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Pound Seen as Diminished No Matter Who Wins Election (Update1)
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(Updates prices in seventh paragraph.)

By Lukanyo Mnyanda and Paul Dobson

Jan. 25 (Bloomberg) -- No matter who prevails in this year's election between U.K. Prime Minister Gordon Brown and opposition leader David Cameron, the loser will be the pound because the next government may not have enough support in parliament to rein in the Group of 20's biggest budget deficit.

Strategists cut forecasts on sterling versus the dollar by as much as 2 percent this month to the lowest since June. The currency will be weighed down by polls that point to the first parliamentary stalemate in a generation, growth that lags behind the four biggest industrialized economies and a fiscal shortfall that has ballooned to almost 13 percent of gross domestic product, double what it was a year ago, the strategists said.

SJS Markets Ltd., last year's second-most accurate forecaster on the pound versus the dollar, sees the U.K. currency falling 1.3 percent by Dec. 31. BNP Paribas SA says the pound will wipe out all of last year's 11 percent gain, its best since 2006. The last time a U.K. election failed to produce a clear winner was in 1974. The currency fell 28 percent in the next two years as the government's failure to fund its deficit led to an International Monetary Fund bailout.

"If you end up with political paralysis in the U.K., that would be the worst of both worlds, where no one governs and everybody is fighting each other," said Sebastien Galy, a New York-based senior foreign-exchange strategist at BNP, which sees the pound sinking to $1.40 this year. "It's not a happy time when you have to go through fiscal restraint as it makes nobody happy, and if you do it with a weak majority or weak type of coalition, it's not easy to sustain."

Poll Results

Brown's popularity waned during the U.K.'s worst postwar recession, and Conservative leader Cameron, 43, has struggled to maintain enough backing to avoid a stalemate in an election that must be held by June. A YouGov survey for the Sunday Times, released Jan. 17, showed the Conservatives with 40 percent support and a 9-point lead over Brown, 58, whose Labour Party has ruled since 1997. The opposition needs a winning margin of 10 percentage points to control Parliament, according to Anthony Wells, a YouGov pollster.

Global investors are less enthusiastic about the U.K. than any other major economy, according to a quarterly poll of Bloomberg subscribers released Jan. 22. About 66 percent of respondents are pessimistic about the country's investment climate. As for Brown, 62 percent view him unfavorably worldwide, and 86 percent of British respondents feel likewise.

Declining Forecasts

Sterling traded today at $1.6113, down 0.3 percent this year. The median forecast of 26 analysts in a Bloomberg survey predicts a 3 percent gain to $1.66 per pound by Dec. 31. As recently as Oct. 8, the consensus was $1.71, or 6.1 percent more than today's level.

The median tumbled 2.9 percent in three weeks to $1.62 on Jan. 15, turning bearish for the first time in two months after being bullish for almost all of last year. It hadn't fallen so fast since dropping 4.6 percent in September, at a time when Bank of England Governor Mervyn King was warning Parliament that "the strength and sustainability of the recovery is highly uncertain."

UniCredit SpA in Milan, last year's fourth-best pound forecaster, cut its year-end prediction by 6.7 percent to $1.68, from $1.80, on Jan. 22, citing the U.K.'s slower growth prospects. Britain's GDP, the fifth-biggest among industrialized economies, will expand 1.2 percent this year, compared with 2.7 percent in the U.S., 1.35 percent in Japan, 1.9 percent in Germany and 1.3 percent in France, median analyst estimates compiled by Bloomberg show.

Bearish Bets

"The risk of a hung parliament might be a drag," said Roberto Mialich, a UniCredit currency strategist. "A dramatic worsening of U.K. public finances that forces rating agencies to cut the AAA rating" may push the pound lower, he said.

Hedge funds and other speculators have had an average of almost three times as many bets that the pound will fall as wagers that profit from a rise this month, data from the U.S. Commodity Futures Trading Commission in Washington show. Traders haven't been that bearish since October.

A weaker pound would help U.K. exporters. International Power Plc, the biggest U.K.-based electricity producer, has assets in about 20 countries and gets more than half of its earnings from overseas. The company is likely to report increased profit due to foreign revenue, said Mark Freshney, an equities analyst at Credit Suisse Group AG in London.

"The fall in the value of the pound against the key currencies in which International Power operates has been a driver," Freshney said in a Jan. 20 note.

Interest-Rate Outlook

Thanos Papasavvas, who helps oversee $5 billion as head of currency management at Investec Asset Management Ltd. in London, says bears are underestimating the timing and pace of central bank interest-rate increases as the economy recovers and inflation accelerates. He predicts the currency will rise 5.5 percent to about $1.70 by year-end after policy makers abandon their record-low 0.5 percent benchmark.

Inflation hit 2.9 percent in December, up an unprecedented 1 percentage point from the previous month, while unemployment fell at the fastest pace since April 2007, the government said last week.

"Data is continuing to surprise on the upside, inflation pressures are here, and we're seeing a gradual recovery worldwide," Papasavvas said. The pound is "the cheapest of the major currencies, and that's why we like sterling."

BNP's Galy discounts the positive economic indicators.

"Some of the good performance in the U.K. economy is actually backward looking, and some of the elements are probably not sustainable," he said. "When the fundamentals come through, sterling won't be the prettiest currency around."

Highs and Lows

After rising to as high as $2.1161 in November 2007, the pound fell 26 percent in 2008 as the global financial crisis plunged the U.K. into its longest recession on record. It hit $1.3503 last January, the lowest since 1985.

Chancellor of the Exchequer Alistair Darling funded stimulus measures by record borrowing, swelling the budget deficit. It hit 15.7 billion pounds ($25.3 billion) last month, the most for any December since records began, the Office for National Statistics said Jan. 21.

Sterling's gains last year were driven by optimism that the central bank's plan to pump 200 billion pounds of new money into the economy and record-low interest rates would revive growth. Mortgages approved by the country's six biggest banks stayed close to the highest level in a year last month, and lenders predicted demand will remain "broadly stable," the Bank of England said on Jan. 21.

Inflation, Unemployment

The currency rose to a six-week high of $1.6458 last week after the inflation and unemployment data prompted speculation that the central bank would raise borrowing costs.

The BOE's key interest rate will match that of the U.S. Federal Reserve at 1 percent by the fourth quarter, median economist forecasts show. The Fed's main rate is now between zero and 0.25 percent. The predictions see the U.K.'s rate lagging behind higher year-end rates in the euro region, Canada, Sweden and Norway, making the pound a relatively less attractive investment.

"I don't think we can look to interest rates as the savior for the pound," said Nick Beecroft, a London-based senior foreign-exchange consultant at Saxo Bank A/S, in a Jan. 4 Bloomberg television interview. "It faces many headwinds, the most important of which is the possibility of a hung parliament."

No Help

Even a Conservative victory that secures control of Parliament may not help the pound, said Brian Kim, a currency strategist in Stamford, Connecticut, at UBS AG, which Euromoney Institutional Investor Plc ranks as the world's second-biggest currency trader. Investors may spurn the currency on speculation that Cameron's promises to rein in the deficit will prompt the central bank to try to safeguard a recovery by delaying rate increases, he said.

"We could see sterling come back under pressure as people realize that an austerity budget is going to present a problem on the monetary side," Kim said. "You can't suddenly tighten monetary policy then too."

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