HL Currency Outlook

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Great Fall of China reawakens currency volatility

Concerns over the health of China's economy has preoccupied investors' minds over recent months and heightened financial market volatility. Markets had barely had time to digest the better news from Europe where agreement on a third Greek bailout secured its future within the euro (for the time being, at least).

While the general economic outlook in the UK and US looks largely positive, headwinds from foreign shores thwarted hopes the Federal Reserve and Bank of England might start lifting interest rates for the first time in nearly a decade this quarter.

STERLING STRENGTHENS AGAINST EMERGING MARKET AND COMMODITY CURRENCIES

The fallout from developments in China reverberated across currency markets. Some of the biggest casualties were the 'commodity currencies' of nations such as Russia and Australia, which have fallen by more than 5% against sterling over the last three months (see chart below). Both have been hurt by a collapse in the prices of natural resources such as oil and iron ore as Chinese demand weakens.

A stumbling Chinese economy has also been a concern for other emerging economies, which tend to have a strong reliance on international trade. As such, the Turkish Lira and South African rand have both fallen substantially against the pound.

Additionally, the prospect of US interest rates rising in the not-too-distant future has provided investors with an incentive to hold dollars and this is also leaving its mark. Trillions of dollars which previously chased risky investment opportunities in emerging economies are now quickly changing direction. This has pushed the dollar's value up at the expense of emerging market currencies.

Given this turmoil, it's perhaps unsurprising those currencies which are traditionally seen as safe-havens are benefiting. The US dollar and Japanese yen have both appreciated nearly 3% versus sterling this quarter.

CHINA IS ALSO IMPACTING AT HOME

Slowing global growth and the associated drop in oil prices are bearing down on UK inflationary pressures – the annual rate dropped back to zero in August. Consequently, market expectations are for UK interest rates to start rising in late 2016; a delay which has detracted from sterling's performance against some of its key rivals more recently.

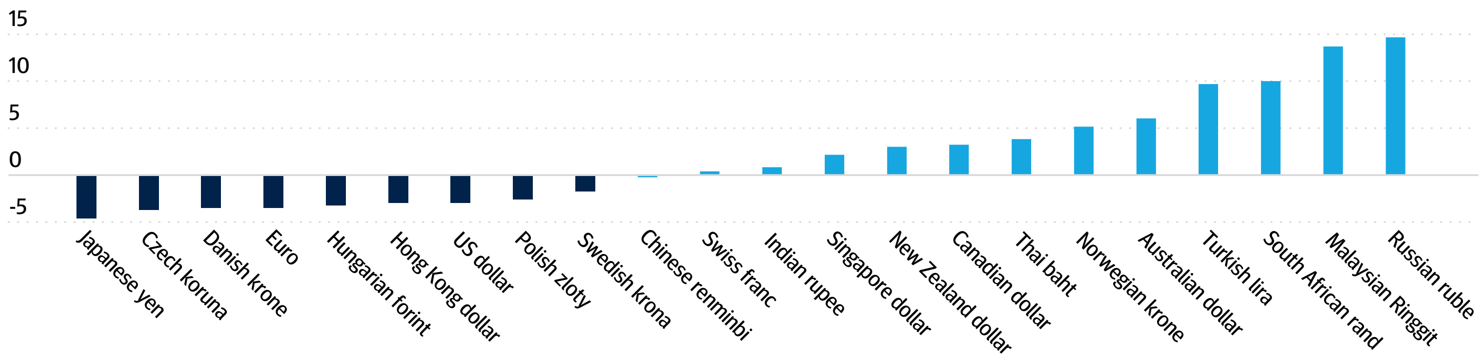
WHERE NEXT FOR STERLING?

The 'lower for longer' view for UK interest rates might be cemented further if China-related fears escalate. Although this would potentially be negative for sterling, the global economy's woes are at odds with the strong domestic picture and this is creating a dilemma for the Bank of England. The UK unemployment rate is the fourth lowest in the EU at 5.5% and average wages are growing at their fastest pace since 2009. The Bank could still opt to raise interest rates sooner if its thinks faster wage growth will push inflation up more quickly than currently anticipated.

And whilst the UK economy isn't entirely insulated from events in China, a fairly robust British economy should continue to support the pound against the currencies of those countries with closer links to the world's second-biggest economy.

However, a familiar catalogue of longer-term risks for sterling include the UK's continued current account deficit (imports considerably outweigh our exports), and a recovery which is overly dependent on consumer spending and rising home values. In addition, there are also looming political risks on the horizon in the shape of the EU 'in/out' referendum which might impact the pound.

STERLING'S THIRD QUARTER PERFORMANCE AGAINST SELECTED CURRENCIES (% CHANGE)



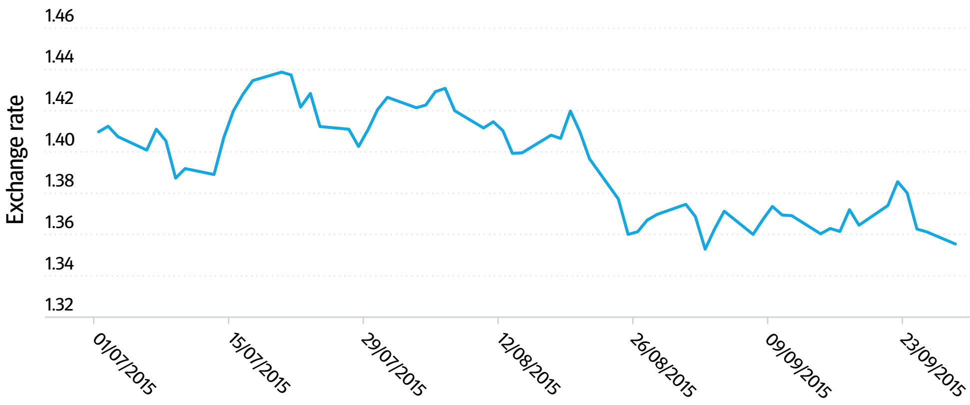
Source: Bank of England, data as at 28 September 2015

Hargreaves Lansdown

One College Square South,
Anchor Road, Bristol, BS1 5HL
www.HLCurrency.co.uk
0117 311 3257

Euro rebounds following difficult start to 2015

STERLING/EURO



Data as at 28 September 2015. Source: Proquote International

01-Jan-15	Current rate	52-week low	52-week high
1.2871	1.3588	1.2428	1.4415

What's happened? The sterling/euro rate held above €1.40 throughout much of July and early August, but quickly dropped back towards €1.35. This came following heightening fears surrounding China and increasing demand for safe haven assets such as German government bonds. This also comes at a time when a new bailout deal for Greece has renewed hopes that the country's longer term future within the euro has been safeguarded.

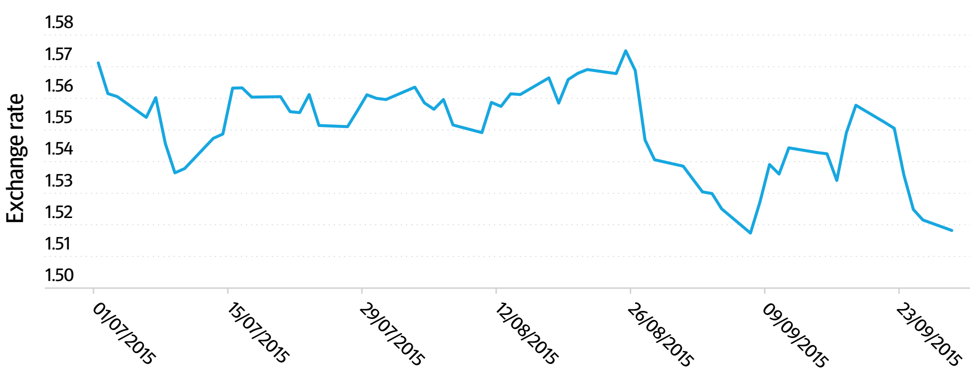
Where next? The euro zone's recovery has gathered steam in recent months, following a prolonged period in which the region struggled to find growth. The region barely grew by more than 1% in total between 2011 and 2014, but data suggests growth for 2015 should come closer to that in the UK and US. In turn, stronger economic activity is likely to continue to reduce unemployment, which has fallen to 11% (from a peak of close to 12% in 2013).

Some of this improvement is attributable to stimulus from the European Central Bank's (ECB) quantitative easing scheme. Worryingly, stronger growth is yet to feed into higher inflation – the central bank recently lowered its inflation forecasts. This has prompted several ECB officials to warn that quantitative easing might be expanded or extended. This threat is likely to keep the euro under pressure if growth and inflation rates disappoint.

Overall, we continue to see some potential for sterling/euro to rebound if financial market volatility subsides. We believe this will lead investors to refocus their attentions on diverging ECB and BoE policy outlooks. In the meantime, a return to €1.40 seems less likely whilst concerns remain concentrated on faltering global growth rather than the euro zone's own shortcomings.

US dollar – Fed delays raising interest rates

STERLING/US DOLLAR



Data as at 28 September 2015. Source: Proquote International

01-Jan-15	Current rate	52-week low	52-week high
1.5574	1.5198	1.4565	1.6287

What's happened? In early September the dollar rose to its highest value against the pound (US$1.51) since early May. This coincided with the US jobless rate falling to its lowest level in seven years. By mid-September it had fallen back into the mid-1.50s as the Federal Reserve confirmed US interest rates would be kept close to zero in response to global economic and financial market turbulence.

Against a broad basket of currencies, the dollar is at its highest value in more than a decade. This reflects the US economy's relative resilience at a time when the outlook for developing and commodity-exporting nations has deteriorated.

Where next? At the Fed's September meeting, 13 out of 17 committee members expected an interest rate rise later this year. Although it will be wary of acting too soon, the Fed has been keen to play down the impact of current market volatility on its decision to raise rates. Stronger growth and employment will support the case for a rate rise. The direct impact of the problems in China's economy will be softened by the fact that China buys only a tenth of America's exports. Lower energy prices should also support consumer confidence and spending.

There are, however, some headwinds which might affect when US interest rates rise. Subdued inflation and the possibility of further negative economic surprises from China suggest the Fed need be in no rush to raise rates. Policymakers will also be keen to see faster wage growth since this would give them more confidence that higher inflation will soon materialise.

On balance, a relatively robust US picture and the dollar's safe-haven status seem likely to keep the sterling/dollar rate subdued in the near term, whilst further falls are possible if the Fed can stick to its course for lifting interest rates this year.

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   - Fix the exchange rate for a flexible time period
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Any questions?
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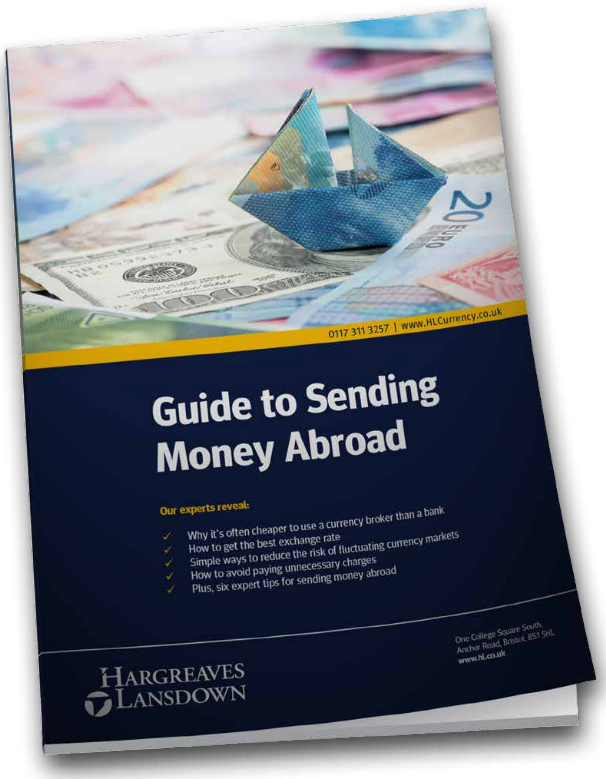

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