MARKET INSIGHTS

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Currency wars, the euro and the recent movements in FX markets

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Introduction

'Currency wars' has become a very popular term in the press, and this conjures up the impression that we are seeing policymakers utilising currency weakness as a legitimate weapon to inflate their economies. In reality, currencies are moving in an appropriate way to relative economic information and perceptions of future monetary policy. However, there is no doubt that recent movements have reignited interest in a critically important market. Perhaps the most interesting developments have been the scale of the appreciation of the euro, its implications for eurozone policymakers and the rise in overall foreign exchange (FX) market volatility. This note explores these developments and their implications.

FX volatility is on the rise

The mainstream media is now full of 'currency war' discussion and headlines. The lack of new initiatives from the IMF/World Bank autumn meetings, held between 8 and 10 October fuelled anxiety among some investors that we are entering a new and potentially destructive environment in the foreign exchange market. However, it could be argued that currency movements to date are merely reflecting the desired and often appropriate monetary and budgetary policy stances in individual countries. While currency movements do have significant implications and are part of the financial landscape that affects macroeconomic developments in all countries, we have not reached the point where large developed countries are deliberately targeting currency weakness as an attempt to stimulate export sectors.

Nevertheless, recent moves have highlighted two key developments that we would like to focus on in this note. First, the shift back to an easier policy stance or message in the US, Japan and UK has placed considerable and unexpected upward pressure on the euro. This will become a key issue for eurozone policymakers in coming months.

Second, after trending lower through much of the summer, foreign exchange (FX) volatility has risen in response to recent developments. This may be a wake-up call. The argument that the underlying macro and policy environment is and will continue to be volatile has been underpinned by the speed of the transition over the summer from talk of central bank exit strategies to expectations of new easing. With different countries facing different issues, and with policy responses

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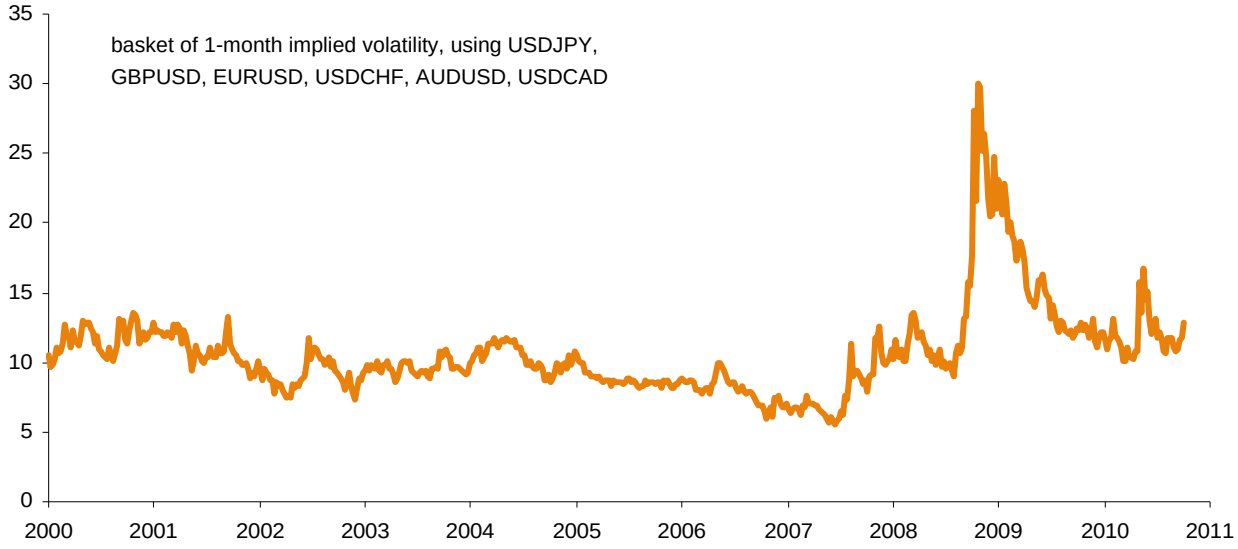
uncertain on a relative basis, underlying FX market volatility must surely remain higher than in previous cycles. There is little doubt that tail risks and the probability of a policy error are higher now as a result of the fallout of the financial crisis than they have been since the 1970s.

Although it is only now that currencies have hit the front page, amid fears of competitive devaluations, the FX market has been in the thick of the action since the onset of the financial crisis in 2007. After a prolonged phase of carry trade outperformance amid low and falling volatility, the emergence of financial stress culminating with the Lehman Brothers bankruptcy led to a super-spike in FX market volatility and huge movements in developed market currencies. After falling to as low as 5.5% in mid-2007, a basket of one-month implied volatilities for the major USD crosses had risen above 30% by the fourth quarter of 2008. The successful introduction of quantitative easing in the US in early 2009 then secured a remarkable decline in volatility and re-emergence of carry outperformance through to April 2010. During this round trip, the euro and the Australian dollar both endured downward and subsequent upward movements against the US dollar of close to two standard deviations in a matter of months.

Exhibit 1: **Major USD Cross Rate FX Volatility**

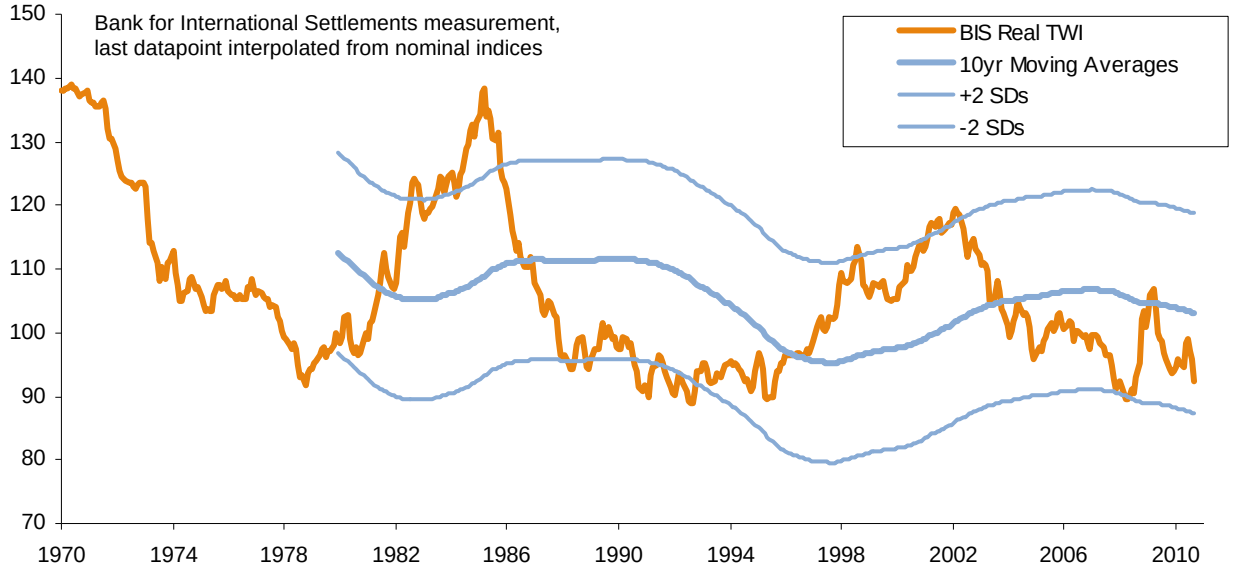


Source: Bloomberg and J.P. Morgan Asset Management

Currencies are responding to the transition to QE II in the US

Since April, the big issue for markets has been the rapid shift in the policy debate from the discussion of exit strategies from exceptional monetary policy measures to the stark reality that the underlying economic situation will require additional stimulus in key countries. Our proprietary economic leading indicators started to signal in March and April that growth momentum was waning in many developed economies. This trend has continued, and these indicators are now consistent with a return to below-trend growth, especially in the US and UK. Through the northern hemisphere summer, the confluence of weakening growth and falling core inflation has allowed policy guidance to move firmly towards additional QE steps. A move by the Federal Open Market Committee (FOMC) at its 10 August meeting to prevent implicit tightening through the accelerated maturing agency MBS holdings was signalled from late July. Comments from Federal Reserve chairman Ben Bernanke and other key officials through the late summer indicated that the 21 September FOMC discussions would lay the foundation for additional QE steps as early as the 3 November meeting. While the prospect of more QE has clearly been a negative force for the US dollar, it is a stretch to argue that this has been the primary motivation of the doves on the committee. The currency has weakened nearly 10% on a trade-weighted basis since May, but is still above March 2008 lows.

Exhibit 2: **USD Retail Trade – Weighted Exchange Rate**



Source: BIS and J.P. Morgan Asset Management

The policy debate in the UK has also shifted toward the potential for additional QE. In some respects this may be more credible than the transition of policy in the US, as the new UK government has announced a tough stance on fiscal retrenchment. Our leading indicator for the UK has weakened the most of the major developed countries and risks of a double-dip recession are commensurately higher given the likely impact of government spending cuts on unemployment and consumer sentiment. Despite the overwhelming impact of US dollar weakness, sterling has fallen since the end of the summer on the growing recognition that the Bank of England could seek more capacity from the government to extend its QE programme in the coming quarters if the economic outlook were to worsen further.

Perhaps the most controversial policy development has been the decision by the Japanese authorities to intervene in the currency markets on 15 September for the first time since 2004. The accelerating weakness of the dollar had pushed USD/JPY below 83.0 and the probability of a more damaging rise in the yen had increased sharply. The Bank of Japan's decision to leave the JPY 22.0 trillion intervention unsterilised amounted to new policy easing and an explicit injection of new liquidity into the global financial system. The central bank followed this up with a decision at its 5 October meeting to extend its QE programme further.

Exhibit 3: **JPY Nominal trade-weighted index (TWI)**

Source: Bank of England

The case for intervention appears to be more compelling than it was during the 2003-4 phase. Back then, deflationary pressures were arguably weaker and the economic environment was considerably less negative. Our proprietary leading indicators are pointing to a weakening global environment in the second half of this year and into 2011. This will place additional downward pressure on the Japanese recovery. From the Japanese perspective it was notable that the yen, on a trade-weighted basis, had breached the post-Lehman bankruptcy risk-aversion highs before the intervention. It was also evident that the yen, and for that matter the Swiss franc, had suffered excessive bouts of strength associated with mini risk aversion phases during the summer. Although USD/JPY has subsequently fallen back below pre-intervention levels, mainly in response to outright weakness in the US currency, the overall trade-weighted value of the yen has remained weaker.

The resulting surge in the EUR will create the biggest policy tension

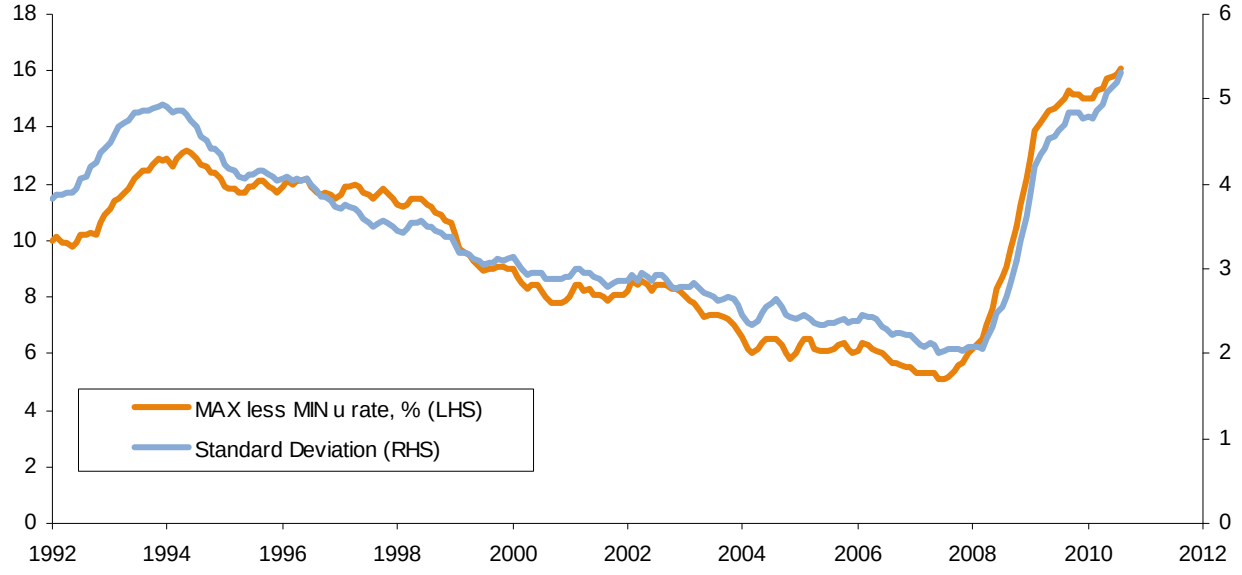
Perhaps somewhat unexpectedly, it was EUR/JPY that ended up gaining the most upside traction in the aftermath of the Japanese intervention, rising over 9.0% from 106.0 in mid-September to almost 116.0 at the beginning of October. This serves to highlight one of the most interesting developments of the last few weeks. Almost by default the euro has surged, in response to a recognition that European policymakers are likely to lag the easing trend evident in the US, Japan and potentially the UK. In fact, notwithstanding the more favourable economic conditions in Switzerland, even the Swiss National Bank has acted swiftly to underpin its dovish stance, and this has facilitated a near 5.0% recovery in EUR/CHF.

The overall trade-weighted value of the euro, although still well off late 2009 peaks, has now appreciated over 8.0% from summer lows. This is a significant appreciation when set against the expectation of most investors that generic euro weakness would persist through much of this year, culminating with EUR/USD falling back toward the 1.15 level. It was also the second fastest pace of appreciation since the launch of the euro in 1999, beaten only by the pace of the surge in the aftermath of the Lehman bankruptcy. It is evident that many longer-term investors who had factored in a

more prolonged period of euro weakness are being forced to re-evaluate. This includes central banks that have continued to allow their foreign exchange reserves to build up in recent months in an effort to slow the pace of appreciation of their own currencies, but which may have allowed the pace of reserve diversification out of the US dollar and into the euro to slow.

Intriguingly, through this phase of euro appreciation, the newsflow out of the eurozone has turned more negative. Economic data releases that had been unexpectedly strong have turned less positive, and budgetary news out of the peripheral countries, especially Ireland and Portugal, has turned more negative. Sovereign debt spreads have widened to new extremes amid greater investor concerns that some form of debt restructuring will be necessary during this economic cycle. Wider sovereign debt spreads have in the past been associated with currency weakness, and this was certainly evident in the spring. This impact has been overwhelmed in the current environment by the more dominant forces of additional easing steps taken elsewhere.

Exhibit 4: **Intra - eurozone unemployment divergence**



Source: Eurostat and J.P. Morgan Asset Management

Ongoing euro strength will exacerbate stress within the eurozone, and this in turn will exert pressure on the European Central Bank (ECB) to provide some relief through either new easing or, at the very least, a dampening down of market expectations of tightening in 2011. It is interesting to note that interest rate markets are still pricing in a decent chance of a rate rise from the ECB in the second quarter next year. The core northern eurozone members have exhibited the greatest flexibility in maintaining competitiveness during phases of euro strength, and they have derived the most benefit from euro weakness. The peripheral members of the eurozone have arguably benefited least from currency weakness when the euro was more competitive, and they are likely to be more adversely affected by the renewed strength in the currency if it should persist. Economic divergences within the eurozone have continued to build this year and an intensification of this process in response to new euro strength will increase pressure on the ECB to signal a more dovish stance. A decision by the US Federal Reserve to introduce further easing measures in November could lead to a further rise in the overall value of the euro if investors begin to sense that offsetting easing action by the ECB is unlikely. A return of EUR/USD back to the 1.40 to 1.50 range that held through much of the second half of 2009 would then be possible before ensuing economic weakness.

Higher FX volatility may re-emerge as a theme

FX market volatility may have been dealt a bit of a wake-up call in recent weeks. After falling steadily from the super-spike of the fourth quarter of 2008 towards the upper end of ranges that had held between 2002 and 2007, implied volatility spiked higher in the second quarter this year in response to the European sovereign debt crisis and the deteriorating macroeconomic environment.

However, this spike had little persistence and by early August volatility had fallen back toward 2010 lows. Interestingly though, FX market volatility has started to increase moderately in response to the prospect of new QE in the US, the actions by the Japanese authorities and the resulting squeeze higher in the euro. This feels like an appropriate response and it is possible that FX volatility will settle in a higher range in coming months. Even if the term 'currency wars' is an exaggeration, recent developments show that individual countries are taking actions and responding to subsequent market developments in an uncoordinated and domestically driven manner. With circumstances differing between individual countries and blocs it is entirely appropriate that currencies adjust in a meaningful way. They are a key barometer of relative economic and policy differentials.

Currency markets are critically important. They are the principal measure of actual relativities between economic and policy developments, and investor perceptions thereof. Although the term 'currency wars' has been adopted widely in the media in recent weeks it is a stretch to believe that we are now entering a phase of competitive currency debasement. Currencies are moving in line with policy actions. These policy actions are in general a credible response by policymakers to incoming domestic growth and inflation news. The interesting questions going forward will be to what extent eurozone policymarkers will tolerate euro strength before adopting a more dovish stance, and to what extent recent developments will underpin a structural move higher in overall FX market volatility.