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Independent Research Providers to the Professional Investment Community

31 May 2004

This Week in the Currency Markets

Worries Abound

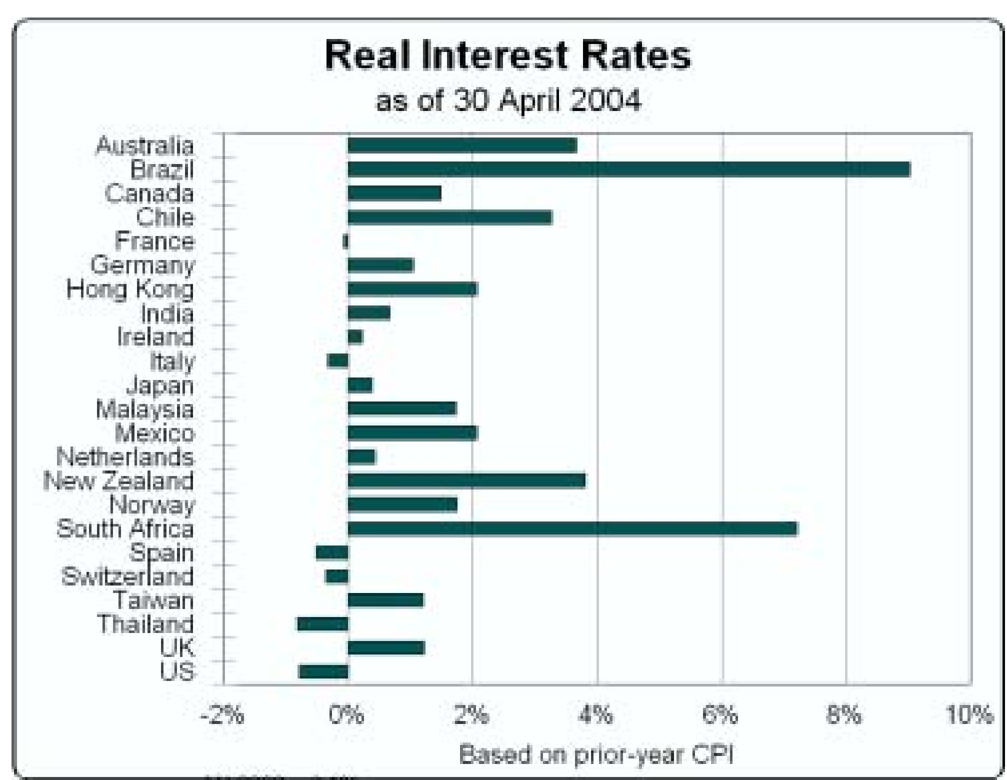
China and Oil Top the List

It was another bad week for the dollar. Against the list of currencies for which we provide short-term forecasts, the greenback lost an average of slightly more than 1½% in the week just ended. Another week like that would bring the dollar back to even for the year to date. As things stand, the dollar is about 6% lower than it was at this time last year.

Pundits are citing many worries that might be contributing to the dollar's recent sell-off. The ones we see most often mentioned are: the possibility of a "hard landing" (i.e. recession) in China, a likely imminent resurgence of inflation, and the risk of a disruption in oil supplies.

Our take on the dollar's renewed dip is based on a bit more of a long-term view. We continue to maintain that the biggest contributor to (what we see as) an inevitable droop in the dollar's value is the chronic US current-account deficit. More on that in a moment.

Another factor is the negative real interest rate (see the chart on this page) being paid on dollar



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deposits. Granted, the illustrated rates are short-term (90-day) yields, and the dollar looks more competitive further out on the yield curve. At the margin, nonetheless, the "hot" money will gravitate toward the higher-yielding currencies. One thing we have discovered in our years of forecasting is that high-yield currencies are to be preferred (ceteris paribus, of course). This is not a conceptual argument (in fact, it violates the theory of uncovered interest rate parity), but an empirical fact.

China and Oil

Returning to consideration of the macro factors mentioned earlier; the reason we focus on global trade, capital, and growth imbalances rather than the speculations about China, oil, and inflation is that (for one) these imbalances are real and upon us now, and (for another) we consider the oil and China factors to be self-cancelling and the inflation scare to be a chimera (at least in the short run).

By "self-cancelling" we refer only to the immediate future (the next few months). We believe the Chinese economy will avoid a recession, but that it will indeed slow down significantly. In either case, the recent voracious Chinese appetite for oil and other raw materials will moderate for a time, which will likely lead to a softening of prices for most commodities, including petroleum products. Lower oil prices will, in turn, restore to the global economy some of the demand capacity lost to weaker exports to China.

The Inflation Chimera

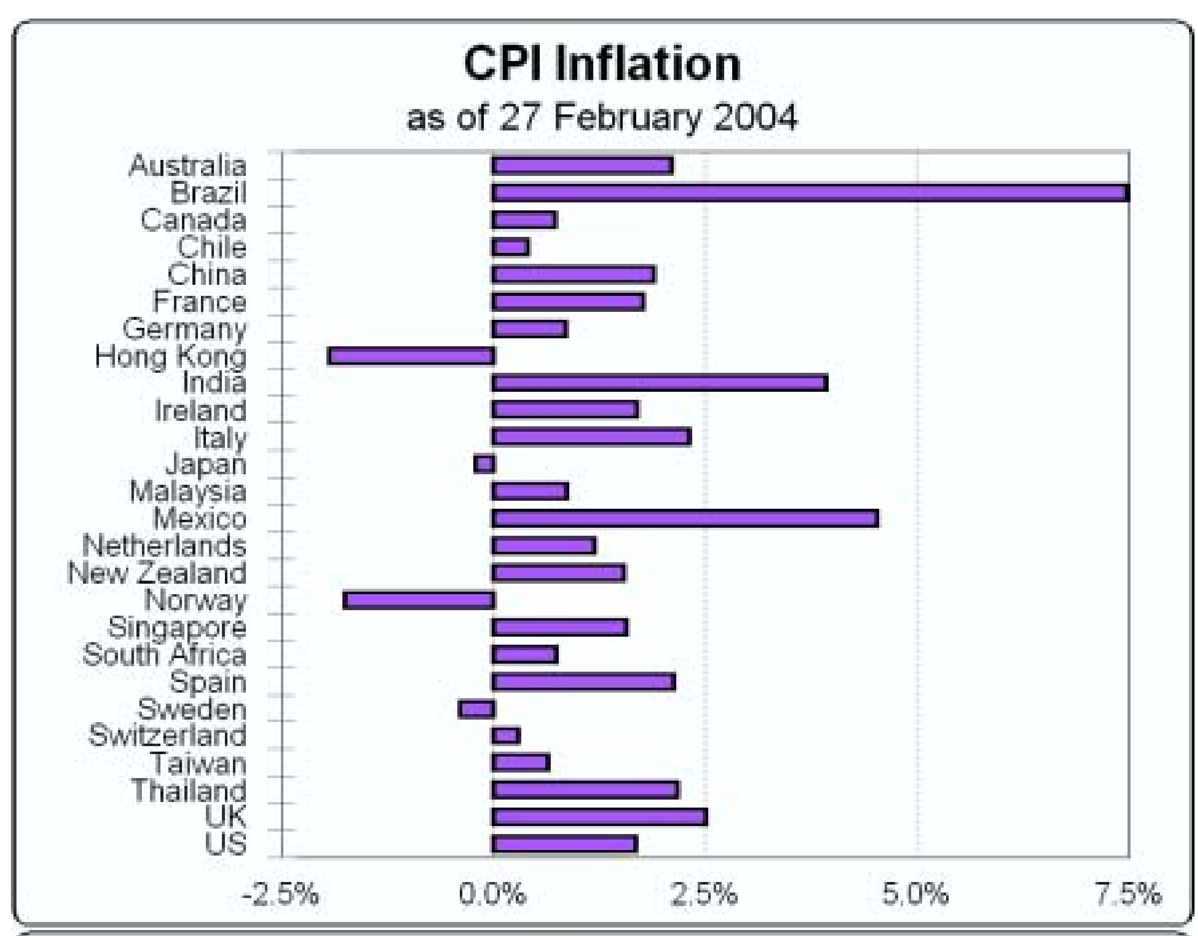
The bar charts on the next page show inflation levels in consumer prices in 26 of the world's largest economies. The top graph shows year-over-year inflation numbers as of the end of February, while the bottom graph updates these numbers with the latest reported statistics available (many countries report these numbers with quite long lags).

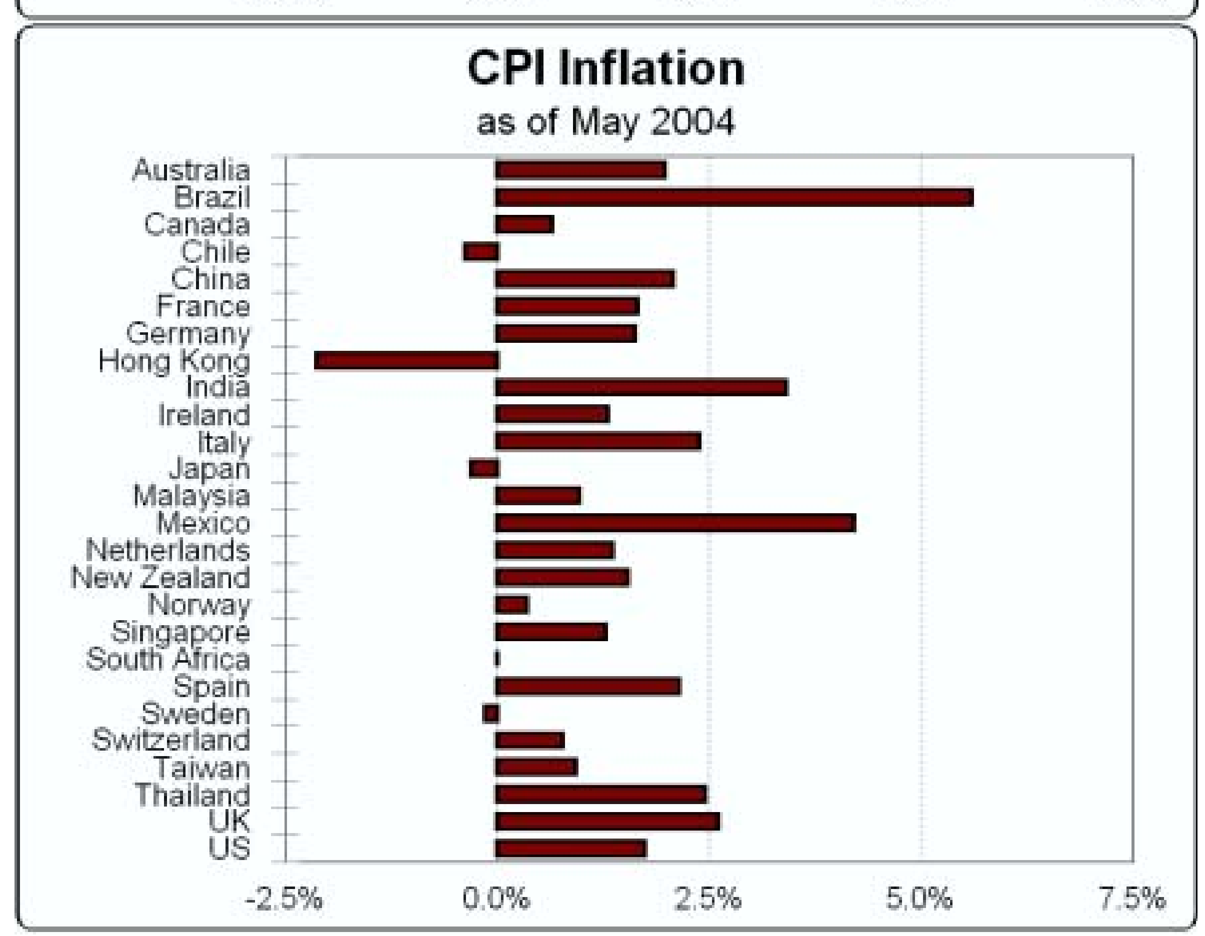
For the most part, inflation rates around the world are lower now than they were in February. In fact, four countries are experiencing deflation, and they are not necessarily the ones you might suspect. Chile? Sweden? Who knew? Many other countries are experiencing deflation if you look at shorter time frames than one year. A year ago, South Africa and Brazil were registering 8% and 20% rates of inflation, respectively. Look at them now: zero for South Africa and less than 6% in Brazil!

All of this doesn't lend much credence to the worrywarts who fret that inflation is about to explode because of the overly accommodative stances of central banks around the world.

Looking ahead, it's hard to make the case that short-term rates will have to rise dramatically. Granted, US rates should be higher, but mostly to provide a cushion in case easing is required to stave off some future shock, not because inflation is a threat. We've cited reduced demand from China as one factor that will ease pressure on commodity prices. Labor costs should also be fairly well-contained because of the widely-publicized global labor arbitrage (rued as "outsourcing" by some).

All in all, then, we see little reason to expect a resurgence of inflation anytime soon, either in the US or in any of the other major economies. Rising short-term interest rates in the US will benefit the dollar, but probably not enough to offset the structural difficulties presented by the country's widening current account deficit.


CPI Inflation
as of 27 February 2004
Australia
Brazil
Canada
Chile
China
France
Germany
Hong Kong
India
Ireland
Italy
Japan
Malaysia
Mexico
Netherlands
New Zealand
Norway
Singapore
South Africa
Spain
Sweden
Switzerland
Taiwan
Thailand
UK
US
-2.5%
0.0%
2.5%
5.0%
7.5%


CPI Inflation
as of May 2004
Australia
Brazil
Canada
Chile
China
France
Germany
Hong Kong
India
Ireland
Italy
Japan
Malaysia
Mexico
Netherlands
New Zealand
Norway
Singapore
South Africa
Spain
Sweden
Switzerland
Taiwan
Thailand
UK
US
-2.5%
0.0%
2.5%
5.0%
7.5%

Europe — Sterling Now Exactly Fairly Valued Relative to Euro

Both the pound and the euro are now about 19% overvalued relative to the dollar, by our calculation. Despite this valuation disadvantage, we are expecting both of them to continue to gain in value. Over the next year, we expect the euro to do slightly better than sterling, rising from its current level of $1.22 to $1.36, with the pound moving up from $1.83 to $1.96.

We find the Swiss franc and Nordic currencies to be misvalued by approximately the same amount, and we also expect them to move up relative to the dollar by about 10% to 15% over the next year.

Asia/Pacific Yen Moves Back to 110

After a brief flirtation with its highest levels since last fall relative to the yen, the dollar has moved back down to about ¥110. We consider the yen to be almost exactly fairly valued at this level (our exact calculation of fair value is ¥108 to the dollar). Yet, as for the euro, we predict that the yen will continue to gain strength over the next few months. We have been saying for quite some time that we expect the yen to achieve "parity" (one yen = one US cent) in a year's time. We still have that expectation, though obviously our target date has slipped somewhat. We were saying that event would happen at the end of this year (and it still might), but for the moment we have our sights set on mid-year in 2005.

Notice that the Aussie and Kiwi dollars are high on the list of currencies enjoying very favorable real interest rate advantages over the greenback. Like the rand (also on that list), these two are among the most overvalued currencies relative to the US currency. Still, we expect all three of these to be among the best-performing currencies over the next year.

We're slightly less upbeat about the Asian currencies. We do expect all of them to register positive performances relative to the greenback over the next year, but we do not favor them as strongly at the triplet we just mentioned or their European counterparts, and we think there could be some rough sledding over the next few weeks for some of these currencies.

Americas & Africa Rand Back Into Positive Territory

As already mentioned, our outlook for the rand is quite positive. Our recent optimism on the currency was rewarded this past week with a 3% rise, bringing the rand back into the plus column for the year to date. Over the past year, it has risen 24% in dollar terms. We don't expect the current inflation-free environment to persist in South Africa, but we believe the central bank has been doing a good job of responding to quite volatile economic conditions, and we remain optimistic.

We are also positive, both near-term and over the next year, on the Canadian dollar, the Mexican peso, and the Chilean peso.

Performance of Our Paper Portfolio

In the latest trading week, we correctly predicted the direction of half of the 10 short-term forecasts we made a week earlier for the major currencies included in our paper portfolio (which tracks the effects of our predictions on a weekly basis, and is measured on an equal-weighted basis). For the week, our portfolio gained 8 basis points, and has now had positive returns in 14 of the 21 weeks in 2004.

Since the beginning of 1999, when we began tracking and publishing the results of this paper portfolio (which is assumed to be rebalanced to equal weightings each time), we have achieved a total gain of 4294 basis points, which is equivalent to 6.8% on an annualized (unlevered) basis over that five-year-plus period. So far this year, we have gained 266 basis points, which annualizes to an almost identical 6.6% rate of return.

Explanation of Methodology and Disclaimer: In measuring these hypothetical results, we use the returns (subject to a 2% stop-loss) from taking long or short spot positions, depending on the direction of our forecast. We do not make any provision for trading costs. This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete. Certain assumptions may have been made in this analysis which have resulted in any returns detailed herein. No representation is made that any returns indicated have been or will be achieved. Changes to the assumptions may have a material impact on any returns detailed. Although past performance does not provide any assurance of future success, all of our models have been calibrated by simulating their performance over a fairly long historical time period. We also continually monitor and fine-tune the models, which are, by design, adaptive in nature. So, it is our belief that the models have a high likelihood of continuing their predictive success into the immediate future.

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