

Britannia Thematic 27 May 2010



- As forecasted in April 2009, the Armageddon/Depression scenario did not materialise;
- Clients that currency switched out of USD & EUR into AUD & GBP last year have been rewarded;
- On a relative value basis we think that GBP is undervalued versus AUD.

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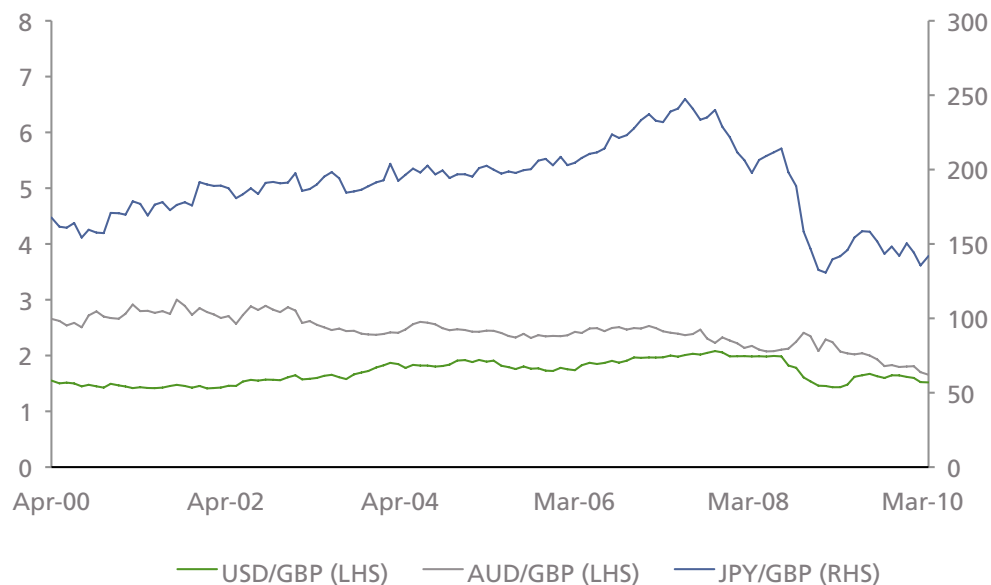
In our April 2009 article published in *The Hedge Fund Journal*, we presented the rationale behind currency switching out of US Dollar (USD) and Euro (EUR) denominated funds, into Australian Dollar (AUD) and Sterling (GBP) denominated funds. This investment thesis stemmed from our belief that the world would recover and that we were not heading into a fierce deflationary cycle. With this in mind, we took profits on our safe-haven FX positions and moved into beat-up commodity and pro-growth currencies like the Australian Dollar and the British Pound during the months of March/April 2009. Those investors who made this tactical switch have subsequently been rewarded. The Australian Dollar has appreciated +21.6% against US Dollars and +31.0% against the Euro. Sterling has also appreciated albeit not as strongly, registering +9.5% against the Euro¹.

Although we are very pleased with AUD's twelve month performance, we believe that GBP is undervalued relative to AUD and as a result we are advising our clients to lock-in their AUD profits and switch into GBP denominated share-classes.

Whilst we remain bullish on the global growth story, it would therefore be inconsistent if we turned bearish on a commodity currency such as AUD (especially in light of the fact that Australian interest rates are one of the highest of the developed economies). That said, we believe it has outpaced GBP too far – too fast (AUD/GBP has appreciated +19.9% during the same time period² as the spot exchange rate currently stands at a 25-year high versus GBP – see Chart 1).

1 Calculation based on the opening price on 1 April 2009 and the close price on 27 May 2010, source: Bloomberg.

2 Ibid.

Chart 1: GBP Performance vis-à-vis Major Currencies

Source: Bloomberg

Our thoughts are that AUD is well-understood by the market (evidenced by the popularity of the carry trade³) and that GBP is mis-understood by the market (evidenced by conflicting signals sent by UK policy makers). We think going forward the environment shall change and GBP should benefit from improving domestic economic conditions, a rebounding property market and strong earnings from the UK financial sector. We also believe that shifting policy out of the Bank of England will further support our case.

With regards to improving economic conditions in the UK, the numbers are constructive. For example, the UK GDP⁴ numbers for Q4 '09 were revised up (from estimated 0.3% to 0.4% q-o-q), raising expectations that the UK economy is better positioned than previously assumed. The UK Manufacturing PMI⁵ rose to 57.2 in March, its highest level since October 1994. The industrial production rebounded by rising 1.0% in February after a weather related slowdown saw it decline by 0.5% in January. While a negative trade balance historically has weighed down GBP, the trade deficit is expected to reduce with

3 The carry trade commonly refers to a currency strategy where investors borrow in a low yielding currency such as Japanese Yen and invest in a high yielding currency such as the Australian Dollar.

4 Gross Domestic Product is an aggregate measure of production equal to the sum of the gross values added of all resident institutional units engaged in production (plus any taxes, and minus any subsidies, on products not included in the value of their outputs).

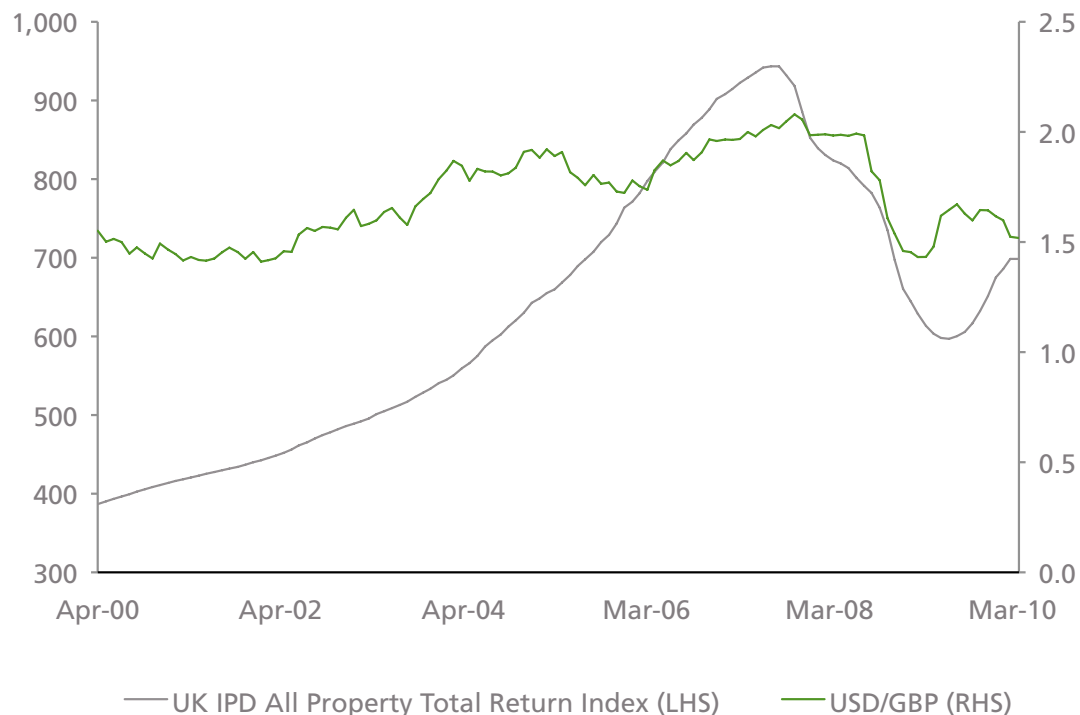
5 The CIPS/Market Purchasing Managers' Index (PMI) indices are derived from continuous monthly surveys of business conditions and tracks activity at the individual company level. Used by the BoE and key economists in the UK and abroad, the PMI indices are based on inputs provided by selected panels of executives in companies who report data each month. The PMIs cover manufacturing, construction, and service sector activity.

goods exports surging 9.5% month-on-month in February 2010, the highest in the last seven years, and imports contracting by 0.5%.

Regarding the improving property market, by way of background, in September 2007 we published our thesis recommending that UK investors diversify out of GBP into safe-haven currencies such as USD. This was based upon our views that GBP was highly correlated with the UK property market along with the banking sector and that they would all exhibit weakness going forward due to over-leverage.

We believe that the high correlation between the UK property market and GBP (see Chart 2) remains intact. The highs of the UK property sector index (943.4) and GBP (2.08) both coincided during 2007, when higher demand for property in the UK resulted in higher demand for GBP especially from foreign buyers. The investment volume in the UK property sector hit a bottom in 2009 at GBP 24.6 billion, compared to GBP 56.0 billion in 2007. We believe good value exists in the property market and that demand is further supported by yield-hungry foreign buyers.

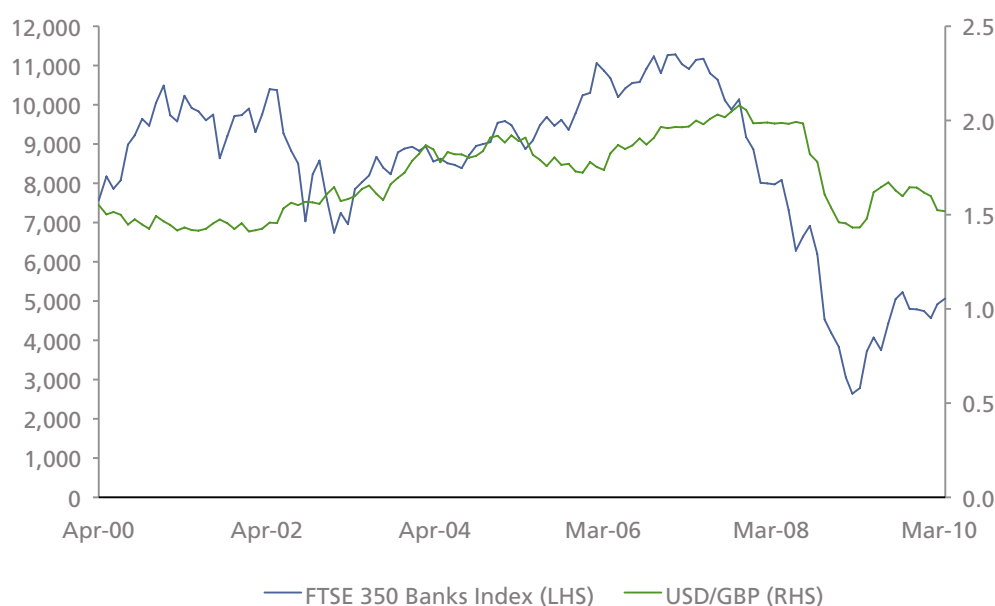
Chart 2: Correlation between UK IPD Total Return All Property Index & GBP Spot Rate (2000-2010)



Source: Bloomberg

On the banking front, except for January 2000 – August 2002, GBP has moved closely in line with the FTSE 350 Bank Index during 2000-10 (see Chart 3). Bloomberg Consensus estimates for FY2010 suggest that the earnings per share (EPS)⁶ for three out of the five leading UK banks will head northwards. Post credit crisis, many banks have already deleveraged and have experienced an increase in their Capital Adequacy Ratio (CAR⁷). This helps to support the argument of a strengthening banking sector.

Chart 3: Correlation between FTSE 350 Banks Index & GBP Spot Rate (2000-2010)



Source: Bloomberg

The increased optimism in the banking sector coupled with the overall improvement in the UK economy (expected real GDP growth rate of 1.20% in 2010 and 2.25% in 2011 compared to -4.90% in 2009) should bolster the financial services sector in the UK. (The wild cards are of course taxation and financial regulation.)

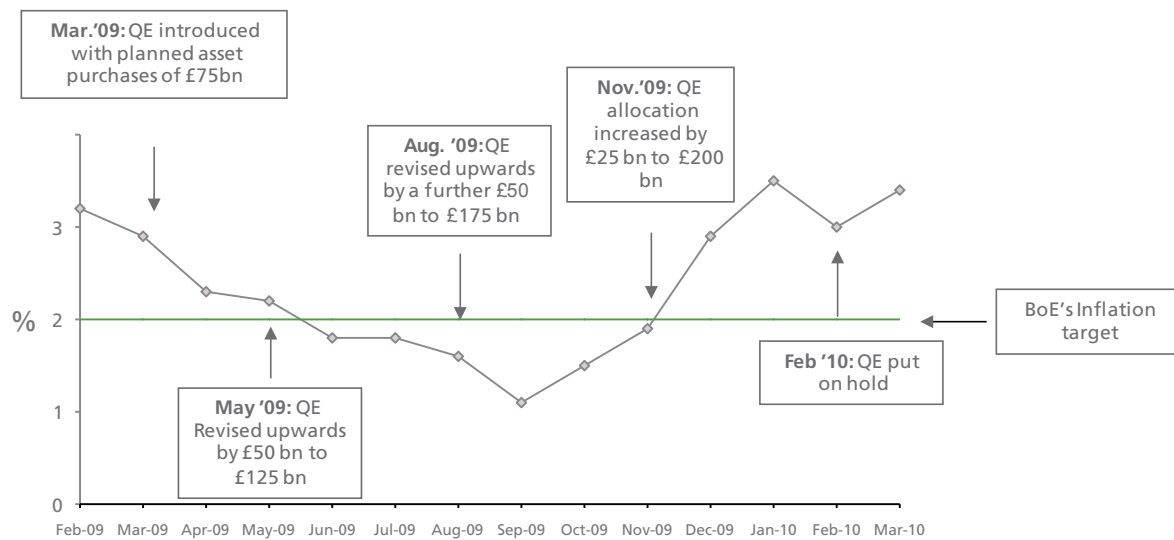
Complementing the improved economic growth, stabilising real estate market and an improving financial sector, is a positive shift in UK monetary policy. The Bank of England (BoE) has stopped lowering rates (currently 0.5%) and has also halted increasing the amount of quantitative easing (QE⁸) in the system (see Chart 4).

⁶ EPS refers to the estimated net income (before extraordinary items) divided by the number of shares outstanding.

⁷ The Capital Adequacy Ratio (CAR) is a ratio of the statutory capital base of a bank and its risk-weighted assets. The ratio indicates a bank's financial strength and its ability to meet its time liabilities and other financial risks.

⁸ Quantitative Easing (QE) is a policy aimed at boosting the level of activity in the economy. Under QE, the Bank creates money, which it uses to buy assets (mainly government bonds). This increases the amount of money in the economy. It is hoped this will boost the economy by encouraging banks to lend and consumers to spend.

Chart 4: QE and UK Inflation



Source: Bloomberg

The BoE initiated the stimulus package in March 2009 to boost the economy and prevent inflation⁹ from undershooting its 2% target, the minimum level the BoE views as necessary to sustain growth, investment and employment, and also to ensure that consumption is not impacted by deflationary expectations. The BoE's measures have worked in favour of increasing economic activity, as reflected by a rising inflation rate since September 2009. Despite various concerns, the economy has not only achieved, but surpassed its inflation target; it was at 3.4% in March (the forecast was 3.1%) compared with 3.0% in February.

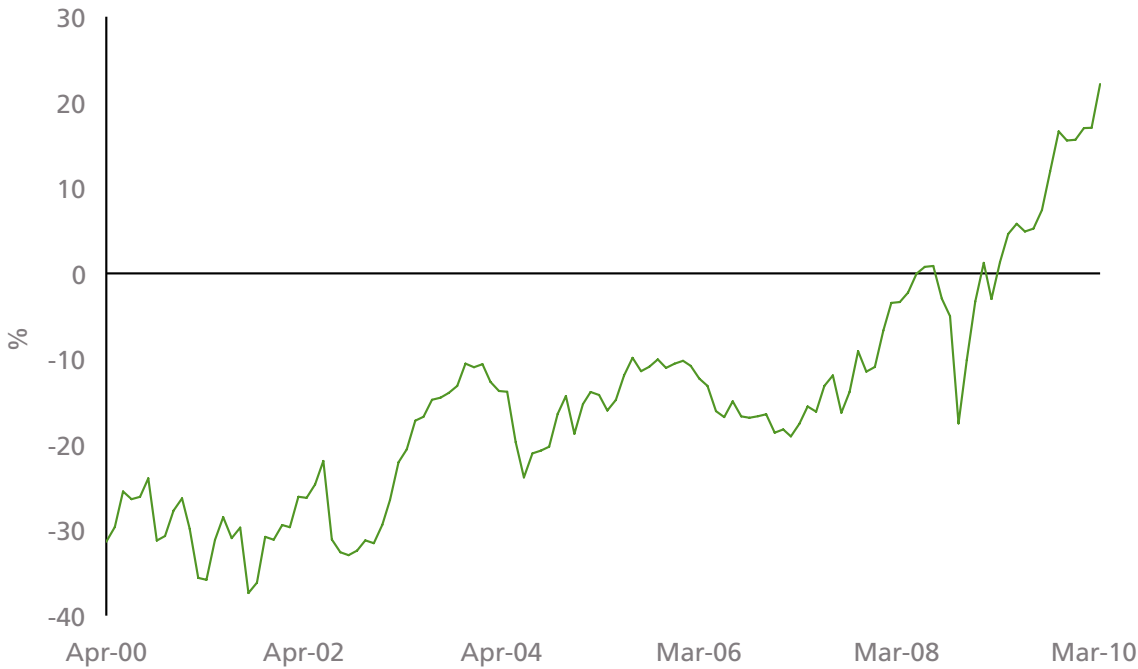
However, inflationary concerns have resulted in the Monetary Policy Committee (MPC) maintaining a status quo on further QE measures and it has adopted a *'wait and watch'* strategy. The MPC has not ruled out the option of further spending and is open to increasing the funding if the outlook turns negative again; but with no new spending decisions announced in the last six months, we believe it is safe to regard QE as finished, indicating that the BoE believes that the recovery is real.

Looking out further, we think GBP will benefit from two additional factors, firstly normalisation in certain relative value measurements such as PPP¹⁰ (see Chart 5) and also from the gradual shift by central banks into non-USD currencies.

⁹ A consumer price index is estimated as a series of summary measures of the period-to-period proportional change in the prices of a fixed set of consumer goods and services of constant quantity and characteristics, acquired, used or paid for by the reference population. Each summary measure is constructed as a weighted average of a large number of elementary aggregate indices.

¹⁰ Purchasing power parity (PPP) (conversion factor) is the number of units of a country's currency required to buy the same amount of goods and services in the domestic market as a unit of foreign currency would buy in the foreign market.

Chart 5: AUD Overvaluation/ Undervaluation versus GBP



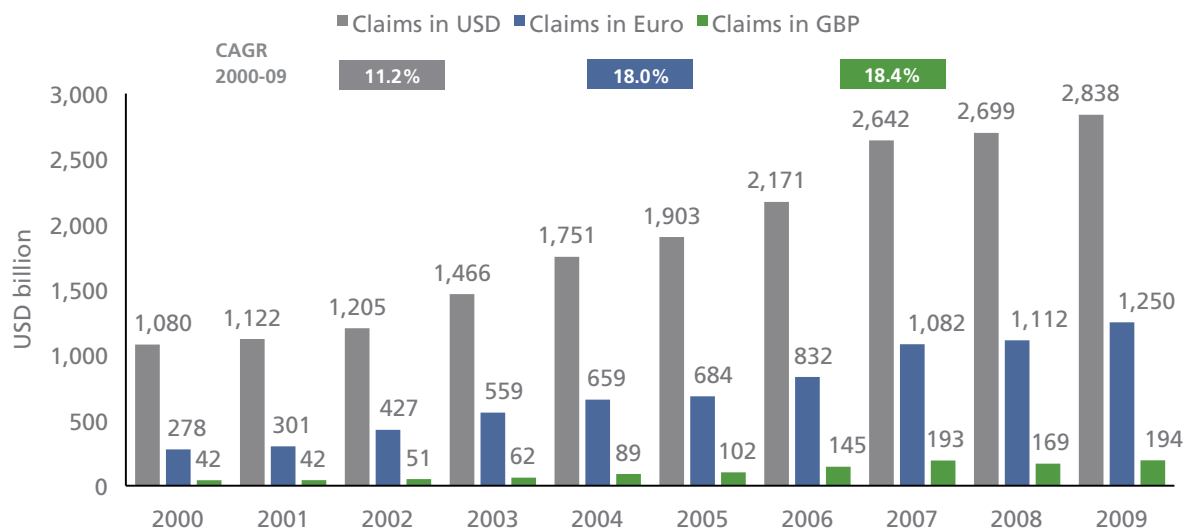
Source: Bloomberg

In PPP terms, GBP is one of the most undervalued currencies versus AUD. Although we recognise that anomalies on a relative value basis can persist in the short term, we believe that in the longer term there will be reversion to the mean which should help to support our thesis.

We also believe that diversification of foreign currency holdings by major central banks¹¹ will add to demand for the GBP. We continue to be bearish on the US Government’s debt issuance (the US Treasury sold a record USD 1.4 trillion of debt in 2009) and believe that the shift of central bank foreign currency holdings towards non-USD currencies will gather pace in the future. USD, which is the world’s most widely held reserve currency (~60% of all global central bank holdings are held in US dollars), has witnessed competition emerging from other viable alternatives led by the Euro (see Chart 6).

¹¹ The Currency Composition of Official Foreign Exchange Reserves (COFER) data is collected and maintained by IMF. COFER data are reported on a voluntary basis. At present, there are 140 reporters, consisting of member countries of the IMF, non-member countries/economies, and other foreign exchange reserves holding entities. The major holding currencies identified in COFER include USD, Euro, GBP, Yen and Swiss Francs. The composition of about 56% of the world’s central banks’ foreign exchange reserves is included in the COFER data (as of 2009). The remaining foreign exchanges reserves are reported to IMF, but its composition is not available.

Chart 6: Currency Share in Global Forex Reserves and CAGR in Reserve Currency (2000-09) Allocation (%)



Source: IMF, COFER Statistics

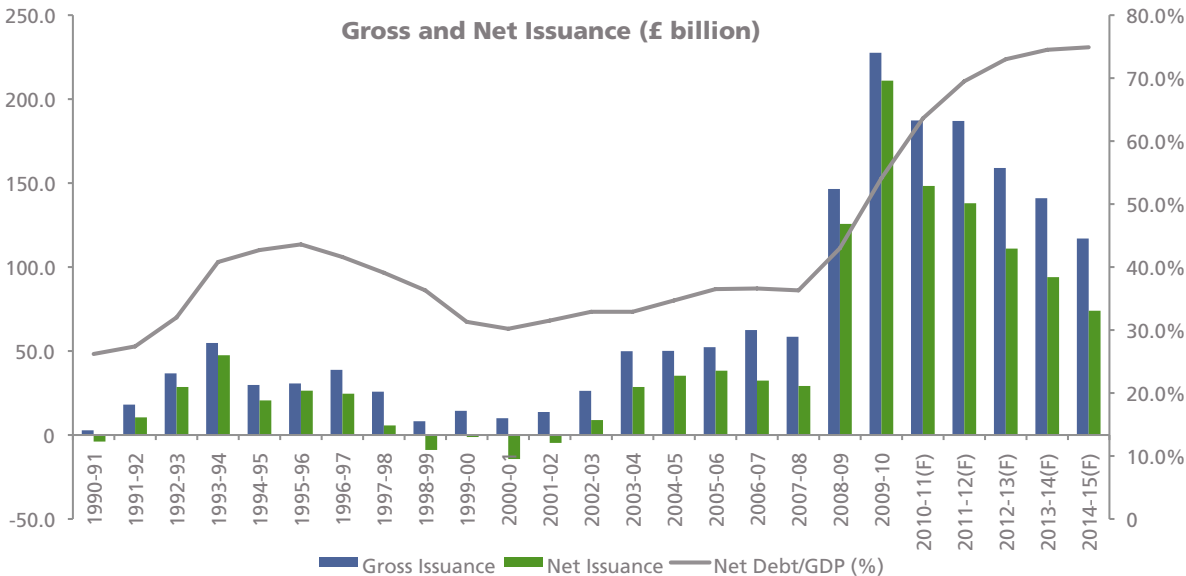
The financial crisis, which severely impacted the Eurozone, has further led central banks to evaluate alternative options such as the GBP, AUD, the Canadian Dollar (CAD), and even Gold. According to the IMF, central banks around the world keep about 60% of their reserve holdings in USD, 31% in Euros, 5% in GBP and the rest in other currencies, including the JPY, Swiss Franc, CAD, and AUD.

However, the markets in the AUD and CAD lack depth and liquidity. Also, slower than expected growth in the major European economies like Germany and Italy, default concerns on major economies such as Portugal, Ireland, Italy, Greece and Spain (PIIGS), raises key questions on the Eurozone's economic outlook and hence on the Euro. We believe these considerations may help the GBP emerge as a potential alternative currency for central banks.

We also recognise that valid counter arguments against an upward move in GBP exist, including the eventual failure of our new coalition government. Some strategists argue that this would lead to political uncertainty because a weak government will find it difficult to push important reforms and resolutions, especially with regards to curtailing

the UK fiscal deficit and rising levels of national debt as a percentage of GDP (see Chart 7). Such a scenario could also lead to the rating agencies potentially cutting the UK Sovereign Debt rating, which may have a negative impact on GBP. That said and in light of the evidence presented in this investor note, our view is that the market has already priced in the bearish sentiment and we believe this presents a strong buying (or switching) opportunity going forward.

Chart 7: Gross and Net Issuance (£ Billion)



Source link: <http://www.dmo.gov.uk/ceLogon.aspx?page=about&rptCode=D5B>

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