the advisor

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Currency Roulette

"If you do not expect the unexpected you will not find it, for it is not to be reached by search or trail."
Heraclitus

During the 1930s, the first countries to escape from the clutches of the Depression were the first ones to abandon the gold exchange standard and depreciate their currencies. Amidst the unexpected turmoil that followed, some rather unfortunate events took place. Today, in an effort to escape from the clutches of the global financial crisis, a similar race to devalue is underway.

You'd think that economic fundamentals, such as GDP growth, relative price levels, interest rates and cross-border trade flows, would determine exchange rates. Unfortunately, you'd be wrong. We live in the age of "extraordinary monetary measures" by central banks. Currency dealers are more influenced these days by the next round of quantitative easing or by the latest iteration of wording in official central bank statements.

The world's central bankers acted together in late 2008 by lowering interest rates worldwide. But it was the US Federal Reserve that moved first in initiating quantitative easing (QE: creating money to buy bonds) policies. This monetary policy, in effect, depreciated the US dollar in a bid to boost American competitiveness and to limit the value of the colossal debt America owes to its foreign creditors. This policy appeared so effective, others jumped on the bandwagon.

Japan unleashed its own extreme QE programme in 2012, increasing the Bank of Japan's balance sheet from just over 20 percent to 75 percent of GDP in less than three years. Consequently, the yen has since fallen some 37 percent against the dollar.

After years of unrelenting gloom - and of the prospects of a Grexit - the European Central Bank finally joined the party with its own QE in early March. Until recently, the ECB had utilised complex transactions to increase 'liquidity' beyond the gaze of member state voters. Now the euro-zone will be overtly flooded with at least €1,100bn of newly created money over the next 18 months, as the central bank buys government and corporate bonds at the rate of around €60bn a month. The ECB's governor, Mario Draghi, said the continent was finally "pointing in the right direction", raising the prospect of even faster QE. In other words, the ECB will attempt to depreciate the euro so as to win back some competitiveness.[1]

Even China has been lowering its rates to weaken the yuan relative to the dollar and is having some success in doing so. Russia, of course, has been devaluing the rouble because of oil and geopolitical tensions.

What we are in fact witnessing is a "currency war" as various central bankers manoeuvre to gain trade advantage and to nurture domestic inflation. Historically, devaluation has been a step on the

Source: Bloomberg. As of 2/23/2015.

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(Currency Roulette cont'd)

road to political and economic collapse, as demonstrated by ancient Rome and present-day Venezuela. Currency wars are not only taking place amongst developed nations but with emerging markets as well.

For five years, emerging markets' central bankers have criticised the monetary policies of the developed countries. Both China and Brazil have complained that QE has lowered the relative value of their deliberately accumulated dollar reserves against the yuan and the real.

For the first time since 2006, however, US interest rates may be about to go up, perhaps as early as June. Such a prospect has pushed the dollar up 25 percent against a trade-weighted basket of currencies since last May (see chart previous page). The dollar index is now at its highest level since 2003.[2]

In March, Ray Dalio, the influential founder of hedge fund Bridgewater Associates, wrote a note to his clients warning that the Fed risked setting off a 1937-style crash when it starts raising interest rates again. In 1937, all that mattered was the stock market.

Today, according to the World Federation of Exchanges, the value of global equities is about $70 trillion, which is dwarfed by the bond market, which is, in turn, dwarfed by the $690 trillion derivatives market. By volume of trading though, at US$4 trillion *per day*, the currency market is the largest market in the world. What matters is that these markets are all interconnected.[3]

Consider the bond market. Low bond yields seem positive for global growth and in some cases they may be – lower yields make debt burdens more tolerable and countries' exports more competitive. Record low interest rates have encouraged companies (notably emerging market firms) to issue US$ high-yield bonds. The primary objective of debt issuance has been for the purpose of leveraged buyouts and equity buybacks, all of which is fine while corporate profit margins remain healthy. Foreign firms, holding US$9 trillion of debt, are now reeling because the US dollar has appreciated so much.

The present environment offers bond yields that are 2% in the US, with conventional five-year German, Danish and Swiss bonds all having *negative* yields for the first time. Even some corporate (e.g. Nestle) bond yields have turned negative too. The universe of negative yielding bonds in the euro-zone now totals $2 trillion. Just to be clear: those buying such bonds are locking in a certain loss on maturity.

We have entered an altered reality of paying governments, and the most creditworthy companies, for the privilege of lending to them! "The possibility of negative interest rates was rarely if ever contemplated in academia prior to 2014. No textbook or central bank research paper even mentioned it . . . It was . . . inconceivable . . ." [4]

Next ponder the equity market. Some believe that low interest rates justify rich equity valuations and investors have responded enthusiastically. To rationalise current equity market valuations, however, economist John Hussman estimates interest rates will need to be held at zero for the next *25 years.* Suppressing short-term interest rates may encourage yield-seeking speculation that results in rich stock valuations, but those rich valuations will probably be followed by dismal subsequent returns. From the standpoint of foreign investors, expensive US equity valuations now coupled with a soaring US dollar makes the American stock market even less attractive.[5]

The more equity prices are artificially pumped up by central bank interventions, the more vulnerable global stock markets are to an exogenous shock. Seeing as how it's every central banker for themselves, such a shock could well originate in the currency markets.

No central bank is bigger than the currency markets, and yet the world's central bankers are competing against each other in a race to debase. Common sense would argue that the global economy cannot devalue against itself.

The lessons from history suggest that currency manipulation is prone to escalation: into higher inflation and taxation, social unrest, political extremism, revolution - and worse. Unlike the 1930s, let's hope the central bankers get it right this time.

Sources:

1. Liam Halligan, "Currency wars threaten Lehman-style crisis", The Telegraph, 14 March 2015
2. Ibid
3. Ben Wright, "The world's next credit crunch could make 2008 look like a hiccup", The Telegraph, 23 March 2015
4. William Gross, Investment Outlook, Janus Funds, 16 March 2015
5. John Hussman, "Extremes in Every Pendulum", Hussman Funds, 16 March 2015
6. Chart, William Gross, Investment Outlook, Janus Funds, 16 March 2015

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