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2013-01-28 10:53:41.209 GMT

By Lucy Meakin

Jan. 28 (Bloomberg) -- As European Central Bank President Mario Draghi celebrates the lifting of the "darkest clouds"
from the euro area's debt crisis, the outlook for the U.K.'s pound is turning gloomier.

Sterling is poised for its worst month in more than four years against the 17-nation shared currency as demand for a refuge from Europe's crisis eases. Options traders are betting for the first time since mid-2011 that it will continue to drop amid concern Britain is headed for a triple-dip recession. Of the 10 major currencies tracked by Bloomberg Correlation- Weighted Indexes, only the yen has fallen more this year.

Britain's economic shortcomings are being exposed as the euro area heals, with the nation's gross domestic product shrinking 0.3 percent in the fourth quarter. The economy has grown just 0.5 percent since Prime Minister David Cameron's coalition took office in May 2010. Sterling extended its decline today after Mark Carney, who will become governor of the Bank of England in July, said central banks have room to ease monetary policy further if needed.

"The demand for safe-haven flows is going down because the euro-zone crisis has eased, but at the same time the U.K. is not a good candidate for a haven," said George Saravelos, a London- based currency strategist at Deutsche Bank AG. "It's got one of the worst balance of payments among the major currencies so the absence of safe-haven flows immediately leads to currency weakness."

Trailing Yen

The pound has weakened 5 percent against the euro this year, reversing its 2.8 percent advance in 2012. It slipped 0.3 percent to 85.48 pence per euro at 10:49 a.m. in London and touched 85.54 pence, the weakest level since December 2011, putting it on course for the worst month since December 2008.
Against the dollar the currency has slumped 3.2 percent this month. It fell 0.4 percent to $1.5732 today and reached $1.5716, the lowest since August.

Against a basket of currencies, the pound's 3 percent drop this year is exceeded only by the yen's 4.3 percent slide, Bloomberg Correlation-Weighted Indexes show. New Japan Prime Minister Shinzo Abe has called for "bold monetary policy" to boost the economy, pushing the yen lower. The dollar is up 0.6 percent, according to the indexes.

Sterling's decline marks a reversal from last year, when the pound strengthened against the dollar and yen as well as the euro, as investors turned away from Spanish and Italian bonds on concern the euro area would splinter and sought British assets as an alternative.

Relative Yields

Yields on 10-year gilts fell as low as 1.41 percent in July, before ending last week at 2.06 percent. The rate on similar maturity Spanish bonds has fallen to 5.17 percent from
7.75 percent in that period.

Draghi said the worst of the financial upheaval is over on Jan. 22, and the "darkest clouds" have lifted due to decisive policy steps last year, such as pledging to backstop debt markets and government measures to cut deficits.

"We are seeing some unwinding of all the euro-negative trades, just because there's a better perception of the crisis management," Carlos Galvis, a money manager who oversees the equivalent of $8.1 billion at Carmignac Gestion in Paris, said in a Jan. 24 phone interview. "Sterling benefited quite significantly from those flows last year and I wouldn't be surprised to see the euro move higher against the pound as that unwinds."

Foreign investors, including those from Britain, are snapping up European assets they abandoned through the debt crisis this year to harvest higher euro-area bond yields.

Bond Sales

Portugal sold 2.5 billion euros of five-year notes on Jan. 23, its first offering of that maturity in almost two years. About 93 percent of the securities were bought by overseas investors, including 33 percent by the U.S., 29 percent by the U.K. and 9 percent by Asia, the debt agency said.

Spain sold 7 billion euros of 10-year bonds on Jan. 22, a sale that Economy Minister Luis de Guindos said had the biggest demand in the nation's history.

U.K. government bonds are now underperforming their euro- area counterparts. Gilts handed investors a loss of 1.4 percent this month through Jan. 24, according to indexes compiled by Bloomberg and the European Federation of Financial Analysts Societies. German bonds lost 1.3 percent and Spanish securities returned 1.8 percent.

Any renewed economic turmoil in Europe may help to reinvigorate demand for the pound as a haven, according to Greg Anderson, the North American head of Group-of-10 currency strategy at Citigroup Inc. in New York.

Pound Bull

"The safe haven trade has been waning for the past three months and that's a large part of the reason why we've seen euro-sterling move higher," Anderson said. "But there's a big difference between waning and being over."

The pound will strengthen to 82 pence per euro and $1.61 over the next 12 months, according to Citigroup forecasts. The median estimates of analysts compiled by Bloomberg show sterling will appreciate to 80 pence per euro and $1.58 by year end.

Demand is stronger for options contracts that protect against a decline in the pound versus the euro than those that insure against an advance for the first time since June 2011, based on closing-market rates.

The so-called three-month 25-delta risk reversal rate rose to 0.13 percentage points in favor or a weaker sterling, from as low as minus 2.15 percentage points on May 21.

Last quarter's 0.3 percent drop in gross domestic product as measured by the Office for National Statistics was steeper than the 0.1 percent decline forecast in a Bloomberg News survey of 38 economists.

German Confidence

The U.K. report contrasted with optimism from Germany, where business confidence rose more than economists forecast in January. The Ifo institute's business climate index, based on a survey of 7,000 executives, climbed to 104.2 from 102.4 in December. That's the highest since June and the third straight gain. Economists predicted an increase to 103, according to the median of 41 forecasts in a Bloomberg News survey.

Citigroup's economic surprise index for the U.K., which measures when data is beating or trailing the forecasts of analysts, slid to the lowest since August this month, further dimming the allure of U.K. assets. The euro-area equivalent has climbed to the highest since January 2011.

Bank of England policy makers may welcome the pound’s slide after noting the damping effects of its strength on growth at their January meeting. “The sterling real exchange rate might be above the level compatible with the necessary rebalancing of the economy,” minutes from that meeting said.

Pound Averages

Even after the drop, the pound is trading close to its five-year average of 84.63 pence per euro. It got as weak as 98.03 pence per euro in December 2008, and strengthened to 77.55 pence on July 23 last year.

The current task of monetary policy is to ensure key economies “achieve escape velocity,” Carney, currently governor of the Bank of Canada, told the World Economic Forum’s annual meeting on Jan. 26 in Davos, Switzerland. He said policy in developed countries isn’t “maxed out” and central bankers can be flexible in meeting inflation goals.

In the 11 months through November, the U.K. trade deficit ran at an average 8.9 billion pounds a month, the Office for National Statistics said on Jan. 9. The gap in the same period of 2011 averaged 8.4 billion pounds.

Half of Britain’s exports go to the European Union, according to Citigroup, and the government estimates about 3 million jobs rely on trade with other EU countries. Exports account for 15 percent of the island nation’s gross domestic product.

“The U.K. economy needs to rebalance,” said Paul Robinson, the global head of foreign-exchange research at Barclays Plc. “It’s not a panacea, but the weaker that a currency is, not only will exports be more attractive to foreigners, but also imports will be less attractive to domestic residents.”

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