

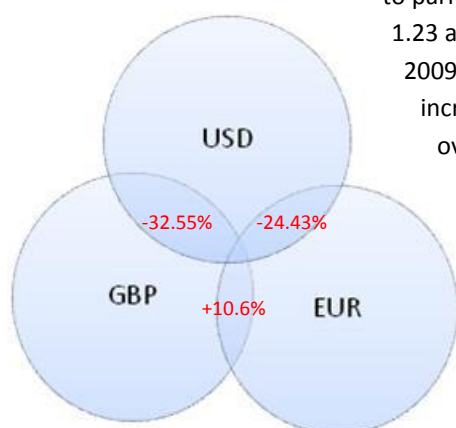
## Market Insight

### £1 = €1 = \$1 - Possible or probable?

The title of the article refers to the possibility of the Euro, US Dollar and British Pound being equal in value at some stage in the near future. By looking at what has happened over the past year the question is at least more reasonable to ask than it was in 2007 when GBP/USD was trading around \$2, EUR/GBP between £0.66-0.76 and EUR/USD between \$1.28-1.50.

Over the past 12 months, we have quite possibly seen the most difficult trading conditions in living memory. Volatility has been elevated across most asset classes and sentiment towards risk has fluctuated enormously as traders struggled to digest unpredictably changing news flow. Traditionally strong currencies such as Sterling, Euro and US Dollar have all suffered negative impacts; whether it be quantitative easing policies, narrowing yield differentials or localised macroeconomic setbacks resulting from the financial crisis – these themes as well as others have contributed to creating selling pressure but with varying magnitudes.

For this tri-parity condition to occur EUR/GBP would need to appreciate by 10.6%, GBP/USD to fall by 32.55% and EUR/USD by 24.43% from current levels. The Euro has already traded close



to parity with Sterling at the end of 2008 and was as low as 1.23 against the US Dollar in November 2008 and March 2009. Future prospects for the Euro are looking increasingly bleak despite the recent surge in confidence over a broad-based recovery worldwide. Potential loan defaults in Eastern Europe, huge amounts of distressed assets on European balance sheets (our research suggests EU banks have combined exposure of approximately €500bn still to surface into view of nervous investors) and a looming QE policy that is likely to include asset purchases, extensions of loan deadlines and persistently low interest rates; all these factors are EUR negative

although the Euro may find support if the financial crisis ebbs away in the shadow of an economic recovery. These reasons alone make an argument for EUR/USD parity in the near future.

The future of EUR/USD from the US side adds weight to this argument. The US Dollar is likely to reach a tipping point at some stage whereby continued weakness induced by rising risk appetite transforms into strength alongside a rise in aggregate demand. It is surely unimaginable for the Dollar to be permanently pigeon holed as a risk barometer, leading to spikes in USD each time US fundamentals are threatened. Eventually, bullish developments in equity and commodity markets which are likely to be linked to a broader resurgence in aggregate demand will begin to have a supportive effect on the Dollar leading to a return to normality for USD dynamics.

In terms of GBP/USD, for our question to have a definite 'Yes' answer, GBP must weaken during a time of economic recovery. This may occur because as the UK economy recovers, large amounts of debt being accrued by UK authorities over the next few years (*refer to FX Weekly*



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27<sup>th</sup> April 09) could put a drag on Sterling leading to capital outflows into more sturdy fiscal environments that not only have lower debt burdens but also higher yields. Banking sector influence on UK GDP has been a prime factor for GBP strength over the past decade so it is quite possible for a revised banking system to drive diversification of capital away from the UK, not to mention the fact that the financial sector is likely to be less profitable and unable to provide as much of a boost to the UK economy as in the past. The rationale here is that banks and other financial services firms will be returning to traditional banking practices with profit expanding exotic derivatives squarely out of the picture – at least until the queue of banker-bashers has had time to recede. The banking environment is unlikely to reap such great rewards for the UK anytime soon with Sterling being a potential indirect casualty. Another important factor is the Bank of England already implementing the strongest form of asset purchases (QE policy) in the world today. Our estimates suggest the UK balance sheet will be pushed up to 23% of GDP with monetary base growth rising to 205%. Comparative policies elsewhere are arguably more sustainable which could mean Sterling weakens as investors beware of its debasement.

Economic conditions are becoming equal as policy initiatives across many different countries begin to look increasingly similar making currency values harder to contrast and differentiate. It is clear that all currencies have been affected by the economic crisis and in turn, most nations are reacting with similar policies. Intuitively, it makes some sense that a certain amount of equalisation must take place as investor sentiment fails to choose a clearly dominant currency out of the three. Over the longer term fluctuating capital flows and economic fundamentals within the UK, EU and US are certain to create divergences but similarly, it is possible for all three to equalise before further protracted moves occur.

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