It wasn't that long ago (2007) when owners of US dollars would have to pay two greenbacks to buy one British pound. Since then we have seen the purchasing power of sterling slowly ebb away, compounded by the announcement of the UK's Brexit vote. This month we consider the currency markets and pay special attention to the future of the pound. The flash crash of Friday last week makes such a review all the more pertinent.

On 2nd October Theresa May announced that the UK would officially begin its separation from the EU in March 2017. Over the course of the following week sterling fell around 3.9% versus the dollar (at the time of writing), which included an intra-day loss of c.6%. This tumble in sterling is an indication of investors' caution over the prospects for the UK economy as a result of Brexit but rather contradictorily it has been the fillip to drive the FTSE back to all-time highs.

<u>Once upon a time…</u>
It is estimated that currency replaced bartering as long ago as 700 BC and possibly before, when valuable metals represented a common commodity with which to trade goods. However, money has long been used as a tool to trade not only goods and services but other currencies too. Before the gold standard was introduced in 1875 (allowing governments to exchange gold for a pre-determined amount of currency), gold and silver were used as the international payment medium of choice. After 1875, the major economies agreed to fix their currencies to a pre-defined amount of gold, thereby allowing countries to trade each other's currencies knowing full well what they were worth in gold. Hence currency trading was born.

The gold standard collapsed because whilst different countries' economies shrank and grew (and therefore the value of their currency should have risen and fallen), their exchange rates were permanently fixed to the price of gold. After WWII, it was agreed that the US dollar would replace gold as the "global reserve currency" and that the USD would be the only currency pegged to gold, the rationale being that the US was the most robust economy in the world. This system, called Bretton Woods, failed when the US economy weakened dramatically during the Vietnam War era, to the point where the US Treasury had insufficient gold to buy back all of the US dollars in circulation.

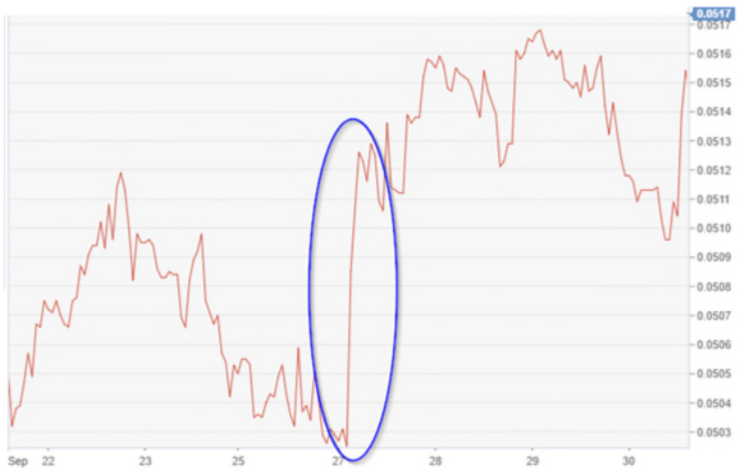
History is now littered with examples of fixed exchange rates breaking down - the gold standard, Bretton Woods, Britain's "exchange rate mechanism" (pegging Sterling to the German Deutschmark) and even arguably the Euro are all failed (or due to fail?) examples of why fixing currencies to each other simply does not work.

So, "free-floating" (variable) exchange rates are now the norm and in Jan 2016 over $4.6 trillion was traded on a daily basis in currency markets across the globe. Rates are driven by many factors, including relative economic strength, interest rates, natural disaster, political turmoil, oil prices and many more. Speculators now dominate the market, trying to predict what governments will do to influence the value of their own currency.

When a country's currency falls, importing goods is more expensive and goods exported to other countries are cheaper. This not only applies to commodities and industrial trade but also to any manufactured goods or services that leave and enter the country, not to mention the impact it has for incoming tourists and outgoing holiday-makers. Sometimes governments will deliberately weaken or "talk-down" their currency in an attempt to kick-start their economy by boosting exports. This was the strategy that the Chinese employed in August 2015, with a significant devaluation of their currency but the immediate impact was to raise concerns of an impending accelerated economic slowdown in China.

So are currency fluctuations a better barometer for economic growth than equity markets? Minute by minute currency "noise" actually distorts the picture rather than clarifies it. However, an example of how a currency can better reflect investors' feelings than markets was witnessed last month after the first US presidential debate. Although no economic data was published and no major financial news looked to influence it, the Mexican peso jumped dramatically against the US dollar on the consensus that Trump had lost the debate to Clinton and that therefore the Mexican economy would not be damaged by his protectionist policies. However, this move wasn't as quickly reflected in the stock market.

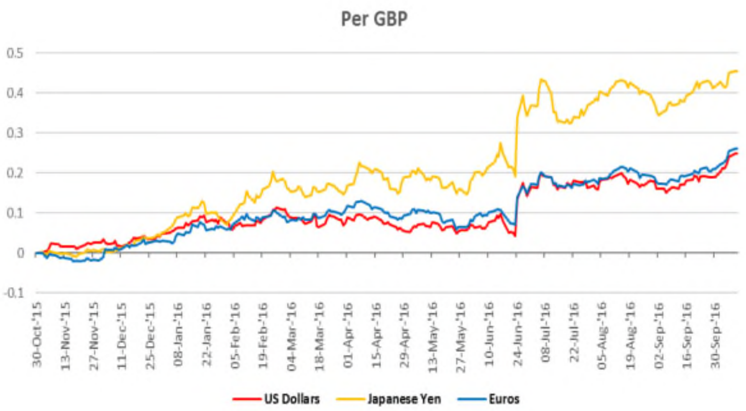
The peso jumps after first presidential debate and then continues to rise:



What about the UK?

At around $1.27, ¥132 and €1.13, sterling buys on average about 30% less in the US, Japan and Europe than it did in November 2015. However, since then, the FTSE 100 has risen c.10.3%. If one argues that currency can better represent fundamentals rather than sentiment, then this suggests an imbalance between the longer-term outlook of the UK economy and the short term momentum seen in markets. Either sterling is due for a big rise or UK stock markets may be due a fall.

Sterling has weakened considerably against US dollar, euro and yen:



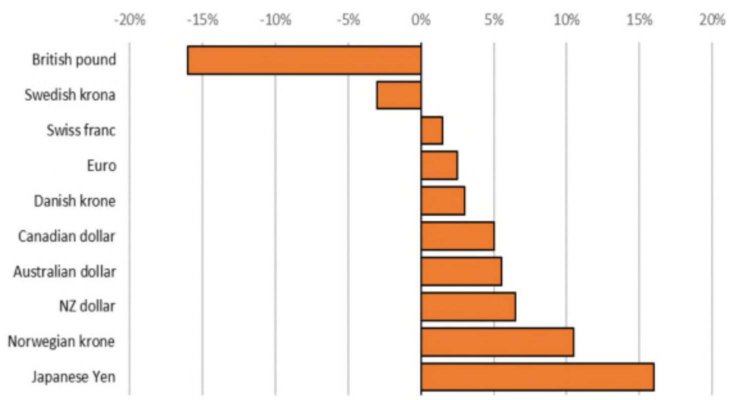
The UK FTSE 100 has recently reached all-time highs because a large component of FTSE 100 businesses derive their earnings from US dollars and a stronger dollar therefore means higher profits when they are converted back into sterling. However, this is a one-off hike in revenue (see previous missives) and not an indication that these companies are any better at what they do than they were before sterling fell.

One positive impact of a weaker currency is Mergers and Acquisition activity and this may mean that UK markets may be supported at these lofty levels despite the economic uncertainty through Brexit negotiations. The 30% currency moves that we have witnessed make British companies very attractive to overseas buyers, a driver perhaps for more deals along the lines of Japanese Softbank's £24bn takeover of ARM Holdings.

Is this a UK only problem?

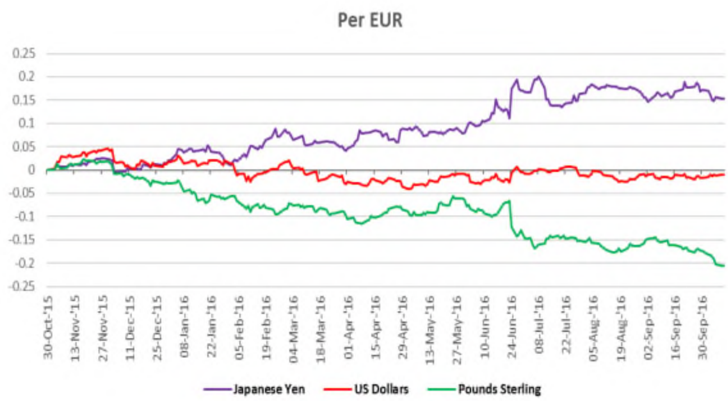
Sterling has been very weak against the US dollar but how has the dollar fared against other currencies? In fact, the dollar has performed poorly against many other major currencies this year, highlighting just how poorly our currency has performed relative to others.

G10 currency performance year to date (relative to USD):



Given the fallout that we have seen from Brexit it is surprising to us that there has been little movement in the EUR/USD exchange rate or that euro generally hasn't declined with sterling. The region is likely to be influenced by Brexit and there is a similar wave of populism spreading through the region, with many governments due elections that may steer the block towards further disarray. Surprisingly, the euro has been strong whilst the European stock markets have been relatively weak (the opposite to the UK, despite similar economic pressures during Brexit!) Hints that the European Central Bank (ECB) might begin tapering their quantitative easing programme may be keeping the euro from depreciating but otherwise there is a serious mispricing going on somewhere in the system.

Euro has been very stable against USD, compared with sterling's demise:



What about Japan?

Versus the dollar the Japanese yen has been the best performer of the G10 currencies this year (see previous bar chart) and in comparison to sterling, the yen has also strengthened considerably. The yen has been perceived as a safe-haven currency like the US dollar for years, due to Japan having a large current account surplus (exports more than it imports), the "carry trade" (investors borrowing in yen at very low interest rates to buy other currencies with higher interest rates) and the long-standing perception that Japan's currency is safe. This year investors have been piling into yen whilst the Bank of Japan and the Japanese government continue to implement policies to try to weaken their currency and boost growth at the same time. So far the currency speculators are winning but we believe that this trend is starting to turn.

More to come

It can often be difficult to pinpoint the rationale for short-term trends between currencies. That said, there have been some consistent trends this year such as a stronger yen.

However, the standout, and most concerning trend for us has been the weakness of sterling due to Brexit. With a 'hard Brexit' being encouraged by François Hollande and driven home now by Theresa May's government, we feel that the pound's weakness is justified and that it may continue. We have embraced this rather unsavoury trend by increasing exposure to US dollars this year via various investments although we would caution that sterling has weakened very quickly and we are looking for signals that a bounce back is imminent. That said, given the likely fluctuations as Brexit negotiations continue we believe that investors should increasingly shift longer-term investment away from the UK and look more globally for returns in the years to come.