Heartwood Investment Management

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Investment Insight

Weekly Insight

Sterling weakens, but it's not all bad news

There is perhaps some irony in the fact that the Bank of Japan and the European Central Bank have been futilely trying to devalue their domestic currencies in attempts to stimulate growth and reflate their economies. However, the mention of 'hard Brexit' sent sterling into a tailspin in the first few days of October, as a clear timetable was set for triggering Article 50. Sterling has shown its vulnerability to perceived hard 'Brexit' rhetoric, but we should recognise that conference season has a tendency to induce glib sound bites to appease the party faithful. That said, away from the political noise, we expect currency markets to continue to test sterling in the short term for two reasons.

Currency markets will test UK fundamentals

First, notwithstanding the recent bounce in data, the underlying fundamentals of the UK economy are less supportive from a currency perspective. The UK continues to have a large current account deficit (-5.9% of GDP as of 30 June 2016) relative to the US and other developed economies (the eurozone and Japan are both in surplus), so a weaker currency is one way to redress this imbalance through the attraction of capital inflows.

The UK's fiscal position is another concern for currency markets, in light of the UK government's decision to relinquish its commitment to achieving a budget surplus by 2020. Furthermore, additional Bank of England policy easing remains likely at some point over the next few months, although recent comments from policymakers acknowledging the better growth profile and more positive economic data since June's vote have dampened down expectations of another interest rate cut in November. Bank of England policymakers continue to highlight the medium term risk of slowing UK growth, highlighting in particular that the shock to economic activity will take time to feed through as businesses adjust spending decisions to the new climate.

Second, we expect the interest rate differential between the UK and the US to be an important driver of sterling's performance versus the US dollar. Since the start of the period of the US dollar's ascent in mid-2014, the two-year interest rate differential between the UK and US government bond markets has widened by more than 100 basis points. This trend may well continue with a Federal Reserve looking to raise interest rates and a Bank of England still in easing mode. However, higher imported inflation over the medium term could provide an offset to UK gilt yields plummeting too low.

The tailwind of a weaker sterling supports large-cap UK equities

The tailwind of the currency devaluation - sterling has fallen 12.5% on a real effective exchange rate since before the European Union Referendum - is good news for large-cap UK exporting companies, where two-thirds of their revenues are sourced from outside their home market. This part explains the divergent performance between the robust performance of the FTSE100 and sterling's decline since Prime Minister May's announcement. It is also worth noting that in US dollar terms, the FTSE 100 remains 15% off its high in June 2014 and this may represent an opportunity for return-seeking international investors or for international companies looking to target UK companies for takeover. Indeed, we may see more merger and acquisition activity as UK plc is discounted.

For more domestically-exposed small- and mid-sized UK equities, performance has been resilient so far, but we expect this area of the market to be pressured by

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higher import costs and potentially weaker demand. For these reasons, we have shifted some of our UK equity allocation away from this area of the market and into the FTSE 100.

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