

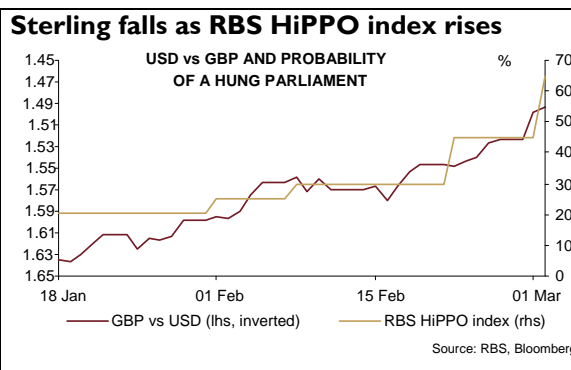
Sterling hangs in the balance

Sterling has taken a beating against the backdrop of economic weakness and the potential for a 'hung parliament' after the UK general election, due by June at the latest. RBS' HiPPO indicator, which measures this risk, suggests an almost two-thirds probability of a hung parliament. This is significant, because it has not occurred following a general election since 1974. The history of that period, with political deadlock and spiralling inflation leading to a sterling crisis, is not a happy comparison. However, while sterling is likely to remain under pressure, the recent drop is modest compared to the one-third drop from over \$2 in July 2008 to \$1.38 last March. Nor are UK debt markets showing any alarm. A temporary relief rally is even a distinct possibility, although the main support for sterling is that other major currencies share some of the same issues.

In the event that no party wins a majority of seats in Parliament, the likely outcome is that the biggest party (Conservatives or Labour) would form a minority government or coalition. Although the uncertainty will not sit well with investors, Sweden in the early 1990s does provide a precedent for successful fiscal consolidation in the context of a minority government. Even if the Conservatives had more seats, Prime Minister Gordon Brown would have the first shot at forming a minority government. But that would be dependant on his being able to fight off a vote of no confidence or form a coalition with the Liberal Democrats.

This political uncertainty comes at a time when the economy is still in poor shape. While growth returned in the last quarter of 2009, it was heavily dependent on fiscal and monetary stimulus. Our forecast for modest growth in 2010 remains reliant on government support and very vulnerable to any further shocks.

The necessity of government support is unfortunate as the UK is struggling with a huge structural budget deficit and the national debt is rising exponentially.



Sterling is acting as the lightning conductor for investor worries, but UK debt markets are showing little concern over these issues. This reflects the limited risk of a default on sterling liabilities by the UK government, given it can simply print more money. By comparison, Greece is unable to print euros in order to pay off its euro-denominated debt. Still, a renewed flood of British pounds would increase the risks of currency depreciation and inflation, especially through higher prices for imports.

Finally, sterling's recent swoon also appears to have been driven by a one-off factor – large sales of sterling linked to the \$25 bn cash element of Prudential's acquisition of AIA. However, Kraft's \$19 bn cash purchase of Cadbury in January failed to give sterling a comparable boost. This suggests underlying sterling weakness - plenty of ready sellers and only nervous buyers.

Gold's recent gain to a new sterling high at £750 shows the level of concern. But until other UK assets display signs of panic, sterling weakness does not yet constitute a crisis.

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