Will sterling hit the wall?

DAVID BLOOM TAKES A LONG, HARD LOOK AT STERLING'S FRAILTIES – AND REACHES A CONCLUSION THAT MAY SURPRISE MANY PEOPLE.

I will start with a bold statement: there will be no sterling crisis. This statement does not come easily, because the risk/reward profile of making such a claim seems incorrect. If sterling does not go into a crisis, then this article will pass you all by like a ship in the night, but if there is a crisis I am forever damned.

So why am I so confident? At the risk of teaching my grandmother to suck eggs, I would say the most important point about a currency, compared to any other asset class, is that in the foreign exchange (FX) market we deal with relative concepts, not absolute ones. So there are some very startling and absolutely true facts about the poor state of the UK economy and public finances, but what we need to ask is how these issues compare with other countries.

In the FX market one has to be an expert on the relative differences between countries, rather than an expert on a particular country. For example, the UK's relative economic underperformance in the third quarter last year was largely driven by temporary factors: inventory rebuilding and large fiscal boosts to both the US and the Euro Zone economies which we didn't see in the UK. However, as these temporary factors fade later this year the UK should outperform and this will boost sterling.

In my early career at HSBC, I was the US economist and subsequently a UK economist, and I am always comparing the two economies. For the moment, it is a score draw given the similarity between them, and this is reflected in the fair value calculation between the two countries. In fact, the OECD currently calculates the purchasing power parity to be 1.55. What is strange is that when sterling broke the 1.50 level, the word "crisis" became a popular media term despite the level being only about 4% away from fair value.

The question is what will be the game breaker to move us away from this level? Here we believe the UK will increase interest rates before the US and that election/political risk will rotate to the US as its November mid-term elections loom. On this basis we are absolutely of the opinion that there will be no sterling crisis and are relatively confident that sterling will rise later this year particularly against the dollar. And as the euro economies are plagued with their own deficit and debt problems, it is difficult to see the euro making too much headway against the pound.

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WHAT ABOUT INTEREST RATES? We expect the first UK interest rate hike in August of this year – yes, August. We expect rates to rise 25bp in August and 50bp in November so that interest rates will have reached 1.25% at the end of this year. We expect rates to hit 3.5% by end-2011. By contrast, we do not expect the Fed to move until well into 2011.

Currently the Bank of England's Monetary Policy Committee (MPC), the UK's central bank rate setting body, would feel uncomfortable with the rise in bond yields that would accompany any move to increase rates, not least because of the vast amounts of private sector refinancing (particularly financials) that need to be completed. It seems likely the MPC will want to lean against such sentiment by continuing to float the possibility that quantitative easing could be restarted if necessary. That, combined with the apparent split in opinion over the economic outlook among MPC members, means it is now probable that the committee will start to normalise policy only later on this year.

We acknowledge that the last quarters of 2009 and the first quarter of 2010 growth have been weaker than anticipated, so on current estimates the level of GDP is lower than expected. Much like the Bank of England, though, we expect GDP to be revised up over time, and expect recovery to continue through the year.

POLITICS NOT AS BIG A RISK AS MANY SUGGEST Most analysts have argued that a hung parliament would be very negative for sterling because of the political uncertainty that would follow. Given the poor state of UK public finances, the country needs to set out a sustainable path for deficit reduction. The fear is that if this is not done, then the UK will lose its AAA rating, forcing a sale of gilts and sterling.

We question how real these fears are. Historically, minority or coalition governments have not lasted long in the UK, and there would be the prospect of another election perhaps only a few months later. However, the experience of even 1974 suggests that a hung parliament is not necessarily a currency negative. All parties seem to believe the deficit must be tackled; some prefer higher taxation and others want greater spending cuts, but all seem to be in general agreement that the UK must set out a path to deficit reduction.

THE ALLURE OF THE EMERGING WORLD Only a few years ago we believed that the influence of political factors on major currencies was a relatively low importance variable, especially with independent central banks acting on inflation targets. Previously, if governments were fiscally lax, the bond markets would act as their nemesis. This meant the political business cycle was snuffed out.

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However, today we have rates at zero and quantitative easing (central banks buying bonds) prevents the bond markets from punishing lax governments. This brings the political business cycle to the fore, and hence a close market focus on the UK election, Greece and its fiscal problems and later on this year the US mid-term elections. The crisis has made us think very differently about what is now influencing markets and exchange rates.

From a strategic angle, we believe it is prudent to continue to favour currencies which have a better fiscal backdrop and for which the risk of political uncertainty causing fiscal noise is lower. This is still consistent with our view of preferring commodity currencies in the G10 group and a number of emerging market currencies, especially in Asia, that are at the beginning of a period of monetary tightening. These tightenings will have to come with a change in policy and politics as it would mean the long held dollar anchor will have to be put to one side.

NO STERLING CRISIS We are confident that there will not be a sterling crisis. This confidence is derived from the view that currencies are a relative concept and the world outside the UK is not exactly a bed of roses. We are less concerned than many about the possibility of a hung parliament, as it seems all parties understand the need for a sustainable path to deficit reduction.

Once the fear of the election passes we will be looking at the very real possibility of a UK rate rise. Meanwhile the baton of political risk will have passed to the US. This should mean sterling will start to rise against the dollar as the year progresses. Although growth and fiscal problems plague the developed nations, those problems have not hindered emerging market growth. We remain confident that emerging markets will continue to be the foundation of growth in the foreseeable future.

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