The Currency Conundrum

Peter Hemple reports on the rise and fall of the sterling and what opportunities it may bring

In the beginning, the pound crashed against some currencies in emerging countries like Poland, Czech Republic and Brazil. Then it weakened considerably against the euro and finally, more recently, it has crashed against the US dollar. When a British one pound coin could be exchanged for two US dollar bills plus some loose change, we Brits were quick to mock the weak dollar but now it seems they are laughing at us from across the Atlantic.

Unfortunately for us, it is now much more expensive to go on holiday abroad in most countries, let alone buy a property. Research just released by the National Institute of Economic and Social Research - coupled with other recent UK statistics - has highlighted that sterling is now at its lowest point against a basket of major currencies.

December 2007 saw sterling trading at around 1.39 against the euro, but it has now plummeted dramatically to 1.13 against the euro. According to Nick Fullerton at FC Exchange a property investor buying a €350,000 property abroad will now have to spend on average £55,000 more than in 2007.

A key factor in the decline of sterling has been the significant change in the interest rate differential between the UK and other G7 nations. The UK suffers from a consistently high balance of payments deficit on its current account. In the past, this deficit was financed primarily by large scale capital inflows, including funds attracted by sterling's interest rate premium over the euro and the dollar. The premium has diminished in the case of the US dollar, which now has even lower interest rates than in the UK, whilst against the euro the differential has been completely eroded and UK bank rate is now 0.5% below the euro equivalent.

Market comment

In our last article on currencies, in the June 2008 issue, most currency traders commented that the biggest single influence on currency fluctuations was trader speculation. But David White, managing director at Axia FX says times have changed: "One year ago speculation would have been way out there as the biggest influencing factor, but now it is more about politics and economics. The problems the banks are now having with regards to illiquidity is causing extreme currency movements.

"The general direction a currency is moving is still mainly influenced by two factors, which are interest rate levels and the perceived future growth of an economy. But don't think that today's news is affecting currency movements because that was 'priced in' six months ago, with the exception of major industry figures.

"Sterling is under so much pressure because we have high levels of borrowing compared to other countries but I think our Government will come up with innovative ways around it. For example, in the last few months it has taken the debt away from many of the banks and slashed interest rates. It is all 'doom and gloom' at the moment and a lot of the recent economic growth came from consumer confidence and that has now gone and there is no longer a reliance on house price inflation to fuel consumer spending."

White says the dollar's recent strength is mainly because the US was first to encounter economic problems and is probably just ahead on the curve. He says: "The US dollar suffered greatly in 2007 when the credit crunch first bit and other currencies strengthened last year because their economies were perceived then not to be in as much trouble. Now some have perceived that the US economy has hit the bottom. It is where an economy will be in the future that affects today's currency value.

"One good thing that has come from all of this is the fact that the man on the street has now become more aware of how important currencies are. For example, when there was \$2 to £1, I advised clients with ▶

homes in the US to 'lock-in the gain' even if they had no intention of selling the property. If they did, they could now switch their mortgage into sterling at the $2 rate and take the 25% gain."

But White warns that some property investors made a big mistake when they switched to a foreign currency mortgage just because the base rate was lower. "What people have to realise is that there are other risks involved. For example, thousands of people in the UK jumped into the Japanese mortgage market because UK base rates were 5% and Japanese base rates were 1%. So they then saved 4% a year on their mortgage payments, but sterling has weakened 50% against the yen, so their debt has increased by 50%. Some people have lost a fortune."

White concludes that the best bet for a 'currency layman' who is planning to buy or sell a foreign property in the near future could be to hedge any loss/gain by changing 50% of the money into/out of that currency now, but he adds: "If you want to buy in Europe in the future, I certainly wouldn't advise locking into the euro rate at the current level."

John Beddell, managing director at TorFX, says: "The biggest factors that influence currency strength are interest rates, followed by economic performance, followed by geo politics. When interest rates are changed, unless it is a really unexpected decision, it has usually been priced into the currency. Traders buy and sell off the back of fundamental data, especially inflation data. For example, the pound weakened further recently when low inflation data was released because it means we are likely to get lower interest rates in the future, which will give investors a less attractive return. Those factors influence currencies in the short-term but the balance of trade always comes through in the long-term, although it can sometimes take five to ten years for that to happen.

"With regards to the 'carry-trade', the New Zealand and Australian dollars and the South African rand all had high yielding interest rates ranging from 6% to 12% but all of a sudden investors needed their cash back so they took their money out of those accounts and paid back their loans in Japan. This resulted in those currencies falling by as much as 10% in one day and because the investors had to buy yen to clear their loans the yen really strengthened. Basically the strength of these currencies, which was partly the result of carry-trade activity, unwound in just a few days."

Beddell agrees with White that some homeowners that take out currency mortgages are unaware of all the risks. He says: "I think currency mortgages are only really for high-net-worth individuals that use professionals to move the money around, sometimes changing the currency of the mortgage 10 or 12 times in a year. I work with currencies and I wouldn't risk it myself!"

According to Beddell, there is good news for property investors that want to buy abroad but are disillusioned at just how weak the pound is nowadays. He says: "Sterling has been desperately over sold. People are selling their shares in 'UK plc' because they think that the country has not been well managed but our situation is not as bad as in Europe and the euro should not be at 1.12, it should be at least 1.25. It went up to almost 1.50 to the pound last summer (2007), because we raised our interest rates quickly but in August 2007, the credit crisis reared its ugly head and the UK was always going to be more exposed than Europe because we have such a large banking sector.

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"But if our interest rates go below 2% that will be the lowest since 1649! I think sterling will rebound strongly in Q1 2009 and the US dollar will weaken next year. We could go back to a $2 pound or even higher. Once all of the UK base rate cuts are out of the way the cloud here will start to lift."

Beddell also has an interesting take on why the US dollar has strengthened so much lately. He says: "The main reason the dollar strengthened is because the US is the largest contributer to foreign direct investment (FDI), but US investors started bailing out of all risky assets overseas so there was 'a wall of money' coming back to the US. Few people 'called it' before it happened and even while the dollar was strengthening, many currency traders couldn't figure out why. Now, when you look back it makes perfect sense.

"I don't think the fear in the global economy will get any worse than it did in October 2008 when there were unbelievable fear levels. I have been very bullish on the stock market since early-November because I think shares were also oversold and the stock market should rally at least 30% in 2009."

Beddell concludes: "Currencies don't move against each other. A currency's value is simply determined by supply and demand. Oil was desperately over bought when it soared above $145/barrel and oil prices are likely to be volatile for some time. I heard someone asked the other day what there prediction is for 2009 and they replied 'prices will fluctuate'. I couldn't agree more."

Currencies to be aware of

According to the professionals then, it seems the worst time to buy a currency is when that country has high interest rates that are about to start falling because it may lead to carry-trade investors withdrawing substantial funds and selling that currency so they can place the money in a higher yielding account in a different country. It also appears that the best time to buy a currency is when the base rate cuts appear to have come to an end and the only way is up.

With this in mind it should be worth noting some countries that currently have very high interest rates, because the global economic slowdown is eventually going to have a negative effect on these developing nations and also slow down their economies, which should lead to base rate cuts. If these cuts take place early next year, at the same time when the cuts in UK base rates are likely to have come to an end, then those country's currencies are very likely to weaken substantially against sterling in 2009.

Any property investor that owns a property in one of these countries may want to consider selling their unit or transferring as much equity as possible back to the UK before that happens. Likewise, anyone thinking of buying in these countries should definitely consider waiting another 6-12 months at least. If you own a property in one of these countries but have no equity in it and want to hold the unit for the long-term, then at least your mortgage rate should be about to come down!

The following countries have been popular destinations for real estate investment and all currently have base rates in excess of 10%. The percentage increase against sterling is from the 5th of July 2007, (when the Bank of England (BoE) completed its final interest rate rise), to the

time when the country listed made its last interest rate rise.

Most of the countries listed below are now at the top of the cycle with regards to high interest rates and could be about to start reducing their rates in the same way that the BoE has been over the past 18 months. However, some currencies have already started to weaken as a result of falling commodity prices. (For more, see the commodities article on page 36)

Russia: While the rest of the world is frantically slashing their interest rates, Russia decided to increase its interest rate to 13% in December 2008, despite massive devaluations and frequent trading halts on its stock exchange. Because Russian oil is now trading at less than $40 a barrel the Bank of Russia has been spending its national foreign reserves to keep the currency from depreciating too quickly. But despite the government spending over $100bn in an attempt to stop the rouble crashing, it has still fallen to a three-year low against the US dollar and has been falling by 2.5% a month since August 2008.

By raising interest rates again this month, the Russian government was hoping to lure in carry-trade investors that would play the rouble against the euro. Because such a large percentage of Russian exports go to the Eurozone, the two currencies have a particularly high correlation, so investors can borrow in the Eurozone, which currently has base rates of 2.50% and buy roubles then deposit them in Russian savings accounts, where the central bank rate is 13%. The problem is that many hedge funds and investment banks are not risking any carry trade activity at the moment for fear of losing any more cash through turbulent currency movements.

Compared to sterling, the exchange rate has fallen from 51.8 roubles to the pound to 41.5, an appreciation of 24.8%, but it is now likely to weaken against sterling in 2009, especially if oil remains under $70 a barrel, which is reportedly the breakeven production price for Russian oil.

Hungary: The Hungarian forint has been very turbulent lately due to the country having both political and economic crises. The national bank raised interest rates to 11.5% in October 2008. From July 2007, the exchange rate fell from 365 forints to the pound to 307, an appreciation of 18.9% against sterling. Hungary began lowering interest rates in November 2008 down by 0.5% to 11% and carry trade investors have already begun to withdraw funds.

Brazil: Raised interest rates to 13.75% in September 2008. At that time there were 2.96 real to the pound compared to 3.86 in July 2007, an appreciation of 30.4% against sterling. However, due to falling commodity prices in the second half of this year, the real was trading at a three-year low against the US dollar at the time of going to press and the stock market has fallen by over 50% this year. But according to Merrill Lynch, Brazil's stock market may climb 40% next year as the nation's central bank cuts interest rates and investors anticipate a recovery in global economic growth during the second half of 2009. The currency is expected to remain very unstable and fluctuated by 10% against sterling in the first week of December alone but it is still up over 20% against sterling compared to two years ago and could well weaken when interest rates in Brazil start being slashed.

Turkey: Raised interest rates to 16.75% in July 2008, which might sound high but in 2002 they were 57%! In the preceding year to July 2008, the Turkish new lira appreciated by 11.5% against sterling from 2.61 to 2.34. Interest rates cuts began in Turkey in November 2008 but they are still 16.25% and the new lira still buys 35% more UK pounds than it did in summer 2006. Considering how reliant the Turkish economy is on tourism and foreign investment, including property purchases, interest rates are likely to fall in 2009 and the new lira could well weaken against the pound as a result. PIN