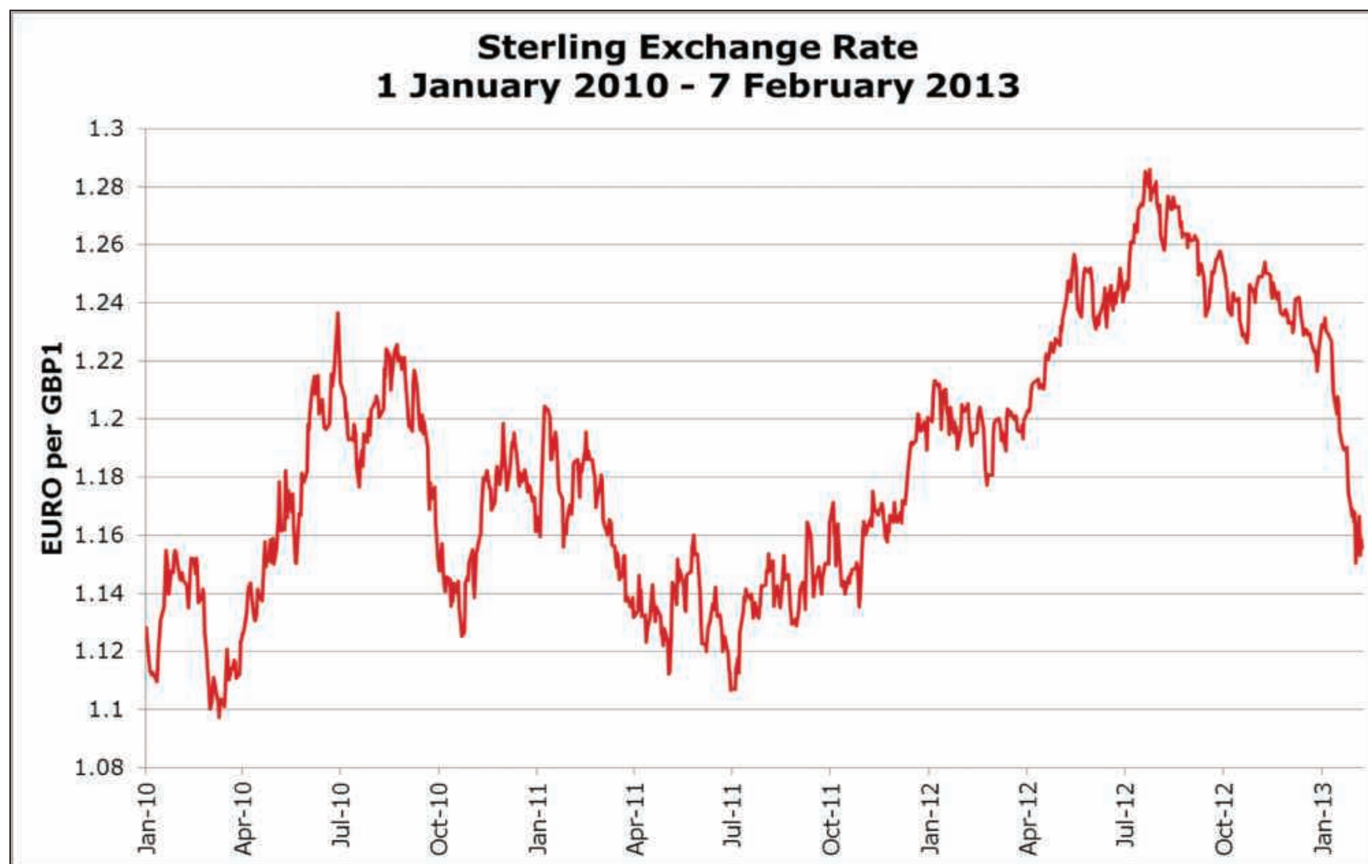
Stock Market Review

Sterling loses 'safe haven' appeal

Edward Rizzo

Edward Rizzo is a director at Rizzo, Farrugia & Co. (Stockbrokers) Ltd.



All currencies are valued relative to each other. The performance of a currency is one of relative strength or weakness against another currency. While sterling appreciated against many of the major currencies during 2012 (+2.6 per cent against the euro and +4.4 per cent against the US dollar) as it was perceived by international investors as a relative 'safe haven' from the eurozone crisis, the British pound has been one of the worst performing major currencies since the start of 2013.

For local investors, the more important gauge is the performance of sterling against the euro. Sterling has so far this year lost 4.5 per cent against the euro and traded at £0.863 (or €1.159 per £1) – its lowest level since late 2011. Since the height of the financial crisis in 2008/9 when the sterling vs euro exchange rate almost reached parity, sterling recovered to a high of £0.7812 (or €1.28 per £1) in July 2012. Before the onset of the international financial crisis, sterling was valued at £0.77 or €1.30 against the euro. When analysing the performance of sterling against the euro, one must take into consideration the significant appreciation of the euro in recent months.

The euro started to strengthen once fears of a breakup of the single currency subsided in the summer. Comments from European Central Bank president Mario Draghi in July were very effective in restoring calm across the international financial markets. In fact, the eurozone periphery countries which were always regarded as the source of the troubles, have managed to return to the bond markets with yields on government bonds declining on reduced perceived risk.

As the eurozone seems to have passed its critical moment, the performance of sterling against the euro is now mainly affected by fundamentals of the UK economy rather than the ongoing developments across the eurozone.There are various factors that transformed sterling from a 'safe haven' in preceding years to a riskier proposition relative to other currencies in recent weeks.

One of the factors that negatively impacted the value of sterling in the last few months was the increasing likelihood of a loss in the country's top notch credit rating. The UK has maintained an 'AAA' credit rating since 1978. However, in mid-January the credit-rating agency Fitch again warned that the risks of Britain losing its 'AAA' status are "clearly increasing". The agency cited that this is very much dependent on the state of the country's finances and the overall level of debt. Figures released on January 25 show that debt as a percentage of GDP surpassed the 70 per cent level for the first time since the early 1970s.

Additionally, both Fitch and Moody's had officially changed their outlook from 'stable' to 'negative' on UK's credit rating in the first quarter of 2012 with Standard & Poor's following suit in December 2012 also citing weakening economic metrics.

The UK Budget due to be presented next month is therefore a key determinant of the country's credit rating. In 2012, both the US and France lost their 'AAA' ratings and now only three countries (Australia, Canada and Germany) have the highest rating by all three rating agencies.

The UK's economic performance has increasingly come under the spotlight in recent months as the focus of the eurozone crisis subsided and economists paid more attention to the economic fundamentals of the other major countries. The Chancellor of the Exchequer George Osborne recently had to concede that the austerity programme aimed at cutting public debt was taking much longer than expected to produce results.

However, he also pointed out that amending the policy now would not be advantageous for the economy. Mr Osborne stated that austerity measures would have to stay in place at least until 2018 (a year longer than initially expected). In the Autumn Budget Statement, the Chancellor of the Exchequer also indicated that the overall debt level would only begin to fall as a proportion of GDP from 2017 onwards.

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Moreover, economic projections were downgraded over recent months with many analysts initially speculating that the UK economy is on course for an unprecedented 'triple-dip' recession. On January 25, statistics indicated that the British economy shrank by 0.3 per cent in the final quarter of 2012 which is worse than what many economists had expected. According to the Office for National Statistics, the UK economy contracted during four of the past five months.

Since late 2012, various institutions have revised downwards their respective 2013 growth projections for the UK. Most notably, the country's own Independent Office for Budget Responsibility is now predicting a 1.2 per cent growth in GDP for 2013, down from the previous forecast of a two per cent growth. The various forecast reductions mainly reflect the deterioration in public finances as the austerity measures have until now failed to reach targets given weaker economic growth. As a result, markets are now doubting the UK government's ability to kickstart the economy and avoid a triple-dip recession.

There is also concern about the future conduct of monetary policy. The Monetary Policy Committee of the Bank of England last lowered interest rates in March 2009 to a historic low of 0.5 per cent. Since then, the BoE focused on a quantitative easing programme (comprising purchases of UK gilts to the tune of £375 billion) but the expected benefits of this measure has not yet filtered through to the real economy in the way desired. Furthermore, the BoE committee members seem to be divided on whether further easing is necessary. The appointment of the Canadian Mark Carney to succeed Mervyn King as Governor of the BoE from July 1 for an eight-year term of office has also been fuelling heated discussions over the conduct and direction of monetary policy in Britain.

His appointment ignited speculation that he might orchestrate unconventional monetary policy actions which will possibly negatively impact the value of sterling. Mr Carney initially hinted that he will allow inflation to remain above the current target of two per cent and he may consider maintaining a very low level of interest rates until such time as the UK economy shows signs of sustainable growth (or "escape velocity" in Mr Carney's words). However, in last week's appearance before the Treasury Select Committee, the BoE governor-designate gave a more guarded approach to the future direction of monetary policy as he stated that "delivering price stability is the best contribution that monetary policy can make to the economic welfare of citizens".

Investor appetite for the pound is also weakening on continued doubts over Britain's future in the EU. As the 17 eurozone members are discussing a closer political union, British MPs are placing increasing pressure on Prime Minister David Cameron to renegotiate terms of EU membership. On January 23, the British Prime Minister announced that a referendum about whether the country should remain in the EU or not will take place by the end of 2017. As a result, foreign exchange markets will continue being influenced by the uncertainty over this issue for some time. A weakening pound should be beneficial to help drive exports, stimulate domestic economic growth and help to reduce unemployment levels.

However, the uncertainty surrounding Britain's EU membership status together with a potential credit rating downgrade could trigger a sell-off in UK government bonds which is detrimental to the economy since borrowing costs by the Treasury will have to rise. In view of some MPC members' opinion on the beneficial impact of a weakening sterling on export growth, the BoE may opt for measures to maintain a weak currency over the coming years.

Many local investors continue to maintain exposure to GBP and currency movements should be monitored closely since, in certain instances, they could have a sizable impact on the performance of an overall investment portfolio. Moreover, investors should also regularly reconsider their investment objectives including the need for such foreign currency exposures. A 4.5 per cent drop in GBP-denominated investments in just a few weeks could have a sizable impact on an investment portfolio if this has a meaningful exposure to sterling-denominated investments.

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