The sterling play [1]

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The front page of Saturday?s Financial Times featured some prominent hedge funds making lots of money betting against sterling. This fits nicely with Britons? ingrained pessimism and wailing over its economic condition. Look a bit closer, though, and it?s possible the next UK government just may escape a sterling crisis.

Start with those hedge funds mentioned in the FT. They all claim to have made money from sterling?s decline so far but no self-respecting hedge fund is going to declare its current trading book, suggesting they have moved on. This ties in with the pro?s view that, if a market play is on the front page, it?s too late to get in. J.P. Morgan turned bearish after getting stock tips from his shoeshine boy.

The really big money in pension funds, investment trusts and the like have only three realistic destinations for the bulk of their monies because of regulation, prudence and liquidity ? sterling, the eurozone or the US dollar. A small chunk of money may speculate in Asia and other emerging markets but only a foolhardy pension fund strays too far into these murky waters.

The pound at around $1.50 to the dollar is now where it should be on a purchasing power basis, after so many years being overvalued at nearer $2 - at much cost to manufacturing exports. Against the euro at €1.11, sterling is undervalued by about 25% on a purchasing power basis as is the dollar but, apart from British sun seekers in the Costas, that?s really Europe?s problem.

As for the bond market, 10-year bonds in the UK now fetch about 4%, a tad more than US Treasurys, some 50 basis points more than French bonds and some 75 basis points more than German bonds. Those spreads aren?t wildly out of line with historic norms.

Since the financial storm broke in 2008, the dire state of Britain?s finances has been thoroughly criticised, scrutinised, analysed and politicised. Remarkably, all three main political parties are now in almost total agreement about the next Parliament?s mission ? dramatically reduce the government?s budget deficit. They may differ on the pace and method but their professed destination is the same.

That?s not the case elsewhere. The US hasn?t even started down this road. In fact, just the opposite as a whole new tier of spending gets added following the passage of Obamacare. That battle suggests a working consensus on deficit reduction is far, far, away.

Meanwhile, the eurozone has its own demons. The recent agreement to bail out Greece is still unclear as to who will cough up the required cash and how much. And waiting in the wings is Spain, Portugal and Italy.

Against this background, the new British government just may turn sterling into the markets? favourite if it demonstrates credibility and resolve from day one. Time to place your bets!

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