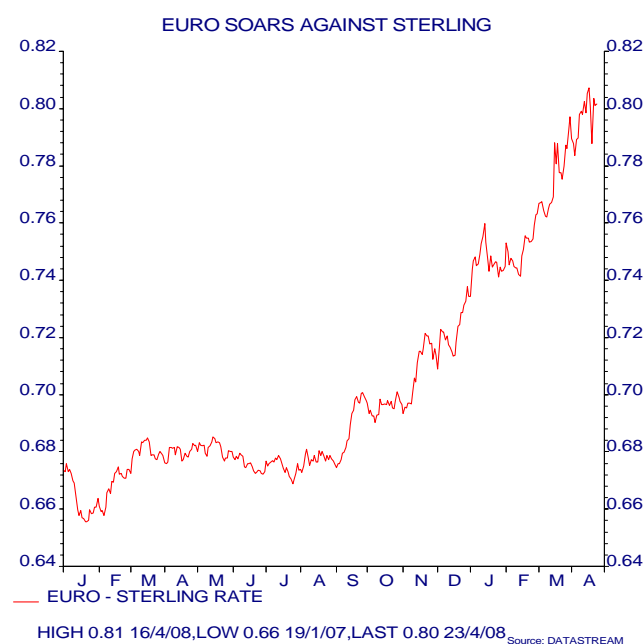


Strategy Matters

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Thoughts on Sterling and the Euro

Earlier this week the Euro breached \$1.60 for the first time since it was launched in 1999, though it has subsequently dropped back a little and currently trades at \$1.57. The Euro is also close to a record high against sterling, being worth close to 80p. Since the end of August last year the Euro has risen by 19% against sterling, reflecting a combination of sterling weakness and Euro strength.



Why has sterling been weak?

First, the outlook for UK interest rates has swung through 180 degrees. The Bank of England raised UK interest rates to 5¾% last July and in August, even though the credit crisis was beginning to develop, expectations were for a further move to 6%. That move never happened and the Bank has since cut interest rates three times, to 5%. Further reductions are expected. Second, foreign exchange markets are now attaching more importance to external deficits. One aspect of the unfolding credit crisis may be that countries with large external deficits

will find it more difficult to finance them. The UK fits into this category; its current account deficit in 2007 was £58bn, or 4¼% of GDP. Third, for a number of reasons, including past reliance on the public and finance sectors for growth and the deteriorating housing market, risks to economic growth seem more heavily tilted to the downside in the UK, compared to other economies.

Why has the Euro been strong?

Here the story is all about interest rates because the Euro-area as a whole has an external account roughly in balance. The European Central Bank (ECB) remains adamant that it is not close to cutting interest rates in the region. Economic growth looks to have slowed a little and the latest indicators suggest it may have dipped just below trend. But, while there are clearly countries with serious problems (Spain and Italy), for the region as a whole growth is clearly a lot stronger than in the US and the downside risks are a lot less than in the UK. Meanwhile, inflation has climbed to 3.6% - well above the ECB's target of close to, but just below, 2% - and one or two members of the ECB have even hinted that they might argue for higher interest rates, were it not for the strength of the Euro and the uncertainties caused by the credit crisis.

What next?

Based on simple valuation measures (which compare movements in relative prices between countries/regions) the Euro is expensive. Our measures suggest fair value is around \$1.16 and £0.68. However, the large US and UK current account deficits suggest that it is appropriate for the dollar and sterling to be undervalued for the next few years (to encourage export growth at the expense of

imports) and the valuation case for a fall back in the Euro is not a strong one.

The path of the credit crisis is very difficult to predict, but now that currency markets have focused on the UK's current account deficit, it will probably be a factor holding back sterling for some time.

Interest rates will probably continue to be the dominant factor driving major currency markets. Our view is that the outlook for the UK is a little worse than consensus forecasts now suggest. UK households, in particular, are facing a number of pressures. These include higher food, petrol and energy prices at a time of moderate wage growth, falling house prices and reduced mortgage availability. These are likely to combine to slow spending growth in the rest of 2008 and in 2009. Other things being equal, UK interest rates might be expected to fall to 4%.

However, other things rarely are equal. It appears that sterling has moved up to near the top of the Monetary Policy Committee's (MPC's) agenda. Two of its members (Charles Bean and Andrew Sentence) have discussed its role in monetary policy during the last week. The implication of their remarks is that the drop in sterling has done some of the MPC's work for it, and that the stimulus it provides means less stimulus is needed through lower interest rates. The combination of a further sharp fall in sterling and much lower interest rates is probably not one that the MPC would be happy with. Sterling may have further to fall, but perhaps not a lot further.

Meanwhile, the Euro has lost some of its upward momentum in the last day or so, following some weak survey evidence from the region. If this proves a temporary set-back and growth and inflation data remain strong, then a stand-off may develop between the ECB and the foreign exchange markets, with the ECB refusing to cut interest rates and the markets seeing how high they can push the Euro before the ECB is forced to act. Financial markets like nothing better than what appears to be a one-way bet, and that is how they are treating the Euro at the moment.

If this analysis is right, then the turning point for the Euro will be when financial markets sense that a change in ECB policy could be coming. This might be signalled by a fall in inflation pressures (so oil and food prices are important) or by a sharp drop in economic growth (which is why business confidence surveys are so closely monitored). It may be necessary to wait until later this year, though, before there is enough evidence to impress the ECB.

Conclusion

The best guess, therefore, (and forecasting exchange rate movements inevitably involves an uncomfortable amount of guesswork) is that sterling might fall a bit further against the Euro in coming months, but the bulk of its fall could be behind it.

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