Sterling faces an uncertain future

The dramatic global financial turmoil continues to have a huge impact on many different asset markets. Nowhere has this been felt more strongly than in the foreign exchange markets where volatility has been acute.

The US dollar (USD), which had been gradually weakening since 2002 against major world currencies, suddenly soared in value when the economic crisis struck as a total loss of confidence led to a massive flight to safety with panic stricken investors retreating into the world's reserve currency.

Sterling was one of the currencies most affected by this appreciation of the US dollar. In July 2008, the pound was trading at USD2.00 and just six months later in January 2009 it was languishing down at USD1.37, a drop in value of over 30 per cent. The impact on UK importers who were paying for goods and services denominated in

US dollars was significant with many unable to pass on the higher cost of imports to their customers and consequently suffering a hit on their profit margins.

The return of risk appetite

Global economic conditions have been gradually improving during the course of 2009 with several countries, notably France, Germany, Japan and New Zealand already out of economic recession. Indeed, HSBC forecasts that the UK economy will be back in positive growth territory by the end of Q3. This spark of optimism surrounding the global economy has somewhat encouraged the return of risk appetite by international investors which has seen renewed selling of the US dollar as the flight to safety begins to unwind.

Between March and August 2009, Sterling had a great run against the US dollar when it appreciated from less than USD1.40 to USD1.70. Since then, however, the British pound has decoupled from this general trend of currency strength seen across the markets and has weakened markedly against other major currencies such as the euro and the yen, and has even resumed its downturn against the USD.

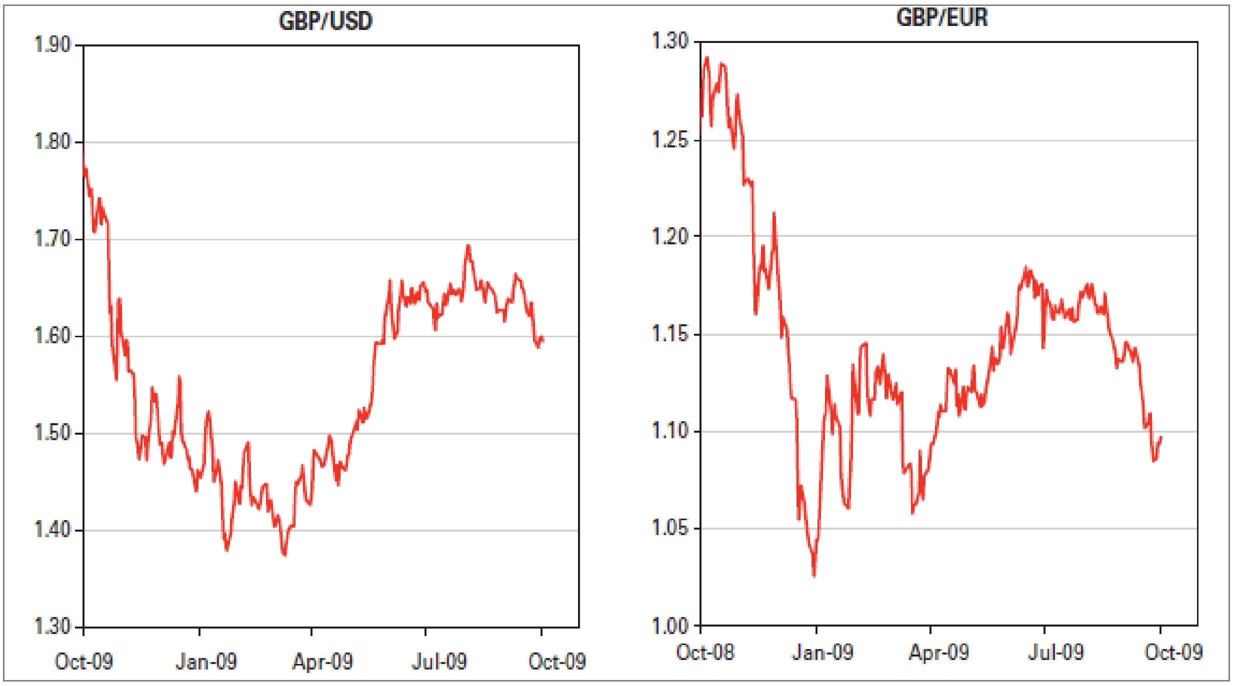
There may well be several reasons for Sterling's current bout of weakness. Certainly, the pound seemed to hit a brick wall in August when the Bank of England's Monetary Policy Committee (MPC) unexpectedly expanded its Quantitative Easing (QE) programme by GBP50 billion to GBP175 billion.

The purpose of the Bank of England's policy of Quantitative Easing (QE) is to inject new money into the economy in a bid to increase liquidity and the flow of cash around the financial system. Technically the QE process involves the BoE buying gilts from foreign and domestic investors. While buying up gilts from domestic investors has little impact on the FX market, international investors who receive GBP receipts and then convert them back into their local currencies does put downward pressure on Sterling.

Sterling's benign neglect

The pound's weakness suggests the FX markets were worried about why the MPC felt they needed to take out as much extra insurance for an economic recovery, especially when the UK economy and countries elsewhere were already showing signs of life. After all, a steady recovery in the UK economy should, in theory, be good news for Sterling, particularly if UK rates are raised next year before those in the US and the eurozone. On the other hand, if extra insurance for a recovery is needed through more QE, does this mean that the Governor and the MPC also want extra insurance from the boost to exports that a weaker pound tends to bring with it?

Sterling has come under increased selling pressure recently as Mervyn King, the Governor of the Bank of England in comments reported in *The Journal*, a Newcastle-based newspaper, that "the fall in the exchange rate that we have seen will be helpful in rebalancing the UK economy there's no doubt that



what we need to see now is a shift of resources into net exports". The FX markets interpreted this as Governor King suggesting that Britain might benefit from a further fall in the value of the pound.

At this moment in time, given the factors influencing Sterling's value on the FX markets judging the direction, let alone the magnitude of the next move is a fruitless task. It would seem that GBP will be as unpredictable coming out of the global crisis as much as it was at the outset of the turmoil.

HSBC has a local team of risk management specialists to help you protect your business from today's volatile foreign exchange rates and make plans for 2010. For further details please contact Sean MacHale Head of Treasury Ireland 01 6356922.