

CURRENCY STRATEGIES

At an estimated \$3.2 trillion a day the foreign exchange market is the biggest of all the capital markets. The types of participants range from tourists and retail speculators, to institutional speculators like hedge funds and proprietary traders at banks, to hedgers like corporations and asset managers. Some view the currency market as a source of alpha or potential profits. Some view currency movement as a risk that needs to be managed. Some view foreign exchange as simply a transactional vehicle while others view it as a legitimate asset class.

Valuation in the currency market tends to be elusive. When one buys a bond or a stock, one acquires a claim on a future income stream that can be modeled. In their pure form, currencies do not generate an income stream. Nevertheless, despite the depth and breadth of the markets, the numerous players and problems getting a handle on valuation, there are three general ways in which one can make money in the foreign exchange market.

The three strategies are: momentum, carry, and mean-reversion. It is a worthwhile exercise to think about those strategies in light of the recent price action. The investment climate prior to last summer was characterized by low volatility and high liquidity. For medium term participants in the foreign exchange market, there was really one dominant strategy and that was carry.

Recall the Japanese yen and Swiss franc, the lowest yielding currencies among the majors, were used to finance the purchases of high yielding or higher returning assets. As recently as last spring, on a real-trade weighted basis the yen was near a couple of decade lows. It was only last October that the Swiss franc was near record lows against the euro. The net speculative position in the IMM currency futures market was consistently short yen and Swiss francs from around the middle of 2006 into August 2007. On the other side, the high yielding Australian dollar, New Zealand dollar and emerging market currencies generally turned in stellar performances. Equity bourses from around the world were generally in bull markets.

That low volatility high liquidity climate ended abruptly and the carry strategies do not appear to be as profitable. Indeed, in the Jan-Feb period, the Swiss franc and Japanese yen are the strongest of the G10 currencies, appreciating nearly 8.5% and 7.3% against the dollar respectively. The net speculative position in the yen has gone from record lows near the middle of last year to one of its largest net long positions in a decade. Similarly in the middle of January, the net long speculative Swiss franc positions reached their highest level in nearly 4 years.

The strength of these currencies may be understood as a reflection of the other two main strategies. Short-term operators tend to often chase momentum. The currency (or another instrument) is rallying and they want to participate and jump aboard for the ride. Other, longer-term investors may have been buying the yen also under a mean-reverting strategy.

The high yielding currencies, like the Australian and New Zealand dollars and many of the emerging market currencies may also be played under momentum strategies, not just a carry strategy. What often is not appreciated by many observers is that the "normal" volatility of the foreign exchange market can overwhelm the yield (carry) pick-up in the short-term.

Consider a typical carry trade-- long Australian dollars short Japanese yen. Using 3-month interest rate differentials, one can earn about 13 bp a week in yield. Look at what happened this week. The Australian dollar finished last week (Feb 22), according to Bloomberg data, near JPY99.00. It moved about 1.5% higher in the first few days of the week to about JPY100.49 and then collapsed to JPY97.00 at the end of the week. The interest rate pick-up was a negligible contribution. And yet most speculative positions in the foreign exchange market appear to be held for little more than a week.

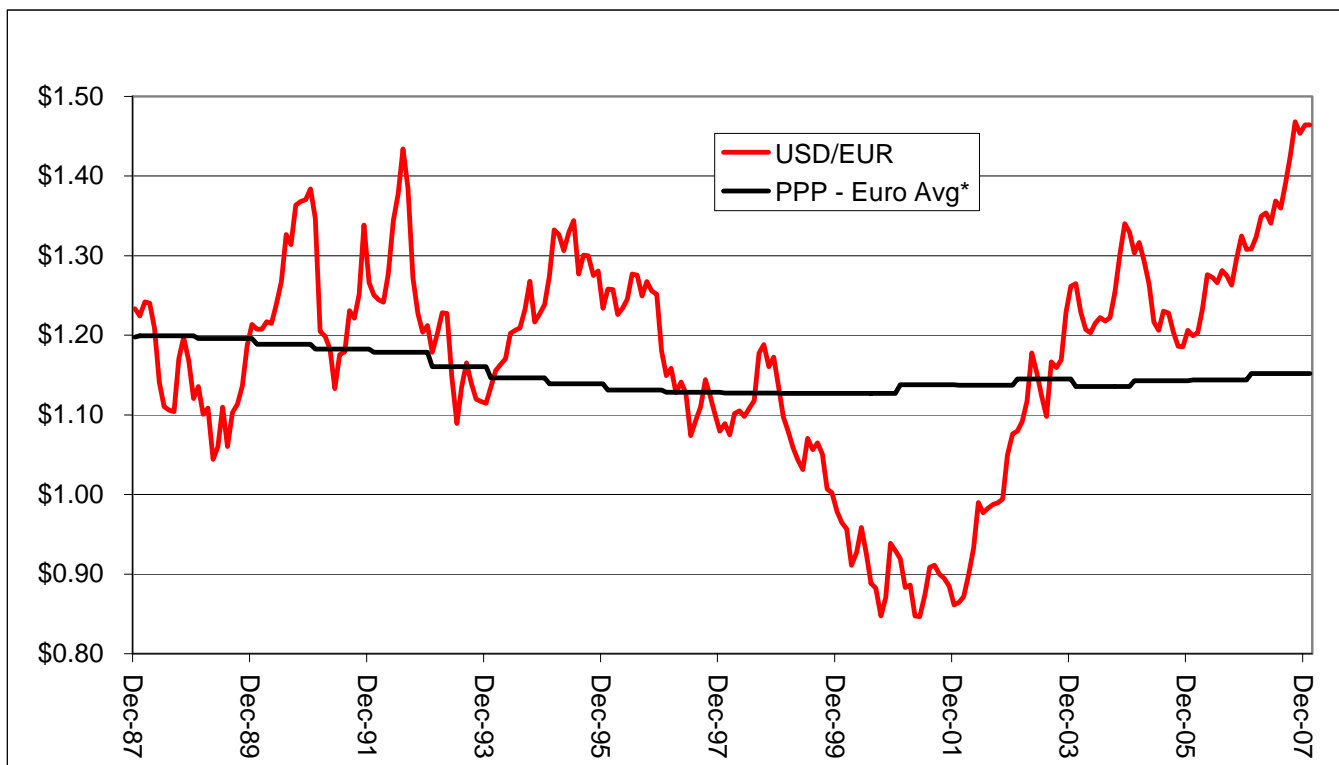
For the most part, it seems as if the recent price action in the currency market can be better explained by the momentum strategies than carry trades. Of the three previous times the euro tested the air above \$1.4900, this time the speculative community seemed to have the least exposure to the euro. Many, like ourselves, were perhaps lulled into a bit of complacency by the clearly identifiable trading range which had confined the euro for the better

part of 4 months. Until it didn't and then various types of participants, acting like momentum traders, had to scramble and chase the euro higher.

It may take a little while longer, but we would look for mean-reverting strategies to move into ascendancy. In lieu of an income stream to model, economists try to get their hands around valuation in the currency markets by considering the purchasing power of a particular currency. Economic theory holds that currencies in the long-run gravitate around their purchasing power parity.

By nearly any such measure one can find, the dollar is not only below its PPP levels, but against some currencies, like the euro, sterling and the Canadian dollar, for example, it has not been this under-valued in at least a couple of decades. Long-term investors, debt managers, and corporations are likely to begin looking more favorably at the US dollar on a valuation basis.

The higher volatility in the foreign exchange market makes carry strategies less attractive. That coupled with the market positioning has compressed time frames and forced many players to adopt momentum strategies. It can be dangerous and expensive to fight momentum. However, medium-term and long-term investors may be best advised to begin thinking about mean-reverting strategies. Such strategies entail selling that which is over-valued and buying that which is under-valued. Picking the exact bottom in the dollar in terms of price and/or time remains hazardous (though it continues to appear that the dollar has already bottomed against sterling and the Canadian dollar), but is somewhat less important for the mean-reverting strategies.



Source: OECD, Bloomberg, Brown Brothers Harriman

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