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Elston Insights

16th September 2022

Weakening pound: portfolio positioning

- Pound Sterling hits lowest level since 1995
- Driven by stronger dollar, and deteriorating UK economic outlook
- Currency outlook affects decision-making across each asset class

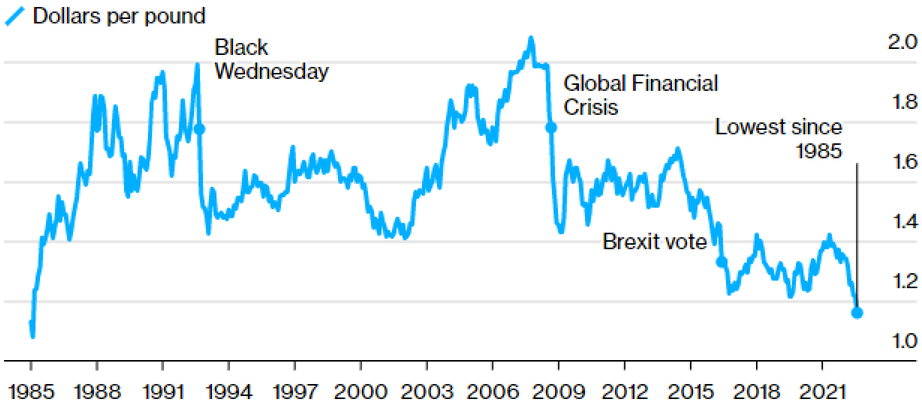
The pound takes a pounding

The thirty-year anniversary of Black Wednesday – when Sterling crashed out of the European Exchange Rate Mechanism on 16th September 1992 – was marked by the beleaguered currency reaching its lowest levels against the dollar since 1985.

Part of this is a function of dollar strength against global currencies, another part about rising concerns on the UK economic outlook and future policy-making. Sterling's weakness and outlook is forcing investors to consider how to manage currency risk in their portfolio across each asset class.

We outlined the risk to sterling in our previous Insights Hedging currency risk requires clear policy (5th May 2022) and UK inflation and sterling pressure (18th May 2022).

Fig.1. The pound hits its lowest level since 1985



Source: Bloomberg

This chart shows the long-term performance of the Pound against the Dollar and key macro and market events. The Pound has reached its lowest level since 1985.

Dollar strength

A stronger dollar relative to other currencies, on a trade-weighted basis, has gained momentum all year with the Fed's rapid tightening and investors' flight to safety. Furthermore, unlike Europe and the UK, the US has its own energy reserves so has been more insulated both on energy supply and has no exchange rate risk when purchasing energy which is globally priced in dollars.

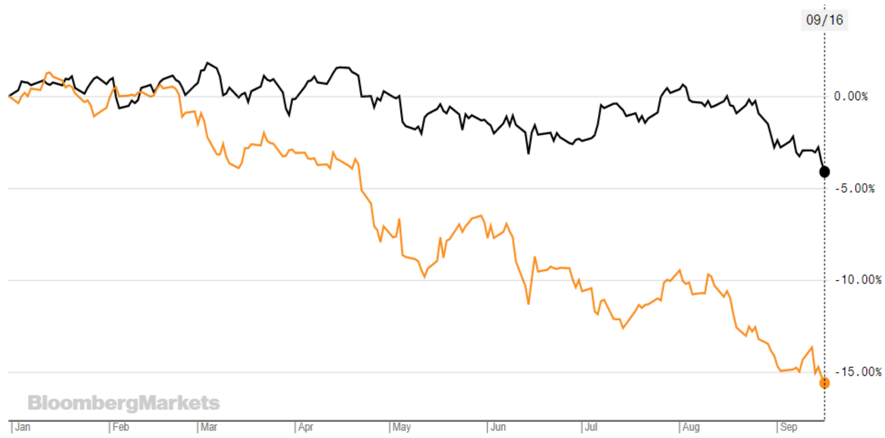
Fig.2. The Dollar has risen +13.55% over 1 year and +11.52% YTD vs other currencies

Source: Bloomberg Markets, as at 16-Sep-22

This chart shows the performance of the dollar relative to a basket of 10 leading currencies including predominantly EUR, JPY, CAD & GBP. The weighting of each currency is determined by the level of trade ("trade-weighted") with that economy and liquidity.

The Euro has weakened -11.91% against the Dollar, and Sterling has weakened -15.61% against the dollar year to date. Sterling weakness versus the Euro is less pronounced. Like the UK, the Eurozone is also having to pay more for imports and faces inflationary pressure and a recession. Relative to the Euro, Sterling has weakened -4.12% YTD vs the Euro.

Fig.3. Sterling has weakened -4.12% vs Euro and -15.61% vs Dollar YTD



Source: Bloomberg Markets, as at 16-Sep-22

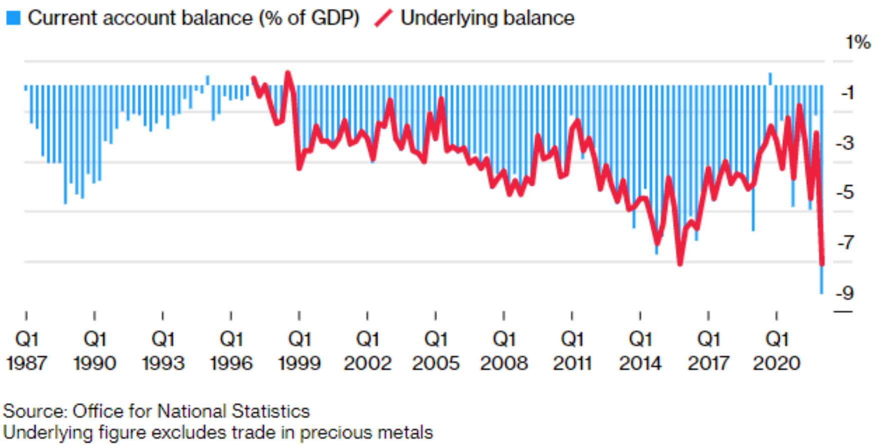
This chart shows the performance of the Pound showing slight weakness against the Euro and significant weakness against the Dollar, year-to-date.

Sterling weakness

In addition to dollar strength, Sterling has been particularly vulnerable for three reasons:

1. Risk to growth: the Bank of England forecast of a recession highlighted the risk to UK growth as inflation soars and rising interest rates penalise borrowers: recent UK retail sales data only added conviction to that view. The UK faces harsher economic headwinds than the US.
2. Current account deficit: the UK's current account deficit has widened highlighting our dependency on imports. It could worsen with the risk to growth, and further undermine confidence in the economy, gilts and sterling.
3. Political instability: the change of UK leadership and uncertainty as regards Liz Truss' planned economic policies – whether potential tax cuts and higher spending commitments prove viable – and the (since dispelled) concerns about Bank of England independence and mandate.

Fig.3. UK current account deficit nosedives



This chart shows the UK's current account balance – the different between goods and services it exports and those it imports. In 1q22 the underlying current account balance was in deficit (as a percentage of GDP) reaching -7.1%, compared to -3.9% in 1q19 pre-COVID (excluding trade in precious metals that may represent financial flows). The deficit widened as imports of manufactured goods, oil, and other fuels increased.

Notes: Whilst a change in data collection and reporting methodology for trade with the EU since Jan-22 makes cross-comparison less consistent, the headline figures are nonetheless a concern. Current account deficit could worsen if either or both of the following happens: the value of the gap between exports and imports widens further, or slowing economic growth or recession means that the same balance in value-terms looks higher when expressed as a percentage relative to (weaker) GDP.

How does this affect portfolios

Traditionally managers created large home biases to UK equities and bonds to reduce currency risk. But if Sterling itself has become a risk, does that approach make still make sense, given our high import dependency?

We consider options for implementing currency views across each asset class:

1. **Equities:** whilst the risk to growth increases equity volatility, portfolios with a lower UK home bias will have higher exposure to world (predominantly US) equities and therefore earning dollar returns on those equities. However world equities also bring in a higher Growth-bias relative to Value-oriented UK. Within UK equities, the performance of larger cap equities – which have significant dollar-based revenues – is helped by a weaker pound owing to a "translation effect" as those dollar earnings become more valuable in pounds. By contrast, UK mid-cap and small-cap funds, whose companies' earnings are predominantly sterling-based, provide less currency diversification away from sterling. This, together with concerns over a Growth-bias and risk-off environment is why UK large cap equities have been more resilient this year than mid-cap and small-cap.
2. **Alternatives:** investors often use Property as an alternative asset class and can chose between targeting sterling-based UK or USD-biased global listed property securities to access that exposure. The performance of those exposures echoes the currency movements with some 15ppt performance difference between UK and global property securities funds. For Gold, investors have a choice between investing in an unhedged ETC such or a GBP-hedged version. Hedging gold into GBP reduces its diversification effect in our view for long-term investors and would only make sense to own tactically if conviction on near-term GBP strength was high.
3. **Bonds:** many managers use Global Bonds hedged to GBP to remove currency risk as defensive buffer within portfolios. Whilst this may make sense strategically, it means that this year the combination of rising inflation, rising rates and falling sterling have delivered a triple blow to sterling-based bond performance. By contrast, unhedged global bonds have been relatively more resilient. If sterling remains a riskier currency, unhedged bonds may continue to be more defensive. This challenges conventional wisdom on currency risk and hedging policy.
4. **Cash & Equivalents:** money market funds are GBP based. For additional yield over cash with near-nil volatility, ultrashort duration bond funds, with less than 1 year duration and similar to money market funds, are accessible in GBP or USD format.

Summary

Whilst the war/energy crisis continues, the current account deficit widens, the economic outlooks is uncertain and the new government finds its feet, sterling could remain under pressure. A mis-step on any of those could lead to further declines in Sterling relative to the Dollar.

Currency risk is a consideration that requires both strategic and tactical decision-making. There are a range of ways to implement or adjust portfolios to reflect a view on currency risk within each asset class.

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