Riding out volatility

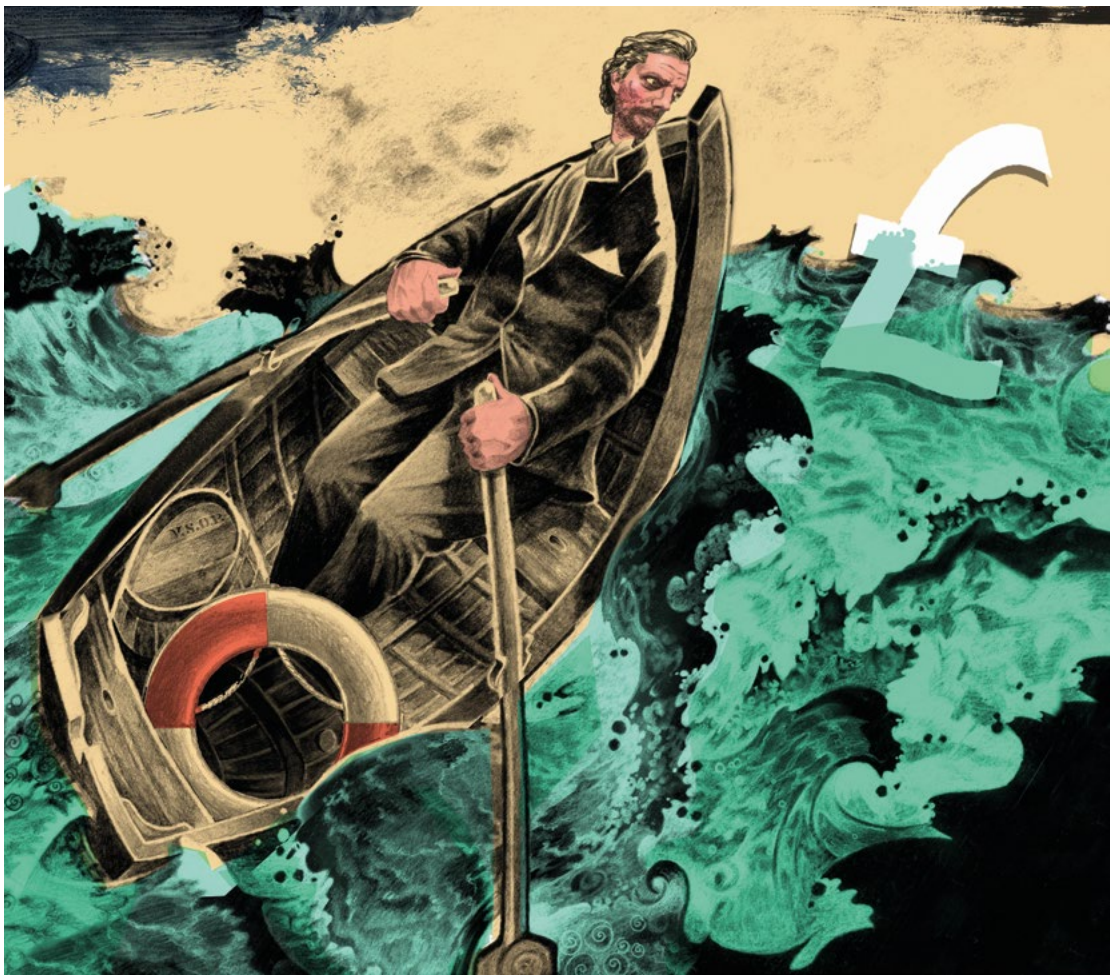
STERLING'S PERFORMANCE SO FAR IN 2016 HAS HIGHLIGHTED THE IMPORTANCE OF MANAGING CURRENCY MARKET VOLATILITY FOR UK COMPANIES THAT CONDUCT BUSINESS INTERNATIONALLY, LEE MCDARBY ARGUES

As the new year dawned, sterling was still in relative good health – on 4 January the pound stood at €1.36 – thanks to the wave of success it rode in 2015. Borne out of political and economic factors, such as steady economic growth in the UK, quantitative easing (QE) in Europe and Greek Grexit speculation, this fruitful period for the pound saw GBP/EUR reach a seven-and-a-half-year high in July 2015, when £1 bought €1.44.

Q1 of this year was a different story, however, as sterling failed to maintain its bull run against the euro – as outlined in the chart on page 53.

A range of events conspired to put the pound under considerable downward pressure during the first three months of 2016: concerns over Chinese economic growth once again reared their ugly head; the UK quarterly *Inflation Report* revealed inflation running worryingly close to 0%, meaning expectations for higher UK interest rates were pushed back to 2017; and, most notably, speculation surrounding the outcome of the upcoming referendum – dubbed 'Brexit' – on the UK's membership of the EU intensified.

Ever since UK prime minister David Cameron emerged from lengthy negotiations with the European Council in February, clutching his list of EU membership reforms, and subsequently announced the referendum will take place on 23 June, significant sterling volatility has ensued. A trend fuelled by a 'Leave' campaign that is gathering considerable momentum thanks to the backing of some high-profile political figures, and subsequent concerns among investors that a departure from the EU could have a detrimental impact upon sterling, have added to the uncertainty. For example, in the three days following London mayor Boris Johnson's announcement that he would be throwing his weight behind a Brexit, the pound plummeted to a seven-year low against the US dollar, falling from 1.4330 to 1.3879.



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The potential impact of the pressure applied to the UK's relationship with its largest trading partner has been reflected in the global currency markets. By early March – when £1 stood at €1.28 and £1 = $1.39 – the pound had fallen by 4.7% against the euro and 4% against the US dollar since the start of the year.

What does the remainder of 2016 hold for sterling?

This downward spiral has turned into more of a market roller coaster as the chance of a Brexit becoming a reality mounts. The majority of recent opinion polls indicate the UK population will choose to stay in Europe, but the figures are tight enough and the number of undecided voters high enough that a shock exit is not out of the question. Consequently, by 7 April the GBP/EUR pair had dropped to its lowest level – £1 = €1.23 – since June 2014; although, to further highlight market uncertainty, in the month of April, sterling has recovered by almost 5% against the single currency.

The official campaign period began on 15 April and this should add to the ongoing turbulence, while it is predicted that nervousness surrounding the result of the referendum may continue to direct negative sentiment towards the pound. With this in mind, market analysts are forecasting a tempestuous two months ahead. In terms of sterling's relationship with the single currency market, forecasts suggest that the rate could trade as low as 1.15 before the vote.

As markets come to terms with the prospect of a Brexit, we should try and gain some perspective. Yes, our immediate concern is the coming weeks leading up to the referendum itself, and its influence on the pound. However, both ongoing opinion polls – albeit by a fine margin – and political betting markets, which have become increasingly respected following the pollsters' mistakes in last year's general election, indicate that the public will vote for Britain to remain in the EU.

If the UK does choose to dissolve its membership of the EU, some experts predict a hangover to the tune of a 20% slump overnight in the value of sterling. However, if the public decides against upsetting the status quo and votes to maintain the country's position in Europe, the pound could rally given the precedents of last year's general election and the Scottish referendum before that. If we look back to 2014 as a recent case study, the pound dropped to £1 = €1.24 days before the ballot as polls began to suggest a surprise vote to leave the UK was in the offing, before surging to a two-year high versus the euro, as Scotland decided against independence. This scenario could well be repeated in June, and most market forecasters expect it, with average predictions for GBP/EUR being 1.35 and GBP/USD 1.46 by the end of the year.

What's more, the GBP/EUR rate could be provided with further support by events elsewhere in Europe: namely ongoing QE in the eurozone and the renewed threat of a Grexit, as Greece struggles to meet the fiscal targets required by the bailout programme. We believe there will be a need for FX management services whatever the outcome of the EU referendum. The EU referendum is a democratic decision and we have employees and customers with a wide range of views. We will adjust to either circumstance.

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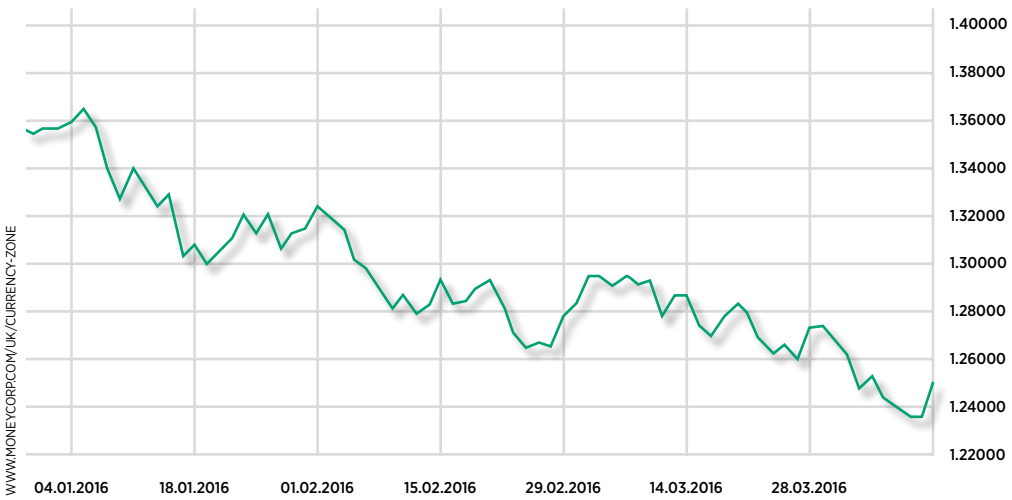
Managing market volatility

Sterling volatility in 2016 presents a challenge for treasurers of companies that trade internationally, as they seek to protect their cash flows. For UK businesses that import, the pound's recent misfortune could have had a detrimental impact on their bottom line if they were not hedged. For example, at the early January rate of £1 = €1.36, €200,000 worth of stock would have been priced at £147,000; whereas at the April rate of £1 = €1.23, the cost would have increased to £162,500. That's a difference of £15,500 in just a matter of weeks, simply due to fluctuating exchange rates.

Using the services of an FX expert service can help to mitigate the risks posed by such market movements, through the provision of astute financial risk management. FX management specialists can help businesses develop – and implement – FX hedging strategies in line with their ongoing cash-flow forecasts, and can provide a proactive service that may not always be offered elsewhere.

GBP VERSUS EUR Q1 2016



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