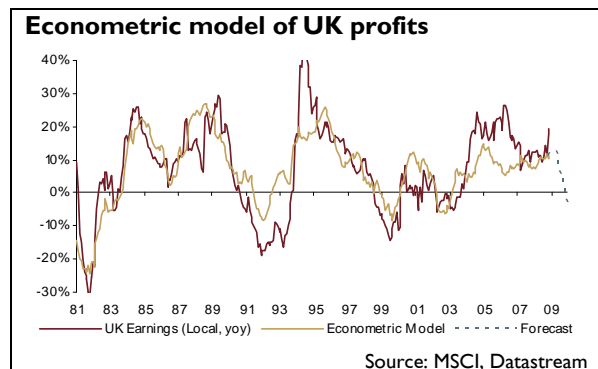


Sterling weakness – who stands to benefit?

At the end of December, the UK equity market was trading on a price-earnings (PE) multiple of 6.9, down from 12.3 a year ago, according to MSCI. That's its lowest level since 1981. Obviously, a large part of this drop was due to the 31% price fall of the stock market. Yet, in sterling terms, trailing earnings actually rose in 2008. Looking forward to 2009, we aren't forecasting a rise in UK companies' profits, but they could remain unexpectedly resilient.

Those rising earnings may come as a surprise, given the recession currently affecting the UK and other developed markets as well as the significant slowdown in activity across the rest of the world. In such conditions, we would normally expect companies' sales to plummet, with their profits coming under pressure as a result. One reason for the resilience in UK profits last year was the weakness of sterling, which gave support to British companies in two ways. First, it increased their competitiveness abroad. After all, the pound depreciated by 25% on a trade-weighted basis last year, so British exports are now de facto 25% cheaper than a year ago. This is known as the transactional effect. Secondly, UK companies which received an order in dollars, say, a year ago may have just delivered the goods and received payment in a currency that has since then risen 28% against sterling, giving their profits an extra boost. This is known as the translational effect.

Using monthly data from 1981, we have regressed the UK and global OECD leading indicators (as proxies for domestic and international activity) as well as trade-weighted sterling to see if they can explain the annual change in UK trailing earnings. This model (see the graph in the next column) shows a very decent fit, with all three variables offering a statistically significant 12-month lead.



Encouragingly, the sensitivities of the variables are also consistent with economic theory: the two activity indicators are positively correlated, while the sterling indicator had a negative correlation. That confirms our view that UK profits are benefiting from the decline in sterling. Analysing the three factors' individual contributions to the overall model also sheds light on the recent relative resilience of UK profits. The two activity indicators are negative for profits, but they are cancelled out by the collapse of the pound. Looking ahead to 2009, sterling weakness will continue to act as a cushion for companies' profits. However, it will not be enough to avoid an outright drop.

So where does that leave us in terms of investment opportunities? It would argue that the UK equity market will continue to outperform the rest of the world in local terms – as indeed it has by 13% since mid-October – which is consistent with our current recommendation. However, to benefit from this opportunity, you need either to have sterling as your base currency or to be able to hedge the currency exposure. Otherwise, the relative strong performance of the UK market may be cancelled out by any adverse move (i.e., a weakening) of sterling.

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