

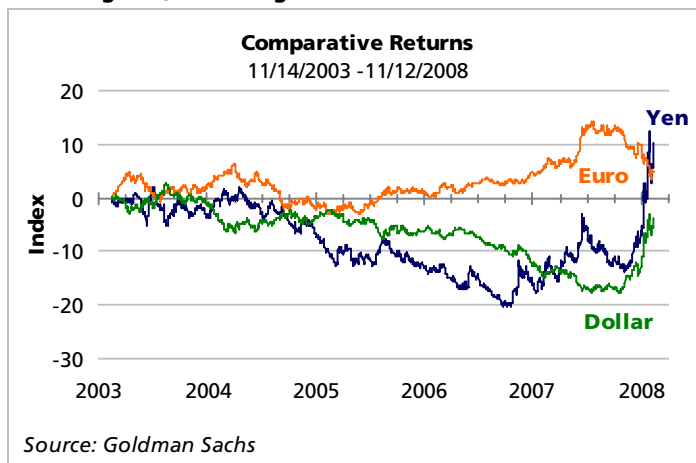
## Convergent Trade Trends, Divergent Currency Prospects?

by Martin Jansen, Senior Portfolio Manager

The turbulence in the global equity and bond markets, which have been severely buffeted since mid-year, are being accompanied by dramatic movements in the currency markets. After hitting an all-time low in the second quarter of this year, the trade-weighted U.S. dollar has appreciated strongly in recent months, and has retraced fully its decline since the end of 2005 in less than four months.

The euro, which took a final fling into the stratosphere earlier this year, rediscovered the laws of gravity and has lost almost 10% of its trade-weighted value in this short period. Most spectacularly, the trade-weighted yen has appreciated by more than 20% since July, and is up 30% from its low in July 2007. While it is normally true that imbalances build up gradually but are addressed more swiftly, the compressed timeframe of this development is dramatic.

### A Soaring Yen, A Souring Euro



Barring the inevitably lagged official confirmations, the world's three largest economies are in a recession that is likely to last well into 2009. The Bank of England capitulated last week by reducing its base rate by 150 basis points to 3.0% in a single move. The European Central Bank was a little more circumspect (ever the hawk of last resistance) and cut its central rate by 50 basis points to 3.25%.

Relative economic strength in its own right does not materially favor one currency versus another. Fundamental over- or under-valuation, which can persist for extended periods but which is a mediocre short to medium-term indicator, could be playing a role. On a purchasing power parity basis, the euro was patently overvalued, and both the U.S. dollar and yen were cheap. The intensity of the recent moves suggests, though, that capital movements are the prime driver.

Are trade account trends having an influence on these movements, or is there a possibility that this will become a far larger factor once the momentum of capital flows slows down? A globally synchronized (near) recession has, it can be argued, a different impact on each of these three major economies.

Turning first to the United States, current economic trends point to a substantial reduction in the trade deficit. Perversely, its large trade deficit as a point of departure may turn out to be a positive. Much lower imported energy prices and lower imports as domestic consumption declines are likely to far outweigh the negative impact of declining exports. While this may be hidden in the volume analysis underlying GDP statistics, in money terms the higher level of imports is likely to decline far more, thereby reducing the external financing requirement. A stronger dollar reinforces this.

Europe, on the other hand, may fall prey to its historic export success. Its relevant strength lies not in domestic consumption growth, but as a supplier of quality, premium products to the rest of the world. While it would normally benefit from a lower currency, ebbing global growth and the need to reduce inventories suggest European exports will continue to contract sharply. As the leading global purveyor of luxury goods, it is additionally vulnerable; an era of relative austerity should be reflected in a shift to cheaper substitutes and Europe is not positioned to benefit from this. Lower energy import prices and lower consumption can offset this effect, perhaps substantially, but the European trade deficit is likely to remain modestly negative.

If the size of a current surplus and the relative strength of a currency were always positively correlated, the Japanese yen would long have been the world's strongest currency. Its stagnant domestic growth and zero interest rate policy since the mid-1990s made it the prime source of finance for carry trades. Japan played a pivotal role in the systemic leveraging of the global financial system. When this trend peaked in early 2007, the yen stabilized and began to strengthen. The frantic deleveraging since mid-year and the resultant unwinding of the carry trades propelled the yen to its prior peaks. Financial flows are likely to push this farther in the short run. Fundamentally, however, the Japanese trade surplus is likely to shrink, suggesting that the yen may retrace some of its gains when the rate of capital flows slows down.

In summary, the U.S. dollar could well extend its gains against the euro in the coming months, given convergent trade trends. It may find itself losing ground against the yen before strengthening on the back of convergent trade trends as 2009 progresses. Interest rates globally are fast moving to the lower Japanese levels to counter a growing output gap, and are not likely soon to be a major factor in the relative movements of the three major currencies. ■