In this month’s issue:

• £, €, $ forecasts for the year ahead
• Fiscal cliff averted, so what next for the $?
• Will the UK economy need further help?
• How to measure your currency costs
Dear Reader,

Happy New Year and welcome to the first edition of Outlook for 2013.

We’re only a week into the New Year, but already there is plenty happening in the world that is causing movement in the currency markets. The big news, of course, is the bill passed by the US Senate to prevent the majority of tax rises and spending cuts that could have taken the world’s economic powerhouse over the “fiscal cliff” and back into recession. Given how important the US economy is to the health of the world’s economy this would have been fairly disastrous.

Back in the UK, some encouraging economic data was released around the turn of the year, raising hopes we might just be able to keep ourselves from falling back into recession. The other big question is how long the Bank of England (BoE) can delay any further quantitative easing – the consequences of which would more than likely devalue Sterling.

In Europe, economic data continued to disappoint with the Euro zone seemingly slipping into a triple-dip recession. Business confidence has been badly damaged, not just in Europe but throughout the world, by the delays in sorting out the debt problems in Greece, Spain and other southern states. Even the mighty German economy is stuttering.

So a busy start to the year, and in the individual currency sections that follow, we go into more detail about what will affect the three currencies’ strength, both relative to each other and other currencies around the world, in the coming weeks and months.

In Smart’s January Feature, we also look in detail at what has happened in the last year - and how much of this could have cost your business in 2012, and what could happen in 2013 - and the possible cost implications if you don’t manage your currency risk properly.

In the coming months we will also issue detailed notes on the Chinese Renminbi and Russian Rouble, two currencies we are now able to exchange and transfer. If you would like a copy of these notes please let me know.

Enjoy this month’s Outlook, and we wish you every success for 2013.

Carl Hasty
Director, Smart Currency Business

Key economic data releases in January 2013

<table>
<thead>
<tr>
<th>Date</th>
<th>Country</th>
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<tr>
<td>January 9</td>
<td>Europe</td>
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<td>Bank of England MPC Announcement</td>
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Sterling

Sterling ended 2012 with annual gains against both the euro and the dollar. The New Year delivered positive news, when British manufacturing activity recorded an unexpected jump in December, growing at its fastest pace since September 2011. This compared favourably to the poor manufacturing data that came out of Europe. The UK economy is still forecast to shrink 0.1 per cent for Q4 2012, although this latest piece of data could help avert a feared triple-dip recession.
A slow path of recovery is the best the UK economy can hope for in 2013, with its performance remaining dependent on stabilisation in the Euro zone. The next Bank of England (BoE) MPC Announcement is on 10th January and will give some indication of how soon its next raft of quantitative easing (QE) could come and what might be done during 2013 to bring down inflation, which had been predicted to fall last year but is proving more resilient than expected. Further better-than-expected data in January will steer the BoE to hold back from extending its QE programme, which has been suggested could happen in February. An immediate consequence of further QE would be the weakening of Sterling.

Looking ahead to July, there is expectation Mervyn King’s successor as BoE Governor, Mark Carney, will bring some uplift to the UK economy, perhaps strengthening Sterling in the short term, compared to King’s preference to devalue Sterling to aid British exports.

While the UK’s economic outlook remains weak compared to the USA, Sterling starts 2013 stronger against the dollar than it has been since September 2011. This is thanks to a resolution to the USA’s fiscal cliff causing relief in global markets and reducing demand for the dollar’s safe haven status.

Sterling ended 2012 hovering around an eight-month low against the euro. Any gains against the single currency will be dependent on how the Euro zone debt crisis progresses during 2013 and it also has to be remembered that the UK economy continues to be fragile, and its struggle to control its debts mean Sterling’s safe haven status is weaker than it was for much of last year. At the time of writing (4th January 2013), mid market rates were £1/€1.234 and £1/$1.605.

Smart’s January Feature

Smart’s analysis of currency costs

“The debt crisis is far from over in Europe” – the key phrase in Chancellor Merkel’s New Year speech to the German people. Human nature is such that we often try and bury our problems and hope they will disappear. Sadly, this won’t be the case with the Euro zone debt crisis. It also won’t be the case with the UK and US debt problems, which are still very significant. And politicians are masters of prevarication and will do anything to move the problem into the future rather than address it head on and possibly lose favour and votes with their electorate. So it would seem that 2013 is likely to have as many uncertainties as 2012 when it comes to forecasting exchange rates.

These uncertainties in 2012 saw Sterling gain eight cents against the euro in the first half of the year, moving from £1/€1.20 to £1.283 and then give back most of these gains in the second half, hitting a low of €1.216 just after Christmas. So what would have been your “currency cost” if you had to buy €1 million in the second half of 2012?

If you had bought at the peak using a forward contract in July then your cost would have been just under £780,000. If you had bought on a month by month basis your average cost would have been around £805,000, a currency cost of over £25,000, and if you had bought at the worst second half rate, your currency cost would have been over £40,000.

US dollar movement has been even more dramatic, moving twice between £1/$1.53 and $1.63 in the course of the year. This means that the currency cost for either buying or selling £1 million of US dollars could have been over £50,000 during the course of the year.

And what of 2013? The forecasts from the banks seem to confirm our view that the coming year is likely to be as volatile as the year just ended. The level of bank forecasts show extremes of £1/$1.56 to $1.78. This means that the currency cost for £1 million of US dollars could be in excess of £100,000 if both extremes were met.

It is important not to assume that we won’t see the same range of movement for the euro as we did last year, as the Euro zone debt crisis will rumble on. If you would like to review your currency risks in detail, please feel free to contact us and we will be more than happy to help.
Eurozone

Summary

The euro reversed the downward trend it suffered during the first half of 2012 to end the year hovering around an eight-month high against Sterling. This was thanks to a combination of factors: European Central Bank (ECB) chief Mario Draghi announcing first a commitment to the survival of the euro and then the ECB’s readiness to buy unlimited short term bonds to curb borrowing costs for Euro zone states, Spanish and Italian yields dropping from dangerous highs and Greece receiving bail-out aid.

However, this bounce back was a crisis ease and the euro enters 2013 still at the mercy of a Euro zone in the grip of austerity measures and suffering from a recession, as well as pockets of lingering sovereign debt uncertainties and severe unemployment. In a New Year’s Eve statement, German Chancellor Angela Merkel cautioned that the economic environment will be more difficult in 2013 than 2012, but added that while Europe’s sovereign debt crisis is far from over, progress has been made.

Current uncertainty – and concern – remains over Spain and whether it will bite the bullet and opt for a bail-out. The next ECB Announcement is 10th January, when we’ll get an indication of the central bank’s plans for 2013, including whether its benchmark interest rate will remain at 0.75 per cent, having been at the record low since July 2012. At the time of writing (4th January 2013), mid market rates were €1/£0.810 and €1/$1.301.

Spain – crunch time

With a quarter of its 2013 budget to go just on servicing debt, it can only be a matter of time before Spain’s government seeks a bailout from a Euro zone partner. Whether it works out or not could determine the future of the Euro zone in its current form. In 2012, Rajoy’s government did its best to comply with some of the ECB’s recommended austerity measures - raising taxes, and slashing spending on health, education and social services. More is needed, however, and the test is whether Spain could survive.

Elections in Germany and Italy

Germany’s role of paymaster to the Euro zone has made Chancellor Merkel pivotal to the resolution of the debt crisis plaguing fellow member states. There is a general election in Germany in September, and victory for Merkel is not a given – a change at the top there could have implications for the euro. While Mrs Merkel’s conservative party holds a 10-point lead in opinion polls over the Social Democrats (SPD), the SPD and their Greens allies have a chance of taking power because Merkel’s coalition allies, the Free Democrats (FDP), have slumped badly and may not win seats.

Before Germany goes to the polls though, the result of the general election in Italy scheduled for the end of February could cause the euro to wobble. Much will depend on how committed the new Italian government is to implementing reforms introduced in the Euro zone’s second most indebted country over the last 12 months.

Eurozone forecasts

Market views seem to be split as to whether or not Sterling will be able to regain ground against the euro in the coming months, but there does seem to be a consensus that the upside for the euro against Sterling is limited given the Euro zone debt crisis and the economic turmoil that has resulted. Given the possibility that these problems will not go away any time soon, our expectations are for the high of 2012 to be tested again in the first half of 2013.
GBP/EUR expectations for 2013

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Source: FX Week

EUR/USD expectations for 2013

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Source: FX Week
United States

Summary
New Year saw US lawmakers pass a bill to avoid the “fiscal cliff” of tax rises and spending cuts, and so preventing a possible return to recession for the USA. The immediate result of the new tax deal struck in Washington was a weakening of the dollar against most currencies, as concerns over the future of the US and global economies were quelled, safe-haven demand for the dollar fell and risk appetite returned. There is still political tension over the USA’s budget and debt ceiling, which is likely to be tackled in February, and with problems in the Euro zone already beginning to steal the headlines, the dollar is regaining value. At the time of writing (4th January 2013), mid market rates were $1/£0.623 and $1/€0.769.

What next after “Twist”
Following their meeting in December, the FOMC have set themselves up for a continuation of their highly accommodative fiscal stance during 2013. The Fed is expected to continue with its open-ended quantitative easing (QE), at least during the first half of the year, expecting very gradual improvements in the labour market. However, the size of the “accommodation” is flexible and subject to change. Building on earlier meetings, the FOMC plans to continue its commitment to QE3, purchasing $40 billion per month in mortgage-backed securities. The FOMC has also voted to purchase additional long-term Treasury securities beginning this month, after its asset purchasing scheme Operation Twist officially ended on 31st December 2012.

Positive indicators
With the fiscal cliff for the main part avoided, the next FOMC Meeting on 30th January should be a cautiously optimistic one. The US unemployment rate is trending lower and payrolls growth continues at a steady, if modest, pace. Data out last week showed US manufacturing ended 2012 on an upswing, with factories recording growth in December after contracting the previous month – and this was despite fears about the looming fiscal cliff and some severe weather conditions to contend with during December. Overall, the US domestic fiscal situation is clearer than it was a month ago, although there is still the debt ceiling to be resolved, and the dollar is on course to remaining the world’s safest currency in 2013.
United States forecasts

The bank forecasts show extremes of £1/$1.78 and $1.56. Given the list of unknowns that could affect the exchange rate in 2013, this doesn't seem unreasonable. Our expectations are based on risk appetite continuing to be restrained, as the Western world works through its economic and debt problems, and US employment doesn’t rebound as quickly as hoped, meaning the Federal Reserve continues its policy of quantitative easing for most of 2013.

GBP/USD expectations for 2013

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Source: FX Week
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