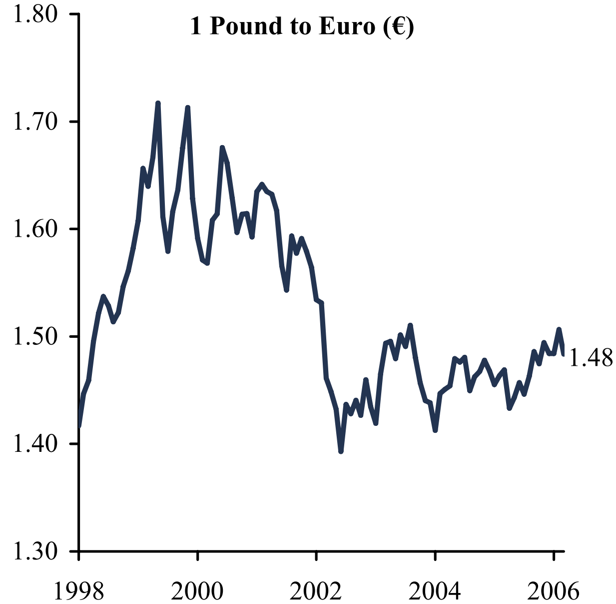


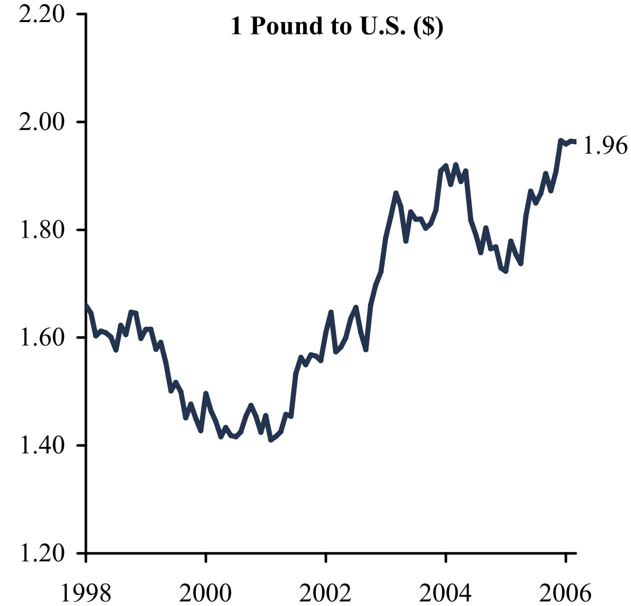
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

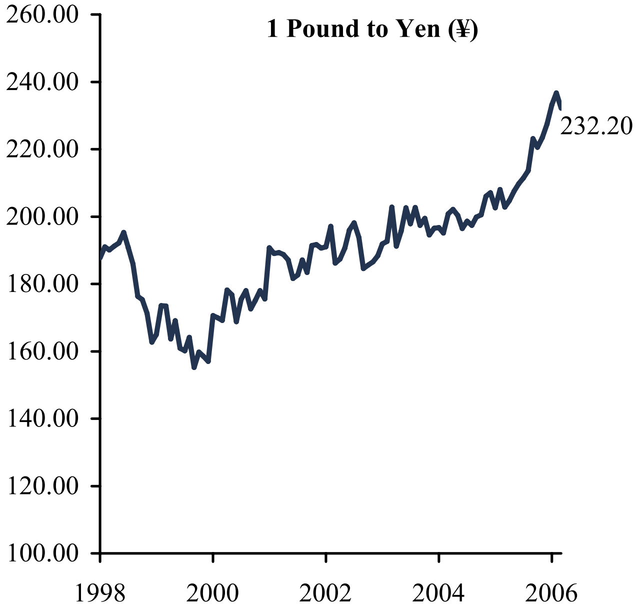
Table B

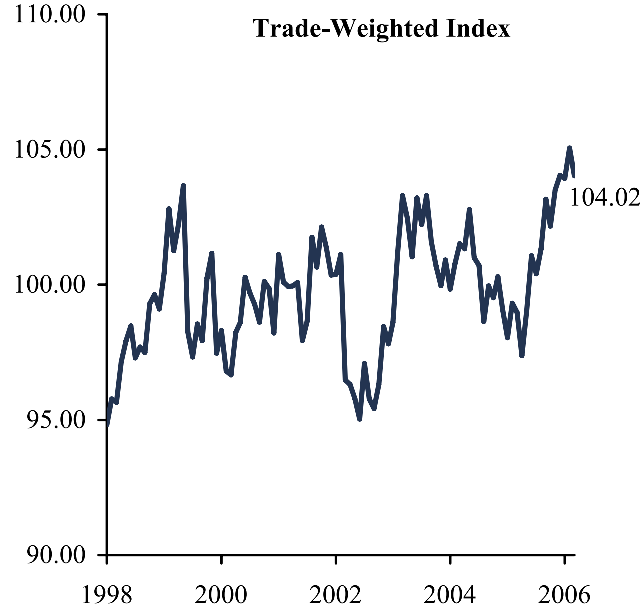
POUND EXCHANGE RATES SINCE DECEMBER 1998

December 31, 1998 - February 28, 2007









Sources: Bank of England and Thomson Datastream.

Note: The trade-weighted index is calculated by the Bank of England.

Table C

LONG-TERM PRICE OF GOLD IN POUNDS

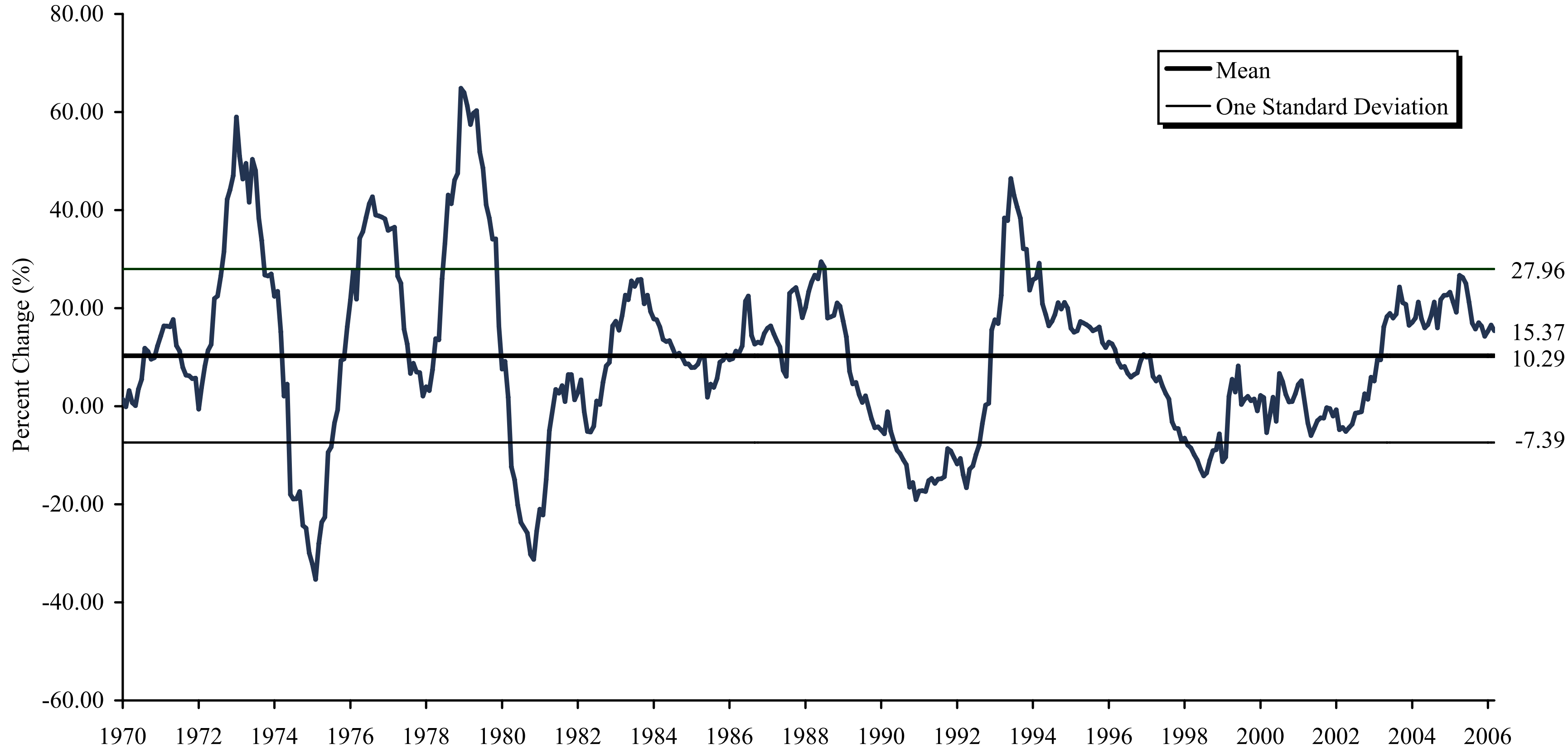
January 31, 1968 - February 28, 2007

Source: Thomson Datastream.

Table D

YEAR-OVER-YEAR U.K. CORPORATE EARNINGS GROWTH

January 1, 1970 - February 28, 2007



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Data represent the MSCI U.K. Index. Data represent the year-over-year growth rate on a monthly basis.