UNITED KINGDOM- GETTING POUNDED

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"But how could we know when I was young
All the changes that were to come?...
The streets were now deserted
The gangs had trudged off home
The lights clicked out in the bedsits
Old England was all alone." The Clash song, "Something About England"

CONCLUSION

As the fifth largest economy in the world and as a major center of international finance, the United Kingdom is not alone. It remains entwined with the long-running worldwide economic crisis. Although challenges to the British economy intertwine with those confronting the Eurozone, they do not duplicate these. England's financial problems are not as severe as Greece's, but they are not minor; England's present situation and near term prospects do not look as strong as Germany's. The British Pound will continue to depreciate over the next few months. This decline parallels that of the Euro FX. Bearish trends in the Pound, like those in the Euro currency, portend or confirm weakness in worldwide equities and commodities.

THE UK'S LESS THAN STERLING SITUATION

Although the UK's 3Q11 GDP was up .5pc, the Bank of England's "Inflation Report" (November 2011) states: "The prospects for the UK economy have worsened" (p5). The Bank advises reading the 3Q11 rise in context. Abstracting from temporary factors, the first three quarters of 2011 growth was "sluggish". This partly reflected "falling household real incomes and the effects of the continuing fiscal consolidation." (p18). Moreover, the near term outlook remains rather gloomy. The UK Treasury's Office for Budget Responsibility's "Economic and fiscal outlook" ("OBR", November 2011, Table 1.1, p11) predicts mediocre GDP growth of .7 percent for 2012 (compare this with 2011's feeble .9pc). The "Inflation Report" proclaims: "output is likely to remain significantly below the level associated with a continuation of its pre-recession trend (see Chart 2, p7).

The OBR expects unemployment will edge higher, from around 8.3pc now to 8.7pc by end 2012. The OBR underlines the recent pressure on consumers given recent rather high inflation levels. Real disposable income probably fell about 2.3pc in 2011, a post World War Two record (p9).

The current British government's determined long run austerity plan contrasts with that of many other nations. However, the UK's overall fiscal situation nevertheless appears rather grim for the next few years. Like the United States, the UK has been a big borrower during the international economic crisis.

Scan the OBR's statistics on the UK's public sector net borrowing as a percentage of GDP. In 2009/10, it was a sky-high 11.2 percent, with that in 2010/11 a lofty 9.3pc. For 2011/12, it dips only modestly to 8.4pc. There's always hope for the long run, right? The OBR is somewhat sunnier regarding future GDP; the OBR estimates 2013 growth of 2.1pc, with that of 2014 at 2.4pc. Despite this modest optimism for 2013 and 2014, and although budget deficits narrow for the next couple of years, a notable financing gap persists. Net borrowing as a percent of GDP in

2012/13 is 7.6pc, that for 2013/14 an elevated 6.0pc. Look through the OBR's spyglass on public sector net debt as a percentage of GDP. In 2009/10 it was 52.9pc, with 2010/11 at 60.5pc. For 2011/12, it rises to 67.5pc, floating even higher to 73.3pc in 2012/13 and 76.6pc in 2013/14 (Table 1.2, p13).

Glance at the substantial UK household indebtedness situation via the Bank of England's "Financial Stability Report" ("FSR", December 2011, Chart 2.29, p31). Household indebtedness rose steadily from around calendar 2000. Though one must estimate levels via the chart, British household debt in 2008 peaked at about 170 percent of the four quarter average of household disposable income. The long run UK household debt relative to income trend is above that of the United States. For 2008, note America's roughly 140pc as well as the Euro area's 90pc. This debt measure has fallen from the ceiling in Britain, but it remains very elevated. It is now about 150pc. It likewise declined in the US, to about 120pc. However, it has floated higher in the euro area, to about 100pc.

In its latest meeting, the Bank of England maintained Bank Rate at the low level of .5pc. The Bank of England's battle to keep policy and overall interest rates low to create and sustain economic health resembles that of the Federal Reserve. However, Britain's current inflation levels exceed those of America and the Eurozone. Its CPI inflation (12 month) in November 2011 was 4.8pc, well over the Bank of England's two percent target. According to the Bank of England's "Minutes of the Monetary Policy Committee Meeting" (12/7-8/11), there has been little sign that above target CPI inflation has prompted rapid wage growth.

Will the UK's relatively high inflation tumble lower? The Bank of England claims it likely will fall back sharply, pointing out the temporary influence of higher energy and import prices and the increase in standard rate VAT.

The Bank of England, like the Federal Reserve, loves money printing. This sustained policy may help to buy time for a recovery, yet it suggests fears regarding the strength of the economy. The Bank commenced its quantitative easing asset purchase program in January 2009. In October 2011, it raised it to L(Sterling) 275 billion from L200bb. Will the Eurozone eventually find a way to embark on its own money printing festival?

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Are the UK's substantial budget deficits and rather high inflation the most fearsome challenges facing Britain? They certainly are not the only ones. The "Financial Stability Report" declares that "Sovereign and banking risks emanating from the euro area remain the most significant and immediate threat to UK financial stability" (p5). "The crisis in the Euro area is one of solvency and not liquidity, according to the Bank of England's Governor. And the interconnectedness of major banks means that banking systems, and hence economies, around the world are all affected." ("Financial Stability Report Press Conference", Opening Remarks by the Governor, 12/11/11).

The Bank is "determined to ensure the resilience of the UK banking sector" (FSR Press Conference, p3). However, the FSR underlines: "UK banks have significant refinancing needs" (p5). In addition, "The Committee is concerned that current strains are being amplified by ongoing structural vulnerabilities in the financial system, particularly a high degree of intra-financial system exposures." (p6).

The International Monetary Fund's "Spillover Report" for the United Kingdom remarks: "The size and interconnectedness of the U.K. financial sector make it a powerful originator, transmitter, and potential dampener of global shocks" (2011 Article IV Consultation, 7/11/11; introduction). "The U.K. lies at the center of global finance, with U.K.-based banks playing a leading role in global financial intermediation" (Spillover Report, p5).

The financial sector is not a province or island separate from a so-called "real economy". In any event, the IMF believes that dangers flowing from UK domains other than finance are important but less scary. The IMF asserts: "the potential for systemic spillovers from the real economy is limited despite the economy's comparative openness to trade. This is not to deny that real spillovers to a number of close partner economies could be significant."

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In the recent European Union summit meeting, the UK opposed a proposed plan on fiscal discipline rules. It has refused to contribute funds to the IMF to deal with the Eurozone debt crisis, insisting that it will do so only as part of a wider international effort. Despite such policy disagreements with many other European nations, and although it is not a member of the Eurozone currency system, Britain is not independent of European (Eurozone)- or worldwide-economic problems.

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Keep in mind that the Pound Sterling retains a modest share in official foreign exchange reserves. The International Monetary Fund's Currency Composition of Official Foreign Exchange Reserves report ("COFER", 12/30/11) reports claims in British Pounds and other currencies. As a percentage of allocated reserves, Pound claims were 3.9pc in 3Q11. Compare the Euro's 25.7pc share and America's 61.7pc. In 4Q10, Sterling claims were 4.0pc; they were 4.7pc in 4Q07 during an early stage of the financial crisis.

HAMMERING THE POUND

In a world of competitive devaluations (currency wars), British Pound declines arguably have limits. The United Kingdom economic (financial) situation and outlook probably are not as bad as those of the worst European nations. Yet the UK's burdens such as mediocre GDP growth, substantial budget deficits (growing indebtedness), relatively high inflation, low interest rates, and noteworthy money printing weigh on the Pound.

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The Euro area currently is almost 16.4pc of the broad real trade-weighted dollar ("TWD"). It was 18.6pc in 2001. The Pound is a comparatively modest part of the TWD. The United Kingdom in 2012 (and 2011) is about 3.5 percent of the broad real TWD (compare 2001's 5.6pc). Currency trading generals nevertheless closely monitor the cross rate between the US Dollar and the British Pound.

The Pound arguably has been in a major bear pattern for some time. The crucial plateau during the worldwide financial crisis period was attained 11/9/07 around 2.116. Although marketplace history is not marketplace destiny, keep in mind the popular chant, "weak US dollar equals strong US stocks, strong US dollar equals weak US stocks". This British Pound top versus the dollar occurred about a month after the S+P 500's major high on 10/11/07 at 1576. Important resistance for Sterling is about 1.665 (see the 4/28/11 high, adjacent in time to the S+P 500 pinnacle at 1371 on 5/2/11 and the Euro FX's 1.494 5/4/11 summit versus the dollar). Also note around 1.700 (see the 8/5/09 level; compare the later timing of the Euro FX high at 11/25/09 at 1.514). The 10/28/11 top was about 1.615.

The Pound versus dollar cross rate settled around 1.543 at the end of last week, close to the 1.538 low of 10/6/11. The October 2011 level is beneath 1.563 (a fifty percent rally from the all-time low close on 2/26/85). The 1.500 level (about a ten percent drop from the 4/28/11 top) probably will be tested and broken. Though it is distant from today's price, the key bottom around 1.430 (see the 5/20/10 low) eventually will be neared and perhaps challenged. Noteworthy additional Pound support is around 1.350 to 1.380. The 1/23/09 intraday low was about 1.350, the 3/9/09 close about 1.376 (Euro FX final cross rate low versus the greenback was 3/4/09 at 1.246). Recall the major low in the S+P 500 on 3/6/09 at 667. A 20pc fall from 1.665 is 1.332.

The S+P 500 and British equities do not travel in exactly the same fashion. However, their trends often are similar. The British stock marketplace benchmark, the FTSE 100 , attained its 2011 summits around the time of those in the S+P 500. The FTSE's February 2011 peak at just over 6100 was grazed by the 5/3/11 high (and 7/8/11's around 6085). The Financial Stability Report (December 2011, p25) says that since its June 2011 Report, "The outlook for UK corporate profitability has weakened".

United Kingdom stock and debt marketplaces are substantial. Based on the International Monetary Fund's Global Financial Stability Report (September 2011, "Statistical Appendix", Table 1, p11), at end 2010, the UK represented 6.6 percent of global stock marketplace capitalization. UK debt securities (public and private) were about 5.0pc of the worldwide total.

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The Bank of England's Sterling broad effective exchange rate index ("ERI", monthly average; January 2005=100) probably is a better indicator of the Pound's strength than the Sterling/US dollar cross rate. In the "ERI", the Euro area is 47.3 percent (Germany 11.7pc, France 7.2pc, Netherlands 5.8pc, Ireland 5.0pc, Spain 4.5pc, and Italy 4.2pc). The United States is 16.4pc, China 7.1pc, and Japan 3.4pc. In December 2011, this broad effective exchange rate index was 80.3.

What are important resistance levels for this index? The current level is well under the January 1981 pinnacle about 108.0, as well as other peaks of the past decade. Note April 2000's 102.0, July 2004's 103.3, and the January 2007 105.1/July 2007 104.7 double top. The July 2007 height is noteworthy, for it was reached just as the worldwide financial crisis was emerging. A ten percent fall from the July 2007 high is about 94.2, a 20pc dive 83.8 (recall June 2009's minor top at 83.7, as well as the last minor high at 82.0 in August 2010). Around 89.0 is the level from which the index collapsed in September/October 2008 as the financial crisis accelerated.

What about key support? The current ERI level is very near the important low of February 1985 at 79.4 (remember the bottom in February 1985 in the Pound versus dollar; also see October 1986's 79.3 index low). This 1985 (and 1986) index support, tested and slightly breached at times in recent months, probably will be decisively broken.

Recall the February 1993 low around 74.5 and the December 1995 trough at 75.4. Also remember the index lows of 76.8 January 2009/76.9 March 2009 (compare the timing of the S+P 500 bottom) and 77.0 in March 2010. The lower part of the 74.5 to 77.0 range probably will be challenged. Two thirds of the January 1981 top is 72.0. A 33pc collapse from the July 2007 height gives 69.8.