Sterling Report

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Sterling has made progress amid improving UK economic conditions, but remains weak by historical standards. In our last report we discussed the likelihood of new Bank of England Governor, Mark Carney, adopting a 'forward guidance' strategy. This is now underway and in this report we look at its implementation and the possible consequences for the pound.

Globally, central banks still seek to reinforce recoveries with low interest rates and extra stimulus measures. Uncertainty surrounding the timing of US stimulus withdrawal and rising tensions in the Middle East are key drivers of investor sentiment, impacting particularly heavily on emerging market assets and currencies.

We firstly look at progress over the last quarter, before our outlook on page 2. Details of how to save thousands of pounds on foreign exchange for international payments are on page 3.

JULY

The pound traded at a three-year low versus the US dollar ($1.48) and four-month low against the euro (€1.14). UK GDP figures showed the three major sectors (production, construction and service) all made a positive contribution to growth in the second quarter. A unanimous vote by Bank of England (BoE) policymakers to leave monetary stimulus unchanged dampened speculation new Governor Mark Carney's arrival would soon prompt extra measures.

US Federal Reserve Chairman Ben Bernanke reaffirmed the timing of QE 'tapering' (scaling back stimulus) would depend on further improvements in the economy. Improving jobs data suggested this could happen as soon as September. The central bank emphasised interest rates would remain close to zero for considerable time after quantitative easing (QE) had ended.

The euro received a boost from a rise in euro zone consumer confidence to its highest level in nearly two years, led particularly by a cheerful mood among German consumers. This coincided with the region's broad index of economic activity pointing to an expanding economy for the first time since January.

AUGUST

The BoE unveiled its new 'forward guidance' strategy, signalling it would aim not to raise interest rates until the unemployment rate falls below 7%. A rise would be considered sooner if inflation is likely to be higher than 2.5% in 18-24 months' time. Unemployment (7.8%) and inflation (2.8%) remained uncomfortably high.

The European Central Bank (ECB) stated euro zone interest rates will stay at 0.5% or lower for an extended period as it tries to underpin the recovery from an 18-month recession. Concerns remained over some of the ailing peripheral nations as Greece admitted it might need further aid.

Mixed US data, including lacklustre non-farm payrolls jobs growth, failed to dissuade investors that the Fed would soon start tapering QE. Emerging market currencies generally suffered as investment outflows from developing markets intensified. The Indian rupee fell below INR106 to the pound, having slumped 25% since March. The Australian dollar fell to a three-year low (AU$1.75) after Australian interest rates were cut to an historic low of 2.5%.

SEPTEMBER

The US dollar slumped to its lowest level against sterling since January ($1.62) after the Fed delayed 'tapering' QE. The surprise decision followed another disappointing employment report, and came ahead of a 1 October deadline to agree a 2014 Budget. As we write, this deadline was missed and the US government began its first partial shutdown in 17 years.

Sterling reached 7-month highs versus the euro (just below €1.20) after the UK jobless rate dipped to 7.7%. Unanimous agreement among BoE policymakers against additional stimulus fuelled expectations the central bank has concluded its own QE measures.

Italy's 10-year borrowing costs rose after the resignation of five ministers from Silvio Berlusconi's party suggested Prime Minister Enrico Letta's coalition government risked collapse. Angela Merkel's conservative party won Germany's election but fell just short of an absolute majority.

Rising investor risk appetite after the Fed's announcement favoured higher interest rate currencies such as the Australian and New Zealand dollars. New Zealand's central bank kept interest rates at 2.5% but signalled rates are likely to rise next year.

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OUTLOOK

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

STERLING: STRONG RUN TO CONTINUE?

The BoE's introduction of 'forward guidance' on interest rates has (so far) proved positive for sterling. The Bank intends not to lift base rates or reverse QE at least until unemployment falls to 7%. Although the BoE's own forecasts suggest interest rates should not rise before 2016, markets expect a rise to occur sooner. This anticipation of an earlier interest rate rise (a higher return on holding a currency) has boosted the pound.

Why might interest rates rise sooner? Certainly the 7% threshold is higher than the 6.5% US target, so there are hopes this goal could be met more quickly than anticipated given recent economic improvement. Importantly, the unemployment goal would be ignored and interest rates raised sooner if the Bank's forecast for inflation 18-24 months ahead exceeds 2.5%. The Bank's recent inflation record is poor, having achieved only three months of sub-2.5% readings since the start of 2010, so it's feasible that inflation will remain higher than the Bank expects.

Much will depend on the UK's fledgling economic recovery sustaining its momentum. Recent economic indicators point to further improvement later this year. Services sector activity, accounting for three-quarters of GDP, is currently expanding at its fastest pace since 2006. Stronger confidence, rising employment and government initiatives to boost the housing market are driving momentum. Meanwhile, stronger growth is easing some pressure on the government's finances via higher tax receipts, although public borrowing remains historically and worryingly high.

Overall, a strengthening and broadening recovery, reinforcing expectations the BoE has concluded its QE measures, should generally underpin support for sterling in the near term. Expect greater volatility in response to employment data in the coming months.

EURO: WILL ITS RESILIENCE BE TESTED?

Despite continuing tensions in some peripheral countries, the euro has been one of the best-performing major currencies this year amid easing fears over the region's debt crisis. To assist recovery the ECB has cut interest rates to a record low of 0.5% and indicated interest rates will be kept low for an 'extended period'. The euro has benefited from investment flows away from emerging markets as uncertainty over when the US will begin tapering QE continues.

Whilst the economic recovery remains weak, it is expected to gradually pick up pace. Overall, the region's GDP is expected to contract by around 0.5% this year, before rising global demand and stronger exports help reverse this decline next year. Encouragingly, there are signs trade will become more evenly distributed, since ongoing structural reforms are helping Greece, Italy, Spain and Portugal lift their exports into balance with their imports. This restoration of the peripheral economies' competiveness will be key to the euro's long-term success.

The applecart could be upset by a number of developments, including: adverse political developments, resentment towards austerity, high unemployment, slow progress in tackling debt, or further bank crises. Many euro zone banks still struggle to access market funding and, particularly in the peripheral economies, remain beset by bad loans. Restoring bank-lending in the crisis-stricken economies is seen as crucial to sustaining the economic recovery, although progress is expected to be slow. Further steps towards a banking union and the ECB's bank stress tests aren't due until 2014.

In view of this, and given sterling's value relative to the euro remains low by historical standards, we see some potential for the pound to recover further ground against the euro in the months ahead.

US DOLLAR: OVERSOLD AS RISKS RISE?

The Fed's decision to delay tapering QE means the dollar's outlook remains tied to lingering uncertainty over when it will happen. A risk is that slower than expected economic growth, continued subdued inflation and weak jobs growth could further delay the start of this process into 2014.

Although the jobless rate has fallen since the start of 2013 from 7.9% to 7.3%, the Fed will be wary this overstates the labour market's improvement. Job creation has slowed in recent months, compared with earlier in the year. As ever the non-farm payrolls jobs data will be keenly watched.

There is some cause for optimism. Household finances are healthier than at any point over the past decade and consumer confidence is at a 6-year high, supporting consumer spending and employment. The headwind from earlier tax rises and government spending cuts should now fade, pointing to some acceleration in economic growth. Potential pitfalls include further fallout from the failure to approve next year's Budget and more political wrangling over lifting the debt-ceiling, whilst a recent rise in mortgage rates might detract from a housing market recovery.

Externally, the Syria crisis remains unresolved and the dollar (as a perceived safe-haven) should usually benefit if tensions start rising. Divergent UK and US monetary policies provide support for sterling at current levels, but we expect the US economic recovery to remain intact and sterling/US dollar to lose some altitude in the near term after a strong sterling run.

CURRENCIES UNDER THE SPOTLIGHT:

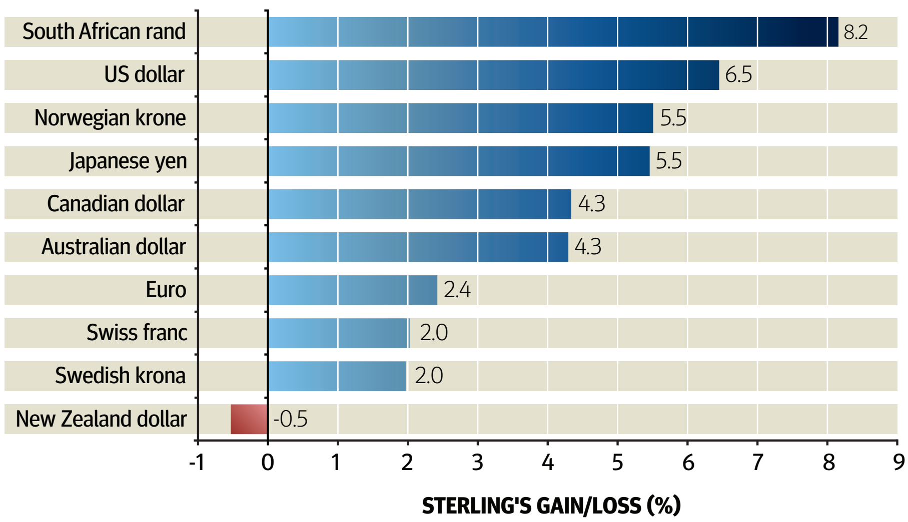
US monetary policy and the rate of slowdown of China's economic growth will be important for higher interest rate currencies such as the Australian and New Zealand dollars, which typically benefit as investor optimism rises. The Reserve Bank of Australia has signalled interest rates are unlikely to be cut again in the near term. The Reserve Bank of New Zealand has suggested interest rates should rise next year, assuming the economy's momentum continues.

The Bank of Japan is committed to an ultra-aggressive QE programme to reflate its economy. This policy is likely to continue to put downward pressure on the yen, although the impact should be moderated by growing signs of the economic recovery being sustained.

The Swiss National Bank (SNB) is committed to enforcing a minimum exchange rate of 1.20 francs per euro, but still considers the franc's value to be high. The SNB policy suggests sterling's performance against the euro is likely to remain a key influence on the sterling/franc rate's direction.

For more information please visit our website at www.HLCurrency.co.uk

STERLING'S PERFORMANCE (THIRD QUARTER 2013)



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THE BEST INFORMATION

Our free Currency Research Centre and currency reports are available at **www.HLCurrency.co.uk**. Our website includes exchange rates, charts, currency updates and our foreign exchange research.

ANY QUESTIONS?

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DATA RELEASE CALENDAR

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STERLING	
10 October	Central bank policy meeting
15 October	Consumer prices
16 October	Unemployment
17 October	Retail sales
23 October	Policy minutes
25 October	GDP Q3/2013 - 1st estimate
7 November	Central bank policy meeting
12 November	Consumer prices
13 November	Unemployment
14 November	Retail sales
20 November	Policy minutes
27 November	GDP Q3/2013 - 2nd estimate
5 December	Central bank policy meeting
17 December	Consumer prices
18 December	Policy minutes; unemployment
19 December	Retail sales
20 December	GDP Q3/2013 - 3rd estimate

NEW ZEALAND DOLLAR	
16 October	Consumer prices
30 October	Central bank policy meeting
6 November	Unemployment
14 November	Retail sales
11 December	Central bank policy meeting
19 December	GDP

EURO	
1 October	Unemployment
2 October	Central bank policy meeting
3 October	Retail sales
31 October	Unemployment; Consumer prices
6 November	Retail sales
7 November	Central bank policy meeting
14 November	GDP Q3/2013 - 1st estimate
29 November	Unemployment; Consumer prices
4 December	Retail sales
4 December	GDP Q3/2013 - 2nd estimate
5 December	Central bank policy meeting

CANADIAN DOLLAR	
11 October	Unemployment
18 October	Consumer prices
22 October	Retail sales
23 October	Central bank policy meeting
8 November	Unemployment
22 November	Consumer prices
22 November	Retail sales
29 November	GDP
4 December	Central bank policy meeting
6 December	Unemployment
20 December	Consumer prices
20 December	Retail sales

US DOLLAR	
4 October	Unemployment
11 October	Retail sales
16 October	Consumer prices
30 October	GDP Q3/2013 - 1st estimate
30 October	Central bank policy meeting
1 November	Unemployment
14 November	Retail sales
15 November	Consumer prices
26 November	GDP Q3/2013 - 2nd estimate
6 December	Unemployment
12 December	Retail sales
17 December	Consumer prices
18 December	Central bank policy meeting
20 December	GDP Q3/2013 - 3rd estimate

AUSTRALIAN DOLLAR	
10 October	Unemployment
23 October	Consumer prices
4 November	Retail sales
5 November	Central bank policy meeting
7 November	Unemployment
3 December	Central bank policy meeting
3 December	Retail sales
4 December	GDP
12 December	Unemployment