In this month's issue:

• Trouble in Cyprus – a blip or terminal blow for the Eurozone?
• Dollar gets ‘safer’, as Europe wobbles and US keeps growing
• SPECIAL FEATURE: what the Budget means for SMEs
Dear Reader,

Welcome to the April 2013 edition of Outlook.

You won’t need reminding how uncertain things have been in the Eurozone recently, caused by the banking crisis in Cyprus, and that here in the UK, we’ve had the Spring Budget.

The highly fragile situation in Cyprus – and threat of “Cypri-out” – demonstrates just how exposed currency markets, and in particular the £/€ rate, remain to the political and fiscal policy of the European Central Bank (ECB) and key decision makers within the Eurozone. So this month, we look closely at what’s next for the euro, as the banking fiasco in Cyprus begins to settle and markets react to what it could mean to other bailout nations answerable to the ECB.

Osborne’s Budget indicated a continuation of austerity measures and the likelihood of the Bank of England (BoE) maintaining low interest rates and leaving open the option for further quantitative easing – conditions that are conducive to a weaker Sterling. Speculation is beginning to mount as to the effect the new BoE Governor, Mark Carney, will have on UK fiscal policy – and the knock-on effects on Sterling. Good news from the Budget for businesses included the cutting of corporation tax to 20 per cent and reduction in the amount of national insurance paid by employers – I talk more about this in this edition’s special feature.

In the US the expected consequence of the Cyprus situation has been a strengthening of the dollar’s safe haven status. Meanwhile, Chairman of the Federal Reserve Ben Bernanke recently justified the ongoing soft fiscal policy of the US and other key economies, at the same time denying there was a currency war in the making. With so much going on, don’t hesitate to contact us for guidance on forming a strategy that will minimise your exposure to today’s highly volatile currency markets.

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

Carl Hasty
Director, Smart Currency Business

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**Key economic data releases in April 2013**

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<tr>
<th>Date</th>
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<th>Key event/data release</th>
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**Sterling**

The crisis in Cyprus – and concerns about the effect it could have on the Eurozone – brought an end to Sterling’s ongoing depreciation against the euro towards the end of March. The knee-jerk reaction to the prospect of Cyprus leaving the euro increased – if momentarily - Sterling’s safe haven status, as euro investments and cash were transferred back to the UK. By 27th March, Sterling had jumped to its strongest level in six weeks against the euro, cutting its decline this quarter to four per cent.

Where next though? Ultimately, Sterling’s performance in the long-term remains as much at the mercy of the UK’s domestic economy as sporadic political sagas unfolding in the Eurozone - hence the significance of March’s Budget. George Osborne’s confirmation that the Bank of England is leaving its asset purchase programme and policy framework, which is geared towards austerity and includes a medium-term inflation target of 2.0 per cent, largely unchanged should continue to keep Sterling’s value suppressed against the euro and dollar. As the situation in Cyprus settles, the expectations are for Sterling will change.

Elsewhere, concern comes from credit rating agency Fitch’s recent placing of the UK on “negative” watch, driven by uncertainty around the UK’s potential output, longer-term trend rate of growth and the implications for public finances. This, of course, mirrors Moody’s credit downgrade in February.
As a SME business ourselves, our reaction to the Budget was largely positive, avoiding any political banana skins and with the extension of a number of existing measures to stimulate small business growth and the introduction of several new measures aimed at supporting employment through SME businesses.

Indeed, international markets reacted favourably to the Budget too, particularly the expanded remit of the Bank of England to take a broader view of the economy than merely inflation, while credit ratings agencies said the Budget would likely keep the UK on a stable outlook. Sterling surged to three-week highs as a result, halting its steady declines that had become entrenched since the beginning of the year.

On behalf of the more than 1,500 SME clients we work with, I can say that the announcement of another staged reduction in the corporate tax rate, which will take the eventual rate to 20 per cent, will be greatly beneficial for small businesses, increasing the amount of their profits which can be reinvested into funding expansion plans. Similarly, the cut in the amount of National Insurance contributions for employers will help support businesses, particularly micro-businesses and start-ups as this can be one of the barriers to expansion.

As an international payments specialist, Smart Currency deals daily with businesses seeking to operate abroad, and so we were pleased to learn of the growth vouchers for small businesses seeking advice on how to expand, and the exemption of certain industries from the green energy levy.

Other tax relief measures, such as Capital Gains Tax relief on employee share schemes and exempting businesses from paying tax on season tickets for staff transport loans, are innovative measures that will enable businesses to support and retain staff without adding to their cost burden, while the abolition of stamp duty on shares traded in growth markets is an encouraging means for medium sized firms to fund their expansion plans.

Furthermore, the rise in the tax threshold for individuals to £10,000 from 2014 should help support small business operators by boosting demand for their products and services in the marketplace.

It is also encouraging to note that the majority of renewed Government spending cuts will actually come from efficiencies and under-spending by Government departments, rather than an attack on funding for frontline services and business support measures.

The only real negative from this Budget, however, is that given the slowing economy even in the three months since the Autumn Statement in December, it was disappointing – although not altogether unexpected – that small businesses in the UK will not benefit from these measures straight away.

Corporate taxes will be cut this month as we enter the new financial year, however the full cuts – and those available under the Employment Allowance on National Insurance contributions, will not be delivered for another two years, by which time, the economy is forecast to have struggled its way to higher growth. We have stated previously that SMEs are struggling now, and these measures, while welcomed, would have a much more positive impact on the British economy if they were introduced more quickly.

Overall though, it is encouraging to see the Government has taken stock of the UK’s economic woes and introduced a number of innovative and important measures to stimulate activity and employment among SMEs, and we will continue to work with SMEs operating internationally to ensure they can take full advantage of the opportunities available to them.

The final revision for UK GDP in Q4 2012 confirmed a contraction. And with growth in the first quarter of 2013 expected to be flat, not helped by the dire weather conditions, the chances of the UK avoiding a triple-dip recession are “50:50”, according to the Bank of England. On top of that, the UK’s GDP forecast for 2013 has been halved to 0.6 per cent. That said, there are flashes of encouraging data: retail sales in February bounced back from a dismal January and unexpectedly recorded the biggest increase in almost a year – the result causing a 3-week high against the dollar for Sterling. Preliminary estimates for GDP in the first quarter of 2013 are published on 25th April – and will be closely watched. Expect currency movement around this date.

Meanwhile, speculation about what devices the new Governor of the Bank of England, Canadian Mark Carney, might employ to kick-start economic growth in the UK when he begins his post in July are mounting. Further quantitative easing, negative interest rates for banks and pitching interest rates for set periods of time have been suggested, each of which would have implications for Sterling. For now, though, we can only speculate.

At the time of writing (27 March, 2013), mid market rates were £1/€1.185 and £1/$1.515.
Eurozone

Summary

First the threat of “Grexit”, now “Cypri-out”… The initial devaluing effect on the euro of the proposed Cypriot bailout terms, announced on 16th March, was hardly surprising, with the crisis being the latest episode in the ongoing Eurozone debt drama. With Cyprus accounting for just 0.3 per cent of the Eurozone’s GDP, it was the prospect of contagion that first worried wider markets - doomsayers warned of a run on banks in other European countries, driven by fear of banks imposing similar levies to those proposed in Cyprus.

That said, Ewald Nowotny of the European Central Bank (ECB) stressed that there was “absolutely no reason to fear contagion” and made the distinction that Cyprus’s banking system accounts for an above-average share of national output compared to other Eurozone nations, has a proportionally higher number of foreign investors, notably Russians, and the alternative to introducing the levies was far worse. When Cyprus refused the bailout terms and struggled to find some kind of compromise, it was then the prospect of Cyprus having to leave the Eurozone completely that worried markets. At the start of the week leading up to the crisis, the exchange rate was hovering around €1/£0.875 but during the height of the crisis, it had fallen to around €1/£0.85. Against the dollar, by the time a deal had been negotiated and a Cypriot default avoided, the euro had hit a four-month low and has continued to decline. At the time of writing (27 March, 2013), mid market rates were €1/£0.844 and €1/$1.279.

What next for Cyprus and the Eurozone?

Cyprus striking a last-minute bailout deal with the Troika (EC, ECB and IMF), which includes the protection of all savings worth less than €100,000 and restructuring of some banks, helped stabilise the single currency. While it might have averted economic meltdown, the country’s economy remains extremely fragile and any form of recovery will be slow. The likelihood is that foreign investors in Cyprus will want to withdraw capital from the country as soon as possible.

The severe treatment of Cyprus by the Troika has been taken by some as a warning that forcing banks to restructure themselves, perhaps to the detriment of depositors, could be a template for other ailing Eurozone countries. There is fear that a deposit tax could trigger capital flight and deposit move out of peripheral Europe into German, British or American banks, as well as result in increased bank and sovereign-funding costs and broader financial market dislocation. In coming weeks, the euro’s performance will be influenced by the amount of capital outflow out of Italy and Spain in particular.

Meanwhile, prospects of the ECB easing monetary policy in coming months to support growth in the Eurozone are also expected to weigh on the euro. The situation isn’t helped by uncertainty over the formation of an Italian government. The next ECB Announcement on 4th April will be especially pivotal and expect some more currency movement around then. Overall, the single currency remains highly volatile.

Eurozone forecasts

As can be seen from the bank forecasts there are very divergent views of where to next for the euro against sterling and the US dollar. The Cypriot bailout has rocked the Eurozone as it has highlighted that problems with government debts throughout the Eurozone are yet to be fully sorted and it has also changed the rules by which bailouts will be funded. Therefore any major upside for the euro in the short to medium term is difficult to see. However we should not underestimate how quickly problems in the UK could come to the fore to undermine sterling again.
GBP/EUR expectations for 2013

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Source: FX Week

EUR/USD expectations for 2013

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Source: FX Week

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United States

Summary

The Cypriot situation in the Eurozone and the flat Budget in the UK kept the dollar strong against Sterling and the euro during March, increasing its safe haven status. Data on 26th March showing a considerable drop in levels of optimism from US economic participants since last month compounded this, drawing more investors to the safety of dollar assets in the lead-up to Easter.

At the same time, Federal Reserve Chairman Bernanke attempted to underpin confidence in the Fed’s ultra-loose policy, stating in a speech that quantitative easing programmes and the low cost of borrowing in the US, UK and Eurozone have actually promoted global economic growth and benefited economic participants in all of the world’s economies. Stronger-than-expected data on US home prices and new orders for long-lasting manufactured goods released in the final week of March backed this up.

The euro fell against the dollar to levels last seen in November 2012. At the time of writing (27 March 2013), mid market rates were $1/£0.660 and $1/€0.782.

2013 – lower deficit, stronger dollar?

Analysts are watching America’s energy situation closely, some predicting that some industries could quite feasibly benefit significantly from cheap energy costs, resulting directly from the fracking of oil and gas in the US. More industries bringing production on shore, would mean fewer dollars in global circulation, driving up demand for the greenback globally. In the meantime, speculation over a currency war between established economies, such as the US, and rising powers such as Brazil and China, was quelled by Bernanke.

The US’s next GDP Announcement will be closely watched on 26th April, followed by the Federal Reserve Meeting Announcement on 1st May. The US is experiencing its fourth year of growth.

Meanwhile, until any real stability returns to the Eurozone, the dollar will strong against the single currency and Sterling, the latter being exposed economically to the Europe.
United States forecasts

The US dollar is currently benefitting from its safe haven status especially against the euro. It also has an improving economy although a lot of this is down to the huge amounts of money thrown at through their programmes of quantitative easing. However we have just seen some significant cuts in government expenditure implemented. Difficult to see any upside for either sterling or the euro in the short term against the US dollar as they battle their own problems. Any strength for sterling is dependent on an improvement in the UK’s economic performance and an increase in business confidence worldwide.

GBP/USD expectations for 2013

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Source: FX Week
Client Support - Contact Details

Corporate Sales:
Alex Bennett +44 (0) 207 898 0502 Alex@smartcurrencybusiness.com
Si Cong Ma +44 (0) 207 898 0500 Si@smartcurrencybusiness.com
Thomas Rudd +44 (0) 207 898 0500 Thomas@smartcurrencybusiness.com
Oliver Pearce +44 (0) 207 898 0500 Oliver.Pearce@smartcurrencybusiness.com

Corporate Trading:
Carl Hasty +44 (0) 207 898 0501 Carl@smartcurrencybusiness.com
Siobhain Barry +44 (0) 207 898 0500 Siobhain@smartcurrencybusiness.com
Duncan Scott +44 (0) 207 898 0500 Duncan@smartcurrencybusiness.com

Partnerships:
Ben Mulroney +44 (0) 207 898 0500 Ben@smartcurrencybusiness.com
Georgina Hawkes +44 (0) 207 898 0500 Georgina@smartcurrencybusiness.com

Address:
Smart Currency Exchange Ltd
One Lyric Square
London
W6 0NB
United Kingdom
Tel: +44 (0) 207 898 0500
Fax: +44 (0) 207 898 0557

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