Autumn Update

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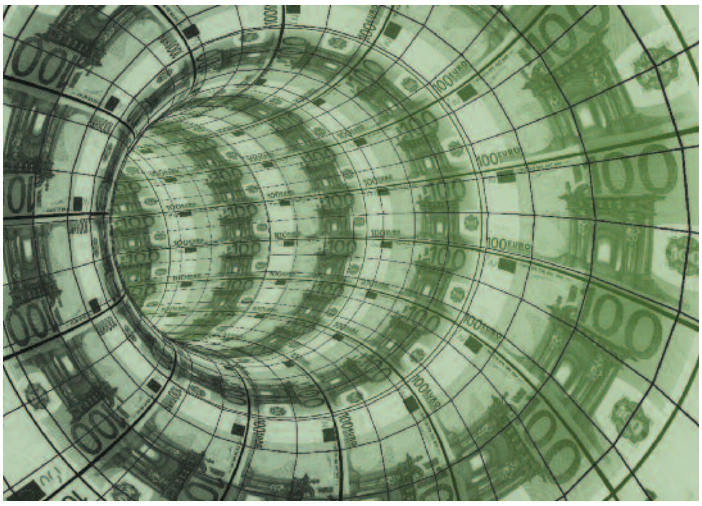
Currency report

October 2012 | Quarterly update

Is there light at the end of the €uro tunnel?



As we enter the final three months of 2012, we examine if there is light at the end of the tunnel for the euro zone. Some headway has been made and the European Central Bank (ECB) has finally shown its hand – but is it enough and will its strategy work as southern European nations remain plagued by recession, debt and high financing costs?

Outside Europe the major economies of the US, China and Japan continue to falter. We look at what action central banks have taken and what's on the horizon. We also review the pound's recent progress against a backdrop of the UK's double-dip recession and identify the key themes which could affect the pound in the coming months.

JULY TO SEPTEMBER REVIEW

JULY

Sterling rose above €1.28 for the first time since October 2008 despite an ECB pledge to do 'whatever it takes' to save the euro. This fuelled speculation the ECB would buy Spanish and Italian government bonds to ease their borrowing costs. Euro zone interest rates were cut to 0.75%, but remained higher than the UK's 0.5% base rate.

The Bank of England (BoE) extended its quantitative easing (QE) efforts, by £50 billion to £375 billion. A shock contraction in the UK's Gross Domestic Product (GDP) during the second quarter was its third consecutive decline, marking a fifth drop out of the past seven quarters. Inflation fell to 2.4%, its lowest level since 2009.

US GDP growth slowed in the second quarter but exceeded expectations. The US dollar fell against the pound despite the Federal Reserve dampening speculation it would engage in a third phase of QE (QE3) in the near term, a policy which typically weakens a currency. A third consecutive disappointing non-farm payroll report signalled the labour market could be running out of steam.

The Canadian, New Zealand and Australian central banks kept interest rates at 1%, 2.5% and 3.5% respectively. The rand lost favour after the South African Reserve Bank lowered interest rates by 0.5% to 5%.

AUGUST

The euro zone's GDP fell by 0.2% during the second quarter. Whilst in line with expectations, it highlighted the gap between the region's strong core and weak periphery. German economic expansion contrasted with shrinking output in Portugal, Italy, Greece and Spain.

German Chancellor Angela Merkel helped the euro, as she confirmed the ECB's recent declaration to do 'whatever it takes' to save the euro was compatible with Germany's interests, fuelling hopes of an imminent plan to support ailing economies.

The BoE policy meeting minutes revealed policymakers had not discussed cutting interest rates, as they had in July. A rise in inflation squeezed household budgets. Encouragingly, the UK economy created 201,000 extra jobs in the second quarter.

The US jobs picture appeared slightly brighter after a better-than-expected non-farm payrolls employment report. US Federal Reserve Chairman Ben Bernanke admitted the high unemployment rate (8.3%) was still of 'grave concern' and hinted more might be done to stimulate the economy.

Fears of a 'hard-landing' for the Chinese economy, the world's second largest, hindered some of the commodity-led currencies such as the Australian and New Zealand dollars. The rand fell after a violent crackdown on striking platinum mine workers curbed South African investment inflows.

SEPTEMBER

Sterling/US dollar rose to a fresh year high above 1.63 after the Federal Reserve gave the green light to QE3. It gave an open-ended promise to 'print money' until employment conditions improve. Non-farm payroll jobs gains were below 100,000 for a fourth month out of the past five.

BoE policymakers voted unanimously to keep QE at £375 billion, although some felt additional stimulus could be needed further down the line. UK inflation eased slightly to 2.5%, resuming its downward trend since September 2011.

The ECB unveiled measures it hoped would help keep the euro intact. It would buy government bonds in potentially unlimited quantities if credit markets were to become inaccessible to ailing countries. Germany's top constitutional court gave the euro a boost after rejecting efforts to block the European Stability Mechanism, the euro zone's bailout fund.

The yen fell after the Bank of Japan joined the chorus of central banks adding stimulus; expanding its QE programme by ¥10 trillion to ¥80 trillion.

China's Premier, Wen Jiabao, stated his country would meet its growth targets despite signs of slowing manufacturing and export growth. He called on the international community to strengthen policy co-ordination rather than adopting 'beggar-thy-neighbour' policies to weaken their currencies.

HARGREAVES LANSDOWN

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Outlook: EURO ZONE DEBT CRISIS REMAINS KEY TO CURRENCY PERFORMANCES

The aim of our outlook is to identify key themes influencing currencies and not predict short-term movements in exchange rates.

STERLING:

The UK economy has barely grown over the past two years and its GDP remains more than 4% lower than its pre-recession peak. In contrast the US and German economies have expanded over this time. BoE governor King's recent assertion of 'beginning to see a few signs now of a slow recovery' might be wishful thinking ahead of retirement next year, although there are hopes we'll see an Olympics-related boost to GDP in the third quarter (a first estimate is released on 25 October).

So why has growth been so weak? It largely arises from the severe squeeze on consumer and government spending. Household budgets have been constrained by stubbornly high inflation, although the BoE still expects inflation to fall below 2% next year. The coalition's 'plan A' remains safeguarding the UK's AAA credit rating. Weak growth hinders tax receipts, which requires offsetting spending cuts to balance the books. This leaves little room for the government to backtrack as pressure mounts on it to spur growth.

If stimulus continues to be needed it is likely to come via the BoE's QE policies. Its current round of asset purchases is expected to conclude in November, so there is a strong likelihood more will follow before the end of the year. Increasing the money supply should be a negative for the pound. Questions remain over QE's longer-term inflationary impact and its effectiveness.

Nonetheless, sterling's performance versus the euro will inevitably be driven by events in the euro zone. Signs the region's troubled economies are making better-than-expected progress could see sterling re-test April's €1.20 level, but we expect renewed fears over the euro's long-term viability to push the pound to €1.30 in the months ahead.

EURO:

The ECB's vow to do whatever it takes to save the euro has given some support to the currency in recent weeks, although the euro's momentum has since stalled after an initial period of euphoria.

The ECB's grand plan is to buy ailing countries' bonds in potentially unlimited quantities in an effort to cap their borrowing costs at affordable levels. Is this the much-needed 'game changer' for a crisis which has dragged on for three years?

Probably not. The ECB will only step in once struggling governments admit defeat, suggesting things will need to get worse before they get better. Whilst many see Spain's recent austerity cuts as paving the way for an imminent bailout, it might choose to delay a humiliating aid request ahead of upcoming regional elections in Galicia and the Basque country. More austerity is unlikely to hasten their emergence from recession. So, even with no increase in debt, their problems are made worse by rising debt-to-GDP ratios.

The widening divergence between the northern and southern economies remains a key issue. At more than 25%, Spain's unemployment rate is over four times that of Germany's. The southern economies are likely to rely on aid from the north until such structural problems are addressed. PIMCO, the world's largest bond investor, recently said it still expects at least one departure from the euro and finds it hard to see how Greece will stay on.

With the ECB's latest forecasts showing euro zone GDP shrinking by 0.4% this year. The weak economic backdrop points to the ECB cutting interest rates (0.75% currently) again in the coming months; eliminating the euro's interest rate advantage versus sterling.

US DOLLAR:

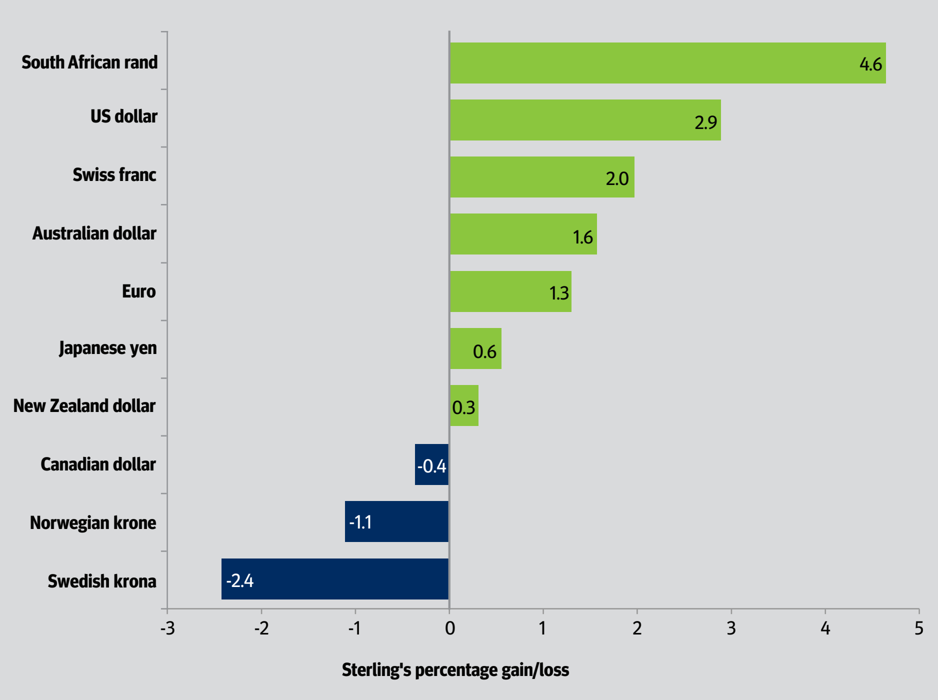
The dollar's recent decline reflects the onset of QE3 and optimism over ECB efforts to address euro zone tensions; lessening the demand for the dollar as a safe-haven. Given the potential for further UK monetary stimulus and the dollar's perceived safe-haven status, we expect sterling/US dollar to retrace below 1.60 in the near term at times when investors' attitudes towards the euro zone turn more cautious. As such, we expect currencies linked to the dollar, such as the Hong Kong dollar and UAE dirham to appreciate against sterling in the coming months.

Dollar strength will be mitigated by very loose monetary policy. In September the Federal Reserve extended its pledge to keep interest rates close to zero until at least mid-2015, from late-2014 previously. QE3 is also a long-term commitment to buy mortgage-backed securities at a pace of $40 billion per month until the labour market outlook improves markedly.

Correspondingly, employment conditions will be crucial to policy expectations (particularly the non-farm payrolls reports released on the first Friday of each month). Worryingly, unemployment remains stubbornly high and has only dipped from 8.3% to 8.1% so far this year. The real picture is far bleaker; a sharp drop in recent years in the proportion of adults in employment implies many more have simply stopped looking for work.

The US economy has so far avoided a 'double-dip' recession, but slowing business investment suggests companies are delaying investing until the outlook becomes clearer. Added uncertainties stem from November's Presidential elections and a risk the US will reach its $16.4 trillion debt ceiling (the maximum government debt level permitted under current law) later this year.

STERLING'S PERFORMANCE (THIRD QUARTER 2012)



CURRENCIES UNDER THE SPOTLIGHT:

The Australian and New Zealand dollars benefit from relatively robust domestic economic conditions, aided by continuing Chinese demand for commodities. China's ample capacity to invest in infrastructure projects and efforts to meet its growth targets should support these currencies versus sterling, although they will be hard pressed to make considerable gains given current high valuations and expectations of further Australian interest rate cuts.

The Japanese yen is viewed as a safe-haven although the Bank of Japan (BoJ) will remain wary of allowing the yen to strengthen considerably if global financial market stresses intensify. The BoJ is liable to expand its own QE measures to counteract a rising currency.

The Swiss National Bank (SNB) is committed to enforcing a minimum exchange rate of 1.20 francs per euro. This suggests sterling/franc direction will depend on sterling's performance against the euro, whilst the SNB could further weaken the currency by committing to a higher minimum exchange rate.

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A SUMMARY OF THE BENEFITS

- ☑ A dedicated currency specialist
- ☑ Low-cost fast transfers
- ☑ A variety of ways to reduce your currency risk
- ☑ Expert currency market information
- ☑ No commission
- ☑ A global choice of currencies
- ☑ A low minimum transaction size of just £1,000 (just £250 for monthly transfers)
- ☑ Ways to convert currency back into sterling

ANY QUESTIONS?

If you have any questions about this service, please call us on +44 (0) 117 311 3257 to speak to one of our currency specialists. ■

Data release calendar

STERLING	
4 October	Policy meeting
16 October	Consumer prices
17 October	Policy minutes; Unemployment
18 October	Retail sales
25 October	GDP Q3/2012 - 1st estimate
8 November	Policy meeting
13 November	Consumer prices
14 November	Unemployment
15 November	Retail sales
21 November	Policy minutes
27 November	GDP Q3/2012 - 2nd estimate
6 December	Policy meeting
12 December	Unemployment
18 December	Consumer prices
19 December	Policy minutes
20 December	Retail sales
21 December	GDP Q3/2012 - 3rd estimate

NEW ZEALAND DOLLAR	
16 October	Consumer prices
24 October	Policy meeting
8 November	Unemployment
14 November	Retail sales
5 December	Policy meeting
21 December	GDP

EURO	
3 October	Retail sales
4 October	Policy meeting
5 October	GDP Q2/2012 - 3rd estimate
31 October	Unemployment; Consumer prices
7 November	Retail sales
8 November	Policy meeting
15 November	GDP Q3/2012 - 1st estimate
30 November	Unemployment; Consumer prices
5 December	Retail sales
6 December	Policy meeting
6 December	GDP Q3/2012 - 2nd estimate

CANADIAN DOLLAR	
5 October	Unemployment
19 October	Consumer prices
23 October	Retail sales
23 October	Policy meeting
2 November	Unemployment
22 November	Retail sales
23 November	Consumer prices
30 November	GDP
4 December	Policy meeting
7 December	Unemployment
20 December	Retail sales
21 December	Consumer prices

US DOLLAR	
5 October	Unemployment
15 October	Retail sales
16 October	Consumer prices
24 October	Policy meeting
26 October	GDP Q3/2012 - 1st estimate
2 November	Unemployment
14 November	Retail sales
15 November	Consumer prices
29 November	GDP Q3/2012 - 2nd estimate
7 December	Unemployment
12 December	Policy meeting
13 December	Retail sales
14 December	Consumer prices
20 December	GDP Q3/2012 - 3rd estimate

AUSTRALIAN DOLLAR	
2 October	Policy meeting
4 October	Retail sales
11 October	Unemployment
24 October	Consumer prices
6 November	Policy meeting
8 November	Unemployment
4 December	Policy meeting
5 December	GDP
6 December	Unemployment