Global Markets: Currency Valuation and the Outlook for the US Dollar

Michael J. Woolfolk
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THE OUTLOOK FOR THE US DOLLAR

Dr. Michael J. Woolfolk*

INTRODUCTION

Since 2001, the US dollar has lost more than 40% of its value against the Euro, 30% against the British Pound, and about 20% against the Japanese Yen. In November 2000 the US dollar traded at 1.16 Euro and today it is trading at 0.6582. As the US descends further and further into debt of several trillion dollars, the value of the US dollar is expected to decline further. What are the consequences of the declining dollar for US multinationals? Over the years, especially during the past seven years, US companies have carefully and successfully maneuvered their way through the volatile foreign exchange market.

The declining dollar is not a new phenomenon. During the mid 1970’s because of elevated oil prices and the actions of Central banks that were torn between dealing with the threat of inflation and the downward risks of growth, the dollar faced similar pressures that it is facing now. One notable difference between then and now is the impact of high oil prices on US inflation. During the mid 1970’s, heavy reliance on imported oil prompted a stronger pass through of oil prices into both Consumer Price Index (CPI) as well as inflation expectations. Today, the dependence on imported oil is materially less and the US Federal Reserve believes that inflation and inflation expectations can remain contained despite the recent rise in oil and commodity prices.

If true, the US is unlikely to succumb to stagflationary conditions as it did in the 1970’s. However, the USD is nonetheless expected to remain weak for some time as both US growth and interest rates lag behind those in other major economies. Accurately forecasting a turnaround in the USD has been made more difficult by the spread of a popular market investment strategy called the “carry trade.”

* Dr. Michael J. Woolfolk is the Senior Currency Strategist for the New York Bank Mellon in New York, New York.
A STRATEGIC OPTION

United States’ multinationals have many different options in dealing with the declining dollar. Over the recent decline in the dollar, the most consistently successful strategy in the currency markets has been the “Carry Trade”. A carry trade is “[a] strategy in which an investor sells a certain currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. A trader using this strategy attempts to capture the difference between the rates - which can often be substantial, depending on the amount of leverage the investor chooses to use.”

There are three basic conditions required to make these trades attractive:

- A sufficiently large interest rate differential must exist to make the trade worthwhile
- A funding currency that is stable to weakening. For example, the US dollar.
- A low volatility environment

Given that “carry trades” are run on an un-hedged basis from a currency perspective, the funding currency must not only have materially lower interest rates than the destination investment currency, but the funding currency must remain weak. If not, the currency’s performance could undermine and even overwhelm the expected yield of the interest rate differential. For example, if overnight interest rates in the US were 2.0% and in Australia it was 7%, investors may wish to capture the 5% differential by borrowing US Dollars (USD) and buying AU Dollars (AUD). If, however, the USD rose in value against the AUD by more than 5% over this period, the investor would end up with a net loss. Consequently, “carry trades” require low volatility market conditions in which the funding currency (the USD in this instance) is expected to remain weak.

By the summer of 2007, the carry trade was the market’s primary strategy. For example, the Bank of International Settlements (BIS) reported that the Japanese Yen denominated lending in the first quarter of 2007 topped one trillion US dollars. In late June, the net short Japanese Yen futures held by speculative players had reached an all time high. The BIS reported that foreign currency investments made by Japanese households increased on average by 1.2 trillion Japanese Yen per month in the first six months of 2007.
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UNDERLYING FORCES BEHIND THE SUCCESS OF THE “CARRY TRADE”

In order to determine what has been the most important driver for alpha creation in foreign exchange, we need to understand the underlying forces behind the success of the carry trade strategy. To understand this, requires an approach that encompasses four key areas. These are:

- Historical perspective
- Cross border financial politics
- Central bank intervention
- Behavior of different investor groups

In addition to the above four areas, the success of the strategy is also dependent on information. Specifically, information on how the asset markets are interacting with the currency markets as well as drawing inferences as to why it is happening.

Historical perspective

Although, no two periods of time are ever the same, however, there are a number of similarities between the backdrops to the current decline in the value of the dollar to the markets in the mid-to-late 1970. Once again, we are facing rising oil prices; people are acquiring more commodities such as gold and other minerals resulting in high rates of growth among countries with vast reserves of mineral deposits such as Australia, Canada, and Chile. The high growth attained by these countries is reflected in the ever increasing US trade deficit that last year topped $700 billion.

One key difference between the pressures on the US dollar in the late 1970’s to the current situation is the impact of currency pegs. Countries have taken measures to contain inflationary pressures even as cost of food and energy has risen. For example, in the US, despite a 26% slide in the US dollar index compared to a decade ago, the consumer price index over the last eight years has remained the same. On the other hand, inflation in the gulf region has risen from below 4% in 2005 to above 12% in 2007. Similarly, there are inflationary pressures in China triggered by rising food prices and also because of the influx of money from abroad.

Although the circumstances are different in each of the cases, one common feature of all of these nations is that they either peg their currency to the US dollar, track a basket of currencies in which US dollar seemingly plays a significant role or actively manage their currency against the greenback. Rising food prices and high currency prices are a common feature of these countries. One suspects, that the currency policies of these countries are, effectively, importing inflation from the G7 nations.
Comparing the performance of gold during the mid 1970's (Graph -1) and now shows some interesting similarities. Overlaying the performance of gold during 2005 to the present suggests that we may not have seen the top yet.

Graph -1
Gold Prices

During 1976-78 (Graph -2), gold began to accelerate in price at an accelerating pace as the USD continued to weaken. The question becomes, whether USD weakness will drive gold and other commodity prices significantly higher in the coming year?
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Graph - 2
US Dollar


Cross border financial politics

Although the Federal Open Market Committee (FOMC) eased policy aggressively through 2001, by January of 2002 the US dollar stood at its strongest levels since 1986. Everything changed after this and some of the forces that affected this change are:

- International criticism of the Japanese Ministry of Finance’s campaign of verbal intervention (and occasional fiscal intervention) and the Bank of Japan’s policy of “quantitative easing,” whereby interest rate were left at effectively 0% but more money was allowed to be borrowed at this rate.
- The US was not the only country to complain about the actions of the Japanese Central Bankers, its Asian Neighbors too voiced their strong disapproval of the Japanese policies, especially China. The call by the Bank of China’s Governor on the Japanese to take measures directed at preventing the continued devaluation of the Japanese Yen that was causing widespread currency devaluations across many Asian countries.
The response from the Japanese Central Bank was more of an admonition of its Asian counterparts, especially the weakness in the Chinese Yuan rather than concrete actions to stabilize the Yen.

While China, Japan, and the US were squabbling about who should have the weakest currency, the Euro-zone was more concerned about the persistent weakness of its own currency.

- In an effort to shore up the value of the Euro and in response to the weakening of the dollar, some countries including China were in favor of using the Euro as an alternate reserve currency.

The result of the cross border politicking was:

1) Contrary to expectations of the Chinese, the US Treasury, and the US Congress, Japan seemed to be pursuing a policy of keeping the Japanese Yen as weak as possible.

2) On the other hand, the Europeans were taking the decline of their currency more seriously and were taking active steps to remedy the problem by promoting the increased use of the Euro as a reserve currency.

3) It appears that the Europeans got their wish and the Euro started to gain against the Japanese Yen and the US dollar.

European officials have effectively got what they wanted far back in 2002, a time when the Euro (EUR) currency was quite weak. The EUR has rallied against many major currencies including the USD (Graph – 3) based upon relatively high interest rates and the promotion of the EUR as a reserve currency.
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Graph – 3
The Rise of the Euro

% change from starting date

Source: The Bank of New York Mellon

Central Bank behavior

According to IMF, at the start of 2002, total global foreign exchange reserves stood at just over 2 trillion US dollars. Of this total amount, about 1.57 trillion reserves had actually been allocated with 71% being held in US dollars and 19.7% in Euros. By the start of 2003, total reserves had grown by about 0.5 trillion US dollars. However, the US dollar now only represented 67% of the foreign exchange reserves while the Euro represented 24.6%. By the second quarter of 2007, just in five years, total foreign exchange reserves had more than tripled to 5.7 trillion dollars while the share of the dollar has decreased to
just 64.7% of known holdings. Meanwhile the Euros’ share had risen to 25.5%.

All the available evidence indicates that the phenomenal growth in foreign exchange reserves over the past five years has been accompanied by a notable push to diversify away from US dollars into Euros. It seems clear that foreign exchange managers took the European pleas at the end of 2001 seriously. Following is a partial list of the foreign exchange managers that have expressed a preference for reducing their exposure to the US dollar over the past two years:

1) United Arab Emirates – is looking to convert up to 10% of its foreign exchange reserves from the US dollar to the Euro, doubling its Euro holdings.

2) Qatar – two years ago, used to invest about 99% of its portfolio in US dollars and now it is down to 40%. About 40% of the balance of Qatar’s foreign reserves, estimated to be 50 billion US dollars is invested in the Euro and another 20% in other currencies including the British Pound.

3) Sweden – The Riksbank has boosted its level of Euro holdings from 37% to 50% meanwhile reducing the level of foreign reserve holdings in the US dollars from 37% to 20%.

The list goes on. The other countries that have joined the exodus of switching its foreign reserves from the US dollar to the Euro include Italy, New Zealand, Russia, Singapore, South Korea, and Thailand. Therefore, it is not surprising to see the appreciation of the Euro

**IS THE CURRENT FOREIGN EXCHANGE STRATEGY REALLY CARRY TRADE ACTIVITY?**

Based on available data, it is not clear that some of the strategies followed in the foreign exchange market are really carry trade. For example, the one-year yield gaps between the South African Rand (ZAR), New Zealand dollar and Australian dollar against the Japanese Yen are substantial – 10.44%, 7.99%, and 6.526% respectively. The same cannot be said for the Canadian dollar and the Norwegian Krone’s interest rate advantage which are 3.9% and 4.72% respectively. It is clear that the yield pick up on the Kroner is noticeably less than that available on the British pound at 5.03%, while the Canadian dollar’s one year yield is only just above that of the US dollar. In other words, the second best performing currency over the period actually had the third lowest yield of the group ahead of the US dollar and the Japanese Yen. Hence, it appears that the driving force here is not simply yield. This added to the fact that the rallies have also come at a time of the heightened volatility in financial markets suggests that characterizing these rallies as being the product of carry
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	rade activity might be overly simplistic.

INVESTOR APPETITE FOR UNDERLYING EQUITY MARKETS

Looking at the performances of the currencies mentioned here in terms of what has happened in their underlying equity markets provides ambiguous results. Although the NZD and AUD have put in healthy rallies so far (Graph – 4 and 5), it’s difficult to argue that the performance of the respective currencies has been down to relative investor interest in local stock markets. Our own cross border custodial flow data seems to confirm this. Although we have registered healthy fresh inflows into South African equities, the same cannot really be said for Australia, New Zealand, Norway or Canada, where the flows have been modest at best.

Graph – 4
New Zealand dollar

Source: The Bank of New York Mellon
A POSSIBLE EXPLANATION FOR HIGH FLYING GROUP OF CURRENCIES

There are two common elements to this high flying group of currencies; the first is the continued strong inflationary stance of their respective central banks. Australia, South Africa and Norway all still appear to be in tightening mode while New Zealand and Canada both remain on inflation watch. In contrast, despite the apparent neutral stance of the FOMC, US markets still expect two further rate cuts by the middle of next year. This is also consistent with British Pound’s relative weakness, given that the market continues to price in at least one rate cut by the end of June 2008. The second and closely related common feature is that they are, in one form or another, commodity currencies.

It appears that in the circumstances that we are in, may be managers should stop thinking about the rally in Japanese Yen as being driven by “risk seeking” carry trade activity and, instead, look at it as a flight to safe haven currencies in the face of rising concerns about the threat of future inflation.
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CONCLUSION

Based on our analysis and reviewing the existing evidence, it seems the most consistently successful trading strategy of the past five years has been driven by inflationary concerns or rather, by concerns over certain currencies as “stores of value”, i.e., currencies that are traded around the clock, are considered a hard currency and have a history of maintaining their value. A similar argument can be made about what has driven the ongoing rally in gold price. As the USD has declined, USD-denominated commodities such as oil and gold have risen in value to maintain their value in foreign currency terms.

Similar arguments can also be made about the performance of the US dollar in recent years. The greenback has tended to outperform when oil prices have been their weakest and the Federal Reserve has been at its most hawkish. Given what has been observed, the driving force behind some of the currency concerns has been an aggressive and ongoing squabble between the US, China and Japan over who should have the weakest currency. Although it would be wrong to say that they have followed policies of “competitive devaluations,” the motivations were essentially the same.

In light of all these different scenarios and situations, it seems reasonable to conclude that a combination of structural economics and politics have proved the ultimate real driver of the most significant trends within the currency markets over the past five years.