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WHAT NOW FOR THE **POUND?**

OCTOBER 2016

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TRADING THE POUND STERLING

FOREWORD

Recent political events have put the Pound Sterling front and centre as far as the world's financial markets are concerned. The UK's decision to seek to leave the European Union surprised many people both inside and outside of the country. The political establishment was rocked to its core and there has been considerable change in personnel in the makeup of the UK government, with almost every major ministerial post (including that of Prime Minister) changing hands over the summer months.

It was not just the political world that felt the fallout from June 23rd's momentous decision. The financial markets have had to deal with their own "period of adjustment" and in fact they are still coming to terms with what the referendum result means (over the long-term) for one of the world's most actively traded currencies.

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In this guide we will look at the history of the British Pound, what has happened since the Brexit vote, and what may happen as the world's fifth largest economy disengages from the European Union.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

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GETTING TO KNOW THE POUND

A proud history

The Pound Sterling, or Great British Pound, is the world's oldest currency in that it has remained in constant use since its introduction. It takes its name from the Anglo Saxon word "pound", which referred to a fixed quantity of silver coins, namely two hundred and forty silver pennies. Coins came into common usage across England during the eighth century, while silver and gold coins remained in use throughout the medieval period, though their purity often varied depending upon the state of the monarch's finances. The foundations of the currency we know today were laid in 1694 with the formation of the Bank of England, which was closely followed by the establishment of the Bank of Scotland. Both Institutions introduced paper money to replace coins.

England and Scotland joined together in 1707 to form Great Britain and the treaty that cemented this merger declared that the Pound Sterling was to be the currency of this new nation

state. Ireland joined in 1801 to form the United Kingdom of Great Britain and Ireland (though the Irish would retain their own pound for further 25 years before adopting sterling).

Trade and expansion

During the 18th and 19th centuries, Britain experienced the profound changes brought about by the industrial revolution and at the same time expanded its empire across the globe. Such was the growth of both these elements and the trade they enabled, that Britain rose to become the world's pre-eminent economic power, whilst the British Pound assumed the role of global reserve currency - a role that it would effectively cede to the US dollar after World War One.

It was the Pound's relationship to the US Dollar that helped give rise to the common name for the exchange rate between the two currencies. By the latter part of the 19th century there was significant trade between the USA and Great Britain. At the same time New York had become a major financial centre in its own right. In order to speed up communications between the two great trading nations, a series of under sea wires (or telegraph cables) were laid across the Atlantic seabed. It was through these cables that exchange rates for Sterling and the Dollar were transmitted, earning the GBP USD pair the nickname of the "Cable Rate". A description which is now usually just shortened to "Cable".

Transformational period

The 1970s were a transformational period for UK and its currency. The first major change was the introduction of decimalisation in February 1971. Prior to this point the standard units of currency within the UK had remained largely unchanged since their Saxon introduction (i.e. 240 pennies to the pound). Despite several attempts to introduce a more user and math friendly hierarchy via parliament in the 19th century, the complicated pre-decimal currency with its units of farthings, shillings, half-crowns and guineas would briefly be used in parallel with the new currency and decimal annotation.

But after the 15th of February 1971, nearly all parts of UK trade and commerce were conducted using the new monetary standard.

A shock for all concerned

In 1976 the Pound Sterling experienced a major crisis under the newly elected Government of Prime minister Jim Callaghan, who had come to power on promises of increased government spending. Mr Callaghan was in for a rude awakening however, when it was made clear to him that the public finances could not support his spending pledges and that the economy was in fact still reeling from the oil shocks seen three years earlier (for example, inflation in the UK had risen to 27% in 1975).

Instead of a fresh round of spending, Mr Callaghan and his Chancellor Denis Healey were forced to implement a programme of major spending cuts (circa 20%) and economic

reforms - conditions that were set out by the International Monetary Fund as part of a $3.9 billion loan programme it made to the UK. This was the largest loan that the fund had ever made - and it had to source additional capital from Germany and the USA to facilitate it.

Freedom of movement

As with the recent referendum result, there was significant political fallout after the deal with the IMF. Culminating in the election of Margaret Thatcher's Conservative government in May 1979, after years of poor labour relations and declining public services and infrastructure. One of the first significant acts of the new administration was the removal of foreign exchange controls, which had severely limited the flow of money into and out of the UK economy prior to that point and had effectively banned individuals and companies from owning foreign currencies or gold. In doing so the government laid the groundwork for the creation of both the modern financial markets and the market led economy we know today.

The Thatcher government would further liberalise access to UK markets in a process (colloquially known as the Big Bang) that abolished the fixed commissions charged by brokers of the day and allowed UK and foreign bank ownership of London's brokers and merchant banks. This also opened the door to screen-based trading between these entities, as opposed to facing counter-parties on an exchange floor. This was accompanied by the creation of a new regulatory regime, a combination which enticed an influx of significant overseas firms to London's markets that was accompanied by

considerable investment into the UK. This in turn drove the rapid growth of the new service led UK economy. The chart below shows the growth in UK GDP, which clearly gathered momentum in the 1980s.

A failed experiment and a mega trade

At the same time that the UK markets were being liberalised, the UK was integrating further into the European Union which it had joined as the "common market" (also known as the EEC) in 1973. As early as 1979 other European states had joined together to try and coordinate exchange rate movements that affected their individual economies. Exchange rates would not be fixed - rather they would be allowed to move within pre-set bands relative to their peers, which were subsequently aggregated into a proto single currency known as the ECU. The UK had decided not to include the Pound in the Exchange Rate

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Mechanism at its inception in 1979. But by 1990 it was felt that conditions were suitable for the UK to join.

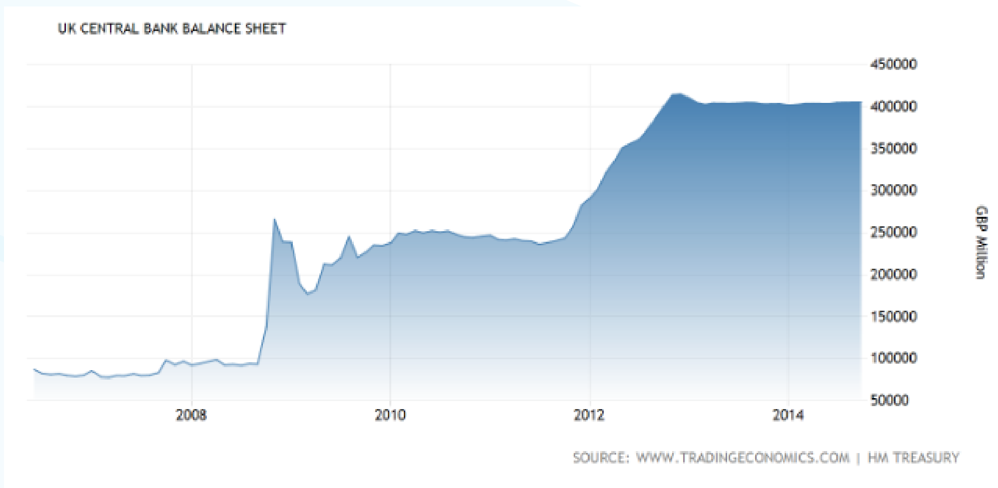
However, this was to prove to be a mistake. After just two years the UK was forced to withdraw its currency from the ERM, as its monetary authorities could not defend the value of the pound which had come under sustained selling pressure in the world's financial markets. This was despite the government and the Bank of England raising UK interest rates to 15% at one point and spending some £6 billion in their attempts to do so. One of world's leading currency speculators, George Soros, was amongst those who had bet against the Pound's continued membership of the ERM. He was said to have made a billion pounds profit from the trade, the equivalent of taking £12 from every man woman and child in the UK at the time. That experience coloured the UK's perception of the EU and not for the better. Though many would argue that by retaining its own currency, the UK was able to enjoy financial independence as a country, whilst having access to the European single market. For a time this scenario seemed to be the best of both worlds.

Unconventional measures to the rescue

In the wake of the Global Financial Crisis of 2008 and the ensuing recession, the Bank of England moved to support and stimulate the UK economy and the Pound. This was achieved by a process known as Quantitative Easing (also known as QE). This is where the central bank effectively prints money with which it buys its own Government Bonds in the open market. The theory being that the sellers of those bonds will reinvest the sale proceeds, thereby stimulating demand and helping to keep

down interest rates. The Bank of England injected £375 billion into the UK monetary system during a three-year programme that ran until 2012 and has recently committed to buying another £70 billion of UK bonds in the wake of the referendum vote.

The chart below clearly shows the expansion in the Bank of England's balance sheet that resulted from the use of QE between 2009 and 2012.



It's also worth noting that two of the UK's largest clearing banks had to be bailed out after the financial crisis in 2008 - as part of £500 billion package of loans and guarantees, that the UK treasury put in place, to stabilise and restore faith in the financial services industry and the operation of the UK economy as a whole. The quid pro quo for this bailout was to be an increasingly tough regulatory and operational regime for

financial services and in particular for the banks. This would have unintended consequences later on in our story of the Great British Pound.

Recent developments

The most significant event of modern times as far as the UK currency is concerned took place on June 23rd 2016. A moment in time that may come to define and shape the very future of modern Britain. On that day the UK populace voted for Brexit. That is it voted to leave the European Union as we noted in our recent eBook on the subject.

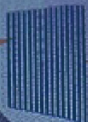
> *"In its simplest terms Brexit was the catch phrase adopted by the media to describe the referendum on EU membership, held in the UK on the 23rd of June 2016. The referendum had been promised by the then UK Prime Minister David Cameron, as part of his Conservative party's 2015 election manifesto. Mr Cameron won that election but "lost" the referendum, having elected to back the remain campaign."*

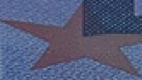
As we now know it was the leave campaign that emerged victorious. That victory has turned Westminster politics on its head and shaken the European Union establishment to its core.

It was clear that the financial markets, both in the UK and elsewhere, had believed that the remain campaign would win the day - as the movements in the value of the Pound late in evening of the 23rd (as the first constituency results were released) testify. However, events were soon to take a completely different turn.

A clearer picture emerges

It soon became clear that these early referendum results were a misnomer. Rather than a narrow remain victory, the result was to be a convincing win for the leave campaign. The price of the Pound Sterling reacted accordingly - as we can see in the chart below, which plots cable (GBP USD) immediately before and after the referendum. The chart is dominated by the by the large red candle (bearish candle) posted on the 24th of June. The high for Sterling that day was US$1.5018, whilst the low was US$1.3229 - an unprecedented intra-day range. The pound would go on to sell-off below the US$1.30 in the days that followed.





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After the initial shock had worn off, the Pound stabilised somewhat and regained the US$1.30 level. But there were more questions than answers for the market - along with a whole host of new personalities taking up senior positions in the UK government. So it was clear that this was the beginning of a lengthy process of uncertainty, rather than the end.

What are the drivers for the Pound and other UK markets?

It's often said that markets hate uncertainty. That's not because traders and fund managers are intrinsically lazy, but rather that unpredictable or random markets turn the whole investment process into a lottery. After all, assets are accumulated and income earned through the repeated application of tried and tested strategies. They may need modifying occasionally, but unless there is an " earthquake" the basic principles should hold. That line of thinking is the cornerstone of modern investing.

Well we now know that the market certainly felt the earth move under their feet after the Brexit referendum result - and there are plenty of aftershocks to come. The uncertainty around the timetable for Brexit, which we are told could take between two and six years to complete, is certainly one concern for the markets and for the value of the Pound.

There are other questions too: what form will the UK's exit from the EU take? What will its trading relationship with Europe be? What will the status of EU nationals and their investments be within an independent UK? How will this affect FDI (Foreign Direct Investment) and the UK's trading relationships with the rest of world - in particular major investors such as Japan, China

and the USA? There are no quick or easy answers to these questions. What's more, there are many other questions around the future for the Pound and the wider UK economy.

It's an ill wind that blows no good

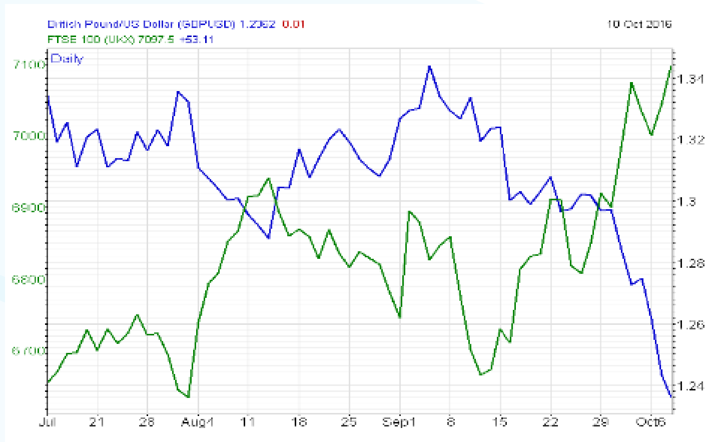
Economic data from the UK since the June referendum has largely been positive, confounding expectations. So much so in fact that the UK stands head and shoulders above other developed nations and regions in the Citigroup economic surprise index. This measures the positive or negative deviation between a country's economic data releases and analysts forecasts. At the time of writing, the UK has a score of around 84 (the higher the number the bigger the economic surprise performance), whilst the Eurozone has a reading of 20 and the USA a reading of around four. So for now at least, the UK is holding its own.

Furthermore, the UK 100 index is also benefiting from the recent weakness in the Pound Sterling. In fact the index hit a new all-time high on October 11th, even as the UK currency drifted lower against the US Dollar. So what exactly is happening here?

Well the answer lies in globalisation - because though the UK 100 measures the performance of the leading 100 UK listed shares, they are not necessarily UK companies. Nor are they dependent upon the UK for their living. In fact research suggests that more than 70% of the revenues generated by these UK 100 companies come from abroad in the form of export earnings. So as the Pound falls in value, so the goods and services they sell

become cheaper to foreign currency buyers. Note that the US is the largest export market for UK goods and services. When you consider that the value of the Pound against the US Dollar has fallen by some 18% since the referendum, you can see just how powerful a driver this has been. In fact some commentators have noted the UK has managed to create a competitive devaluation that is the envy of many of its trading peers.

Chart shows the UK 100 Index vs the GBP USD exchange rate over 3 months



Just what did happen on October 7th?

That's a good question but one that doesn't have an easy answer. UK Prime Minister Theresa May confirmed at the beginning of that week that the UK would formally apply to leave the EU around the end of March 2017. This is done by enacting Article 50 of the Lisbon Treaty, at which point formal

negotiations can commence. One might of thought that a firm date for the start of the process would be seen in a positive light by Sterling traders. But this was note the case - they preferred to latch onto comments attributed to the French President Francois Hollande, which suggested that Britain should pay a heavy price for leaving the EU. Mr Hollande is facing a re-election battle in 2017, so make what you will of those words.

After a nervous start to the week, the pound appeared to regain some composure. That was short-lived, as on early Friday morning in Asian trade, the Pound fell by more than 6% against the US Dollar. It seems the markets were spooked by concerns about the UK's finances, dual deficits and balance of trade. These issues were brought to the fore by an announcement earlier in the week from Chancellor Philip Hammond, who said he was no longer aiming to balance the UK's books by 2020. This is something his predecessor, George Osborne, had pledged to do. In fact in the near term, Mr Hammond said he would look to borrow some more money rather than pay down the national debt. Why traders waited until early Friday morning to show their concern is unclear.

Forex (or currency markets) operate 24 hours a day for five days a week and have the highest turnover of any of the financial markets at $5.1 trillion dollars a day. However, they are also regionally centric. That is to say that the most active trading sessions take place in their own backyard. For the Pound this means London, where almost of the world's FX volumes are transacted daily (see BIS data April 2016: second from bottom) and not the antipodes and Asian markets at the end of their business week.

Downsizing at banks both in terms of personnel and balance sheets (driven by the regulations mentioned above) have greatly reduced their risk taking and market making functions. To some extent this role has been taken on by so-called High Frequency Traders (HFTs) at nimble computer driven firms. However, these businesses are driven by algorithms (not individuals) and operate at speeds that are often imperceptible to human beings. They are often trend following as well and so they added to the selling pressure on the British Pound, rather than counteracting it as old style market makers may have done. In essence, we had a perfect storm of thin and directional liquidity, automated selling outside of the home sessions and general nervousness around the GBP. The Pound rallied from 1.18 versus the US Dollar as the London session got going on Friday the 7th. However, it has started to drift once more back towards the $1.20 level, which was recently nominated as fair value for cable by a leading US investment bank in the run up to a formal Brexit.

What will the future bring ?

It’s hard to be certain here because there are so many unanswered questions, but I think we can expect further episodes of volatility within Sterling exchange rates - though as we have noted some of this will be related to the current market structure, rather than being specifically about the Pound. Much will depend on whether you view this an opportunity to be welcomed or hurdle to be overcome. What’s certainly true is that the success of the whole Brexit project will depend on its execution - i.e. how effectively the UK government and its representatives are at negotiating with Brussels and their

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European counterparts. Whilst UK economic data comes in on the positive side of expectations and there is demand for UK government bonds, the outlook for the Pound could be viewed as positive. Were these factors to change, then sentiment could turn negative very quickly. Whether this would be sustained or justified is open to debate.

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