KAPSTREAM
A JANUS CAPITAL Group Company

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Sound as a Pound? May-be not.

Whether or not UK PM Theresa May's recent 'sooner rather than later' tone in relation to the triggering of Article 50 (and the UK's consequent exit from the European Union) has had a direct bearing is a matter of debate. But what is true is that at the time of writing the British Pound has now lost almost a fifth of its value against the US dollar since the UK voted to leave the European Union in June, and is currently trading at lows not seen for more than 30 years. Commentators have been quick to refer to the volatility of the GBP being akin to an emerging market currency (or perhaps *de*merging would be a more apt description…).

The Bank of England (BoE) itself added fuel to the fire in their comments[1] that further falls were possible, remarks seen as additional rationale for UK rates staying lower for longer. Furthermore, reports of US banks contemplating the transfer of staff out of the UK brought more pressure to bear on the GBP by expounding concerns about the loss of foreign investment.

Perhaps surprising has been the continued resilience of equities. On the day of the most savage fall in the GBP, the FTSE100 hit an intra-day high, closing only marginally lower. However, a weaker GBP directly improves the fortunes of a large proportion of FTSE100 companies for whom non-UK business represent the lion's share of revenues. Converted back to sterling that non-UK income is boosted considerably. Every cloud has a silver lining they say.

So if a weaker GBP is good for a large number of UK (export led) businesses, what's the negative? For a start imported goods become more expensive, such as food and fuel. And for British tourists travelling abroad their holidays just got markedly more expensive. On the flip side travelers to the UK will benefit.

Bigger Picture

At a macro level, the decline in the value of the GBP can be seen as a signal from the market that it has less confidence in the UK's economic growth potential relative to others. Against the backdrop of a worsened economic view continued selling of UK assets is likely as investors flock to more appealing assets and currencies in other markets (for example in the US, Australia, and NZ).

Exacerbating this scenario – and seen by many as a key contributor to the recent devaluation of the GBP – are short-term market participants making incremental profits by shorting a declining GBP. Much of this behavior is attributed – including the most savage daily drop in value – to the electronic algorithmic programme traders designed to rapidly execute ahead of others, self-feeding the downward value spiral.

Any further Quantitative Easing (QE) intervention on the part of the BoE will also have a likely negative impact on currency. In recent communication they have set out their expectation of additional loosening before next year, likely though a cut in rates, perhaps to 0.1%. And at a time when on the other side of the Atlantic the US Federal Reserve is signaling a hike, the relative merit of GBP vs USD worsens further.

Implications for portfolios

While not immune from the extraordinary and extreme moves in the GBP of the last week, our exposure has remained minimal and our actions typical of the risk aversion mantra. Before the 'flash crash' episode, we had initiated a long GBP short AUD FX forward position at a spot entry of 1.6931 with a notional size equivalent to 0.5% across portfolios. The rationale for the trade was both technical and fundamental with a bearish outlook on Australian crosses. As expected the RBA decided to keep the cash rate unchanged at 1.5% in October but did acknowledge that the global economy is growing at lower than the average pace, that inflation was expected to remain low for some time and that China's pace of growth appeared to be moderating. With the AUDUSD trading close to 0.77 at the time of the trade, we wanted to be short AUD but without the risk of being long USD going into the election. The GBP cross was the preferred route as we felt the pound undervalued in the medium term and GBPAUD was already hitting a 3 year level of support. The trade had a risk-to-reward projection of 2 with a target exit level of 1.76 and a stop loss of 1.66. The trade performed well to start, almost touching 1.71 but this soon dissolved following May's surprise announcement on triggering Brexit's Article 50. Renewed and aggressive selling saw GBPAUD quickly trade towards our stop level, we cut half of the trade at 1.6634 to take risk off the table. The trade started to slowly bounce back but little did we know of the mysterious freefall lying ahead. On October 7th at around 10:05am, the GBP fell around 7% and bid/ask spreads exploded as wide as 600 pips in just 30 seconds. Our GBPAUD trade touched a low of 1.543, and intraday volatility greater than that witnessed on the day of Brexit itself. Amidst the storm we held nerve while seeking (like most) to understand the catalyst for the move. For the next 10-15mins it became increasingly likely a 'flash crash' was the culprit given the absence of high impact news. Soon enough GBPAUD recovered and we closed the remainder of the trade at 1.6340 (towards the high of the day). GBP only recovered 80% and is trading today at 1.6012[2].

[1] In a statement by Michael Saunders, one of the BoE's rate-setting committee member

[2] 17th October 2016

This trade highlights a number of considerations we factor in the execution of ‘alpha’ trades; the sizing of positions considering volatility inherent in the trade, and clear stop levels to minimize loss most notable. We are also conscious that the most liquid market in the world – foreign exchange – is undergoing structural changes similar to those experienced in the past by equity or bond markets. High Frequency Trading has reduced the bid/ask spread and increased market efficiency but at the cost of lower market depth and withdrawal of liquidity provision in periods of stress, emphasizing the importance of being more vigilant and precise in trading and risk management activities. The GBPAUD trade only lost 1.4 basis points to portfolio performance, a great outcome from a risk management perspective given half of the trade was subject to intraday volatility of more than 9 sigma[2] (versus historical annualized volatility of 8.7%).

It is difficult to see any reason for a reversion to pre-Brexit levels in the near future. Possibly not until we are in the throes of Brexit itself and the ‘values’ (positive or negative) of a standalone UK economy become better known. Until then given the recent plummets and warnings of a ‘hard Brexit’ we forecast the pound to continue slipping lower before the end of the year. The GBP has of late become increasingly impervious to solid UK data and markets increasingly more jittery ahead of US elections, the Federal Reserve’s likelihood to raise rates in December and rumors of the European Central Bank tapering its QE program.

Sound as a pound? Sterling unnerving.

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[1] arguably an ‘off the charts’ level of implied annualized volatility