Stock Market Review

Sterling's strength against the euro, despite recession

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Few investors may have realised that last week the sterling vs euro exchange rate was quoted at GBP0.7862 for every €1 or €1.2719 for every GBP1, the highest level since October 2008. The British pound had suffered a remarkable setback in the aftermath of the bankruptcy of Lehman Brothers in September 2008 and the resultant significant interest rate cuts by the Bank of England between October 8, 2008, and March 5, 2009.

Within the space of just five months, the Bank of England reduced official interest rates by an astonishing 450 basis points (equivalent to 4.5 percentage points) from a level of five per cent to a mere 0.5 per cent. Interest rates in the UK have remained at this level ever since, with the BOE resorting to quantitative easing as a further measure of stimulus for the economy.

The substantial monetary policy easing by the Bank of England was the primary reason behind the sudden decline in the value of sterling in 2008. The British pound lost 30 per cent of its value against the euro during 2008 with the major part of these losses occurring during the final quarter of the year. The lowest level recorded was on December 30, 2008, when the GBP vs EUR exchange rate was of GBP0.9746 – just shy of the parity level.

While the BOE acted very swiftly and drastically with sizable interest rate cuts during the international financial crisis which followed the demise of Lehman Brothers, the European Central Bank adopted a more gradual monetary easing stance. While the BOE reduced rates by 4.50 percentage points within a five-month period, the ECB reduced rates by only 2.75 percentage points from 4.25 per cent to 1.5 per cent. The ECB adopted further monetary easing in the second quarter of 2009 by reducing rates by a further 50 basis points to one per cent. The higher rates in the eurozone compared to the UK during late 2008 and early 2009 helped support the value of the euro.

Although the pound sterling remained volatile from one period to the next, the currency recovered gradually since the sharp downturn in 2008, strengthening against the euro in each of the subsequent three years. Sterling registered a further 5.6 per cent gain against the euro since the start of this year, pushing up the recovery by almost 25 per cent since the lowest level registered in December 2008. Is the strengthening of the British pound reflective of the improving economic fundamentals of the British economy?

Recent statistics indicate that the UK economy is back into recession with a second successive period of negative GDP growth during the first quarter of 2012. The International Monetary Fund also indicated that the British economy would come to a virtual standstill with growth of just 0.2 per cent this year compared with its earlier forecast in April of 0.8 per cent growth. Furthermore, the IMF reduced its 2013 growth forecast to 1.4 per cent and indicated that there are further downside risks to the weaker outlook. Given this backdrop, it therefore seems odd that sterling is strengthening against the euro at a time when the British economy is officially in recession.

However, when it comes to monitoring foreign exchange movements and comparing currencies, it is the *relative* strength or weakness of one currency against another that comes into play. Some other commentators argue that a strong currency either reflects a strong economy or it means that it is not as bad as the other economy being compared to it. The relative attractiveness of the UK economy compared to developments across the eurozone could easily explain the recent appreciation of the British currency. Some would argue that it is more a question of euro weakness rather than sterling strength.

True, the eurozone is also in a recession, and the European Central Bank has had to reduce interest rates by a further 25 basis points to 0.75 per cent on July 11. This was done in response to the growing tension across the markets following the failure of the end of June EU summit to stem the nervousness around Spain and Italy and the increased speculation on the future of the euro.

The ECB also cut its deposit rate from 0.25 per cent to zero in an effort to stimulate the flow of money between banks and, in turn, from banks to the business community. These decisions by the ECB portray the growing fragility across the region and it is therefore not a coincidence that within a few days from the ECB announcement, the euro dropped to its lowest level since October 2008 against the sterling. Although the British economy is also suffering from the severe crisis across the euro area, it seems to be in a healthier state than the eurozone economy. Some days ago the IMF called on the European Central Bank to do more to support the region and suggested that there is room for monetary policy in the euro area to ease further. The IMF said that the measures taken to date have so far been insufficient and they urged the ECB to consider 'non-standard measures' including quantitative easing.

Apart from the relative strength of the British economy compared to the eurozone and the possibility of further measures by the ECB to support the ailing currency zone, sterling may also be benefiting from a 'safe haven' status coupled with the short-term boost to the economy from the Queen's Diamond Jubilee celebrations and the Olympics.

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However, the recent upturn of sterling against the euro must be placed into perspective and viewed in the context of the value of both currencies before 2008 when GBP vs EUR was trading in the region of GBP0.67 and GBP0.74 (or EUR1.35 and EUR1.49) during the second half of 2007. Therefore, despite the recent upturn, it may be that there still remains further sterling appreciation to pre-2008 levels against the euro. Currency markets do tend to be very volatile and difficult to predict at times, and the recent turbulence across the markets and the increasing factors at play affecting currencies has made forecasting much more difficult.

Major UK economists do not anticipate the rally in sterling to continue with the main argument being that a continued upturn in the British pound would undermine exports which has been the main source of growth of Britain's economy in recent years. These economists claim that a further upswing in the British pound to levels pre-2008 requires the prospect of higher interest rates and this, in turn, requires strong evidence of a decisive economic recovery which is still some way off.

Sterling is closely monitored by local investors given the exposure of many Maltese to GBP-denominated investments in their portfolios. Some companies listed on the Malta Stock Exchange are also quite exposed to the exchange rate movements of sterling against the euro and this can have a material effect on their financial results. The three more relevant in this respect are possibly International Hotel Investments plc (in view of the London hotel and apartments), Island Hotels Group Holdings plc (due to the vacation ownership sales mainly originating from UK nationals) as well as Crimsonwing plc as a result of the significant business activity generated in the UK. These companies should provide guidance to the market through appropriate announcements on the impact from the recent sterling upturn on their overall financial performance.

Movements between sterling and the euro are also relevant to the wider general public in Malta given that purchases in GBP which are financed through a conversion of euros have become more expensive in the context of the euro weakness. Although this may not have any impact on some of the smaller ticket items that are generally purchased online, the more valuable purchases in sterling could be impacted to a much larger degree from such movements.

In recent years, the automotive market in Malta became dominated by second-hand imports from the UK and the strong recovery of sterling could well become a determining factor in this industry. On the other hand, the local tourism industry may be aided by sterling strength given that the UK remains Malta's largest source market and holidays for British travellers to the EU have become cheaper.

Sterling exchange rate
July 17, 2007 – July 17, 2012