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Forces of Movement in FX During the last Third of 2008

We are entering the last third of the calendar year. The first two-thirds have been rough for investors to say the least with a viciously metastasizing financial crisis, a global bear market in equities and a commodity shock of historic proportions. While the last third of the year will no doubt have its challenges, the *annus horribillis* may end on a less dire note.

An important turn appeared to take place in the middle of July around the time that the US Treasury explicitly put the full faith and credit of the US government behind the obligations of Fannie Mae and Freddie Mac. Oil prices have eased since. The seasonal pattern with oil is well established. Oil prices tend to ease in the second half of the calendar year. The CRB index peaked in early July and by the middle of August had fallen almost 20%.

Many major bourses appear to have recorded some kind of bottom around then and have subsequently moved higher. The S&P 500 tends to lead an economic recovery by 6-9 months. This would suggest the US economic recovery takes hold in late Q1 or early Q2 09. And this is consistent with the consensus view, according to Bloomberg surveys. Despite the unexpectedly strong Q2 growth of 3.3%, the US economy is likely to slow in H2 08 before gradually recovering in H1 09.

In the 9 months prior to those events, the US dollar had bottomed against three of the four non-G7 currencies (British pound, Canadian dollar and Japanese yen), the Swiss franc and many emerging market currencies. However, the general perception was that the dollar had not yet really bottomed largely because the dollar was still weak against the euro. In the middle of July, the euro retested its April high near $1.60 and has since sold off sharply. In fact, the euro's 5.6% slide against the dollar in August is one of the single currency's worst monthly performances in its short life.

After cutting interest rates aggressively in the first third of the year, the Federal Reserve has been standing pat. The markets had a scare near mid-year that the Fed would hike rates. This not only failed to materialize, but it seems increasingly likely that the Fed is on hold into 2009. At the beginning of the year, the consensus view, which we shared, was that the ECB would cut rates in late Q2 or early Q3. Instead, it hiked rates in July and some officials continue to threaten to do it again—to prevent a second-round impact, which seems largely a euphemism for wage pressure. IG Metal, the largest union in the euro-zone has indicated it will seek a 7-8% wage increase in the current negotiating round.

However, the euro-zone contracted in Q2, for the first time and early indications suggest the weakness is carrying into Q3. Indeed, because the euro-zone has a less flexible policy response to the assorted challenges, the risk is that it experiences a deeper and more protracted economic slump. Year-over-year growth is unlikely to surpass 1.25% in any of the next say half dozen quarters. Just like the Fed is most likely on hold into next year, so too is the ECB. The main difference is that while the Fed's next move is a hike, the next ECB move will likely be a rate cut.

The Bank of Japan is also likely to keep rates on hold at the lowly 0.5% for at least the next few quarters also. However, this is not true of the UK and Canada. Surveys and the overnight index of swaps point to expectations that the Bank of England will cut rates in the middle of Q4, with 75-100 bp worth of rate cuts by the end of 2009. Expectations for the Bank of Canada are less clear cut. Economic data has generally been weaker than expected, but some surveys find most economists do not expect another rate cut, while the OIS is consistent with almost 50 bp of rate cuts over the next year.

Meanwhile, more write-offs and loan loss provisions from the large financial institutions are likely in the coming quarters. However, policy makers seem very determined to mitigate systemic risk. In the US there is still a great deal of uncertainty surrounding the government support for Fannie Mae and Freddie Mac, but their need to roll-over a large amount of debt by the end of next month suggests some resolution is likely in the coming weeks, if not months.

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In Europe, reports suggest there continues to be a shortage of dollars. European financial institutions also have not replaced as great of a proportion of their losses and write-downs as US banks, though of course this could change. Moreover, the relative flatness of the yield curves in Europe is not as supportive of rebuilding the bank's balance sheets as is the steeper US curve.

Another important consideration is market positioning. Short-term traders and speculators have been generally playing the dollar from the long side for several weeks now, even though after the recent rally many have been looking for a correction, which has been elusive. Since early July, according to TrimTabs data, some $15.5 bln has left US international mutual funds and ETFs. It is not immediately evident where this money has been deployed. While mutual funds that invest in the US have also experienced large liquidations, those funds appeared to have largely migrated to US ETFs. Given the length of time of the US equity market's under-performance and the multi-year dollar decline, it seems a reasonable hypothesis that global portfolios are under-weight the US. Some anecdotal evidence from surveys would also lend support to the view. That in turn suggests that real money may join the speculators and buy dollars in the period ahead.

Geopolitics may be a wild card in the last third of the year. The wars in Iraq and Afghanistan have dominated geopolitical issues, but that all changed in early August when Russia invaded Georgia. Tensions still seem to be escalating and it is difficult to envisage how they will ease in the coming months. In fact, the risk is that things get worse before they get better. Currently the focus is on Georgia and the Black Sea, but this will be overshadowed if Russia seeks to retaliate for the decision to place a missile defense system in Poland. Twice before to protest NATO or US deployment decisions, Russia has tried to establish a military presence in the Caribbean (Cuba and Grenada). This time, Venezuela is a likely candidate.

In terms of politics, the US presidential elections in early November will be the highlight of the last third of the year. It does not appear that there will be a statistically significant dollar impact from the outcome. Our positive outlook for the US dollar is not predicated on any particular outcome. Canada's minority government also appears to be headed for an election, but it is not clear at this juncture if it will be held this year. We suspect next spring is a more likely timeframe.

We expect the US dollar to continue its nascent recovery in the final third of the year. Gains against the yen may be more muted than against most of the other major currencies. We had previously argued the dollar was carving out a major cyclical low against the major currencies. By early Aug, as the euro broke below the $1.5300 area, we suggested that the process of carving out the bottom was over and now the new trend had begun. The subsequent price action has lent credence to our judgment and we continue to advise medium and long-term investors to take advantage of the periodic pullback in the dollar to increase exposure, directly or through reducing short dollar hedges.

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