

Forex Focus: Sterling's Mask Is Starting To Slip

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LONDON (Dow Jones)--Cinderella is rapidly turning into an ugly sister.

For most of this summer, the pound has held up well as investors have focused more on the problems of other major economies, including the U.S. and the euro zone.

If anything, the U.K. has been seen as the best of a bad bunch and sterling has benefited.

But last week, the mask started to slip.

New data showed that the risks of a double-dip recession are much higher than expected and that the prospects for the U.K. economy are now decidedly ugly.

Not only is this likely to hasten the pound's decline against the dollar, it is also likely to bring a sharp reversal in its recent rally against the euro.

See how the pound has started to lose its shine against the dollar:

<http://www.dowjoneswebserver.com/chart/view/4539>

And against the euro:

<http://www.dowjoneswebserver.com/chart/view/4540>

At the moment, financial markets are a little shell-shocked by the economic news.

Most experts had been expecting that a combination of the global slowdown and Britain's harsh austerity budget would ensure that the 1.2% growth achieved in the second quarter of this year couldn't be achieved in the second half.

However, the litany of disappointing data last week, on house prices, employment and activity surveys in manufacturing and construction still came as a big surprise. The final straw was the news that activity in the country's dominant services sector had dived to a 16-month low.

The purchasing manager's survey that brought the bad news are generally seen as forward-looking indicators, making it likely that by the fourth quarter the economy will be contracting again.

With a return to 'negative growth' now looming, speculation over more quantitative easing from the Bank of England is likely to rise, putting the U.K. at the forefront of those countries that have found their first attempts at extraordinary monetary easing have essentially failed.

In the U.S., the Federal Reserve has indicated that it may also need to inject more liquidity but appears in little hurry to do so.

While in the euro zone, the European Central Bank may have extended its liquidity measures for as long as the market needs but has also suggested that, rather than slowing down like the U.K., the euro-zone economy could grow more than expected later this year.

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Sterling is also likely to look less attractive against the euro due to the steady decline in concern over sovereign debt. Last week, peripheral debtors including Spain raised funds in the open market with little problem, suggesting that they should continue to service their borrowing and lower the risk of default.

Of course, the euro would still be at risk if the euro-zone economy turns down and sovereign debt becomes an issue once again.

But for now, flows that once helped sterling as investors fled from euro-zone asset markets are now likely to go into reverse and the euro, like the dollar, may not look so ugly against the pound after all.

Early Monday, the pound is flat against the dollar, trading at \$1.5473, only a tad higher than \$1.5470 late on Friday in New York, according to EBS. But the euro did climb to GBPO.8344 from GBPO.8313 as the single currency benefits from the latest improvement in global risk sentiment.

Last Friday's better-than-expected non-farm payrolls from the U.S. lifted sentiment and triggered fresh flows into riskier assets. In Asia, most stock markets rallied with the Nikkei in Japan gaining 2.1% and the Shanghai Composite in China rising 1.3%.

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Thomson P/1066 or P/1074

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