Economist's Weekly Market View

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Sterling takes a big hit

Economic growth forecasts continue to be lowered as the scale of the challenge posed by the coronavirus outbreak globally becomes clearer. There are some predictions that GDP could contract by 10% in many economies in the first half of the year. This does not seem unreasonable given that whole parts of economies could be shut down for a period of months.

Meanwhile, unemployment looks set to climb very steeply in a matter of weeks – this will represent an unprecedented increase in jobless numbers in such a short period of time. Government measures in some countries, though, to keep laid-off workers on employers' payrolls will help mitigate this. Nonetheless, a deep recession is on the cards as output contracts sharply in both the first and second quarters of the year.

The key question is not so much how steeply will GDP fall, but how quickly and sharply will output rebound. This is not like a normal recession in that much of the economy has simply been frozen in time – activity has come to a sudden stop. It could rebound very quickly once countries get on top of the virus and normal activity and life resumes.

Many governments and experts are suggesting this could be in about three months' time, i.e. around mid-year. We can't be certain about this as the virus could linger on or reappear. It will take more time to get back towards normal activity in some sectors.

However, it is important that policy makers ensure activity is able to ramp up quickly once the virus is overcome. Strong action is being taken. It seems that lessons from the 2008-09 financial crash have been learnt, with central banks acting early and aggressively, announcing a broad range of measures to ease financial conditions and support activity.

Governments have also been rolling out sizeable fiscal measures and promising supports for impacted industries. The mantra everywhere is 'whatever it takes'. Austerity would seem to be confined to the history books.

Meanwhile, the turmoil continues on financial markets, with equities suffering further big falls. It would appear, though, that the major QE asset purchase programmes announced by central banks may be starting to put a floor under government bond markets, with yields falling back from recent peaks.

The crisis tends to roll from one market to another, and the past week saw some major moves on currency markets. The dollar continues to gain ground on safe haven flows into the world's most liquid currency, as is generally the case at times of crises. However, there is also strong underlying demand for the US currency, with central banks opening new dollar swap lines to meet this funding requirement.

Measuring currencies performance against the dollar is an unfair benchmark as they all have lost significant ground against the greenback recently. Sterling stands out, though, crashing to 35 year lows well below the

$1.20 level against the US currency. We have also seen the euro rise from 87p a fortnight ago to as high as 95p when sterling went into free fall last week, before it recovered to around the 91-92p level.

A number of factors have been cited for sterling's sharp fall, including the UK's approach to counteracting the coronavirus and its large current account deficit. However, the speed of the movements last week also suggests poor liquidity conditions – a feature of many markets at present, which is exacerbating price moves. It seems very likely that the dollar will remain well underpinned, but the events of the past week show that forecasting sterling is very difficult and it is likely to stay very volatile.

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