January in Retrospect, February in Prospect

One of the forces that we expected to emerge in January was an unwinding of some of the trends seen in December. This force was evident in parts of the foreign exchange market. The poorest performing currency against the dollar in December was the Japanese yen. It lost a little more than 7% in December. In January it was the best performing currency, recouping almost half of what it had lost in last month of 2009.

The worst performing G10 currency in January was the best performer in December. The New Zealand dollar managed to eke out an almost 1% rise against the greenback in December and is off more than 2.25% in January. The Canadian dollar was the only other G10 currency to have gained against the US dollar in December (+0.80%) and in January it retreated by around 1%.

To capture this "mean reversion" we had recommended buying long Australian dollars and short New Zealand dollars. During December the cross moved by a little more than 1% in Australia's favor as the RBA's record third consecutive rate hike, more neutral comments from some officials and some soft data spurred expectations that the RBA would pause. In January, stronger Australian data swung the pendulum of market expectations back toward an early Feb (Feb 2) rate hike. The Australian dollar gained around 2% against the New Zealand dollar.

This cross is unlikely to be the cash register it was in January. The uptrend has carried the cross toward key resistance around NZD1.2800-50. Long Australian dollar positions are a crowded trade, with the CFTC Commitment of Traders showing the net speculative position as of Jan 19th being the largest since May 2008. Moreover, a March RBA rate hike, which would potentially be the fifth one, may be too much, given the likely lag times and the fragility of the global environment. The good news may have been largely discounted.

"Mean reverting" forces were evident in other markets as well. US interest rates rose sharply in December and fell back off in January. The 2-year yield rose 47 bp in December and has given back more than half of this gain so far this year. The 10-year note yield rose 57 bp in December and managed to recoup about a third of that in January.

The market pushed back out the first FOMC rate hike. On December 3rd, the eve of the stronger than expected nonfarm payroll report, which has now been revised to show an outright gain, the June Fed funds futures implied an average effective rate of 28.5 bp. At the end of the year, it was up to 33 bp and is now near 20 bp.

Oil prices appreciated more than 20% in the last half of December and fell more than 13% in January, its worst month since July. The pattern is roughly the same for commodity prices in general as reflected by the CRB, except it has surrendered nearly everything it gained in the second half of December through early January. Gold declined for the second consecutive month.

Europe

The euro did enjoy a brief reprieve where it looked like it would participate in the mean reverting process. It did manage to appreciate around 2.5% from the low in the second half of December to the high made in the middle of January. Around then European officials began taking a tougher line against assistance for Greece. Its debt crisis emerged early in Q4 09 after the newly elected government revealed the budget deficit was around three times more than previously estimated.

We have argued that Greece exposed a flaw at the very heart of the European Economic and Monetary Union. It is inherent in the great experiment of our day; can monetary union be stable in the absence of clear controls on fiscal policy? Such controls may require a surrender of sovereignty that is tantamount to political union.

The danger is a vicious cycle whereby high interest rates weaken the prospects for growth, which in turn increases the budget deficit directly and indirectly and, in turn, drives up interest rates further. This dynamic can jump to other countries as well. Clearly Portugal and Spain are the next in line with Italy and Ireland getting a greater benefit of the doubt. Eastern and Central Europe have many of their own challenges, including fiscal matters, and the deficit and debt concerns within EMU exposes their vulnerabilities.

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In addition to these issues, it appears that the euro zone lost some economic momentum in Q4 09 and Q1 10 appears to be off to a soft start. The OECD expects private consumption to stagnate in the euro zone this year. Even as the German government revised up its forecast for 2010 GDP to 1.4% from 1.2% estimated in October 09, it acknowledged that private consumption is likely to contract by 0.5%, underscoring the continued reliance of the largest economy in Europe on exports.

While credit tensions may ebb and flow, the Rubicon has been crossed and there is no returning to status quo ante. The euro has been tarnished. Chart based support in the $1.3800-$1.4000 zone may slow the euro's descent, but potential exists toward $1.33. Enthusiasm will be for selling euro rallies rather than buying dips as was the case from April through November 2009. The $1.4200 area should provide a sufficient cap, unless the dynamics change.

The depreciation of the euro will have the effect of reducing the value of reserves. The more a country diversified away from the dollar, the greater will be the valuation impact of the depreciation of those other currencies.

According to the IMF's COFER data, the dollar's share of reserves fell in Q3 09, but valuation considerations suggest that an improvement is likely in the coming quarters. And this is at a time when the depreciation of emerging market currencies, especially in East Asia, and falling regional equity markets, mean that intervention in the region, which often entails dollar purchases, may slow considerably.

China

The biggest surprise of the month in the capital markets was China's central bank engineering higher bill rates and the reserve requirement increase. Many observers had focused on the winding down of quantitative easing in the US and the UK as a Q1 theme, but had China tightening as an H2 story.

The nuanced adjustment of monetary conditions in China, stopping short of an outright rate hike, is probably a reaction to news of an explosion in new bank lending in the first three weeks of the New Year. Reports, yet to be confirmed by official data (due 9-11 Feb), suggest new yuan loans were in excess of three times larger than December's CNY380 bln and something near 15% of the year's target.

Attempting to rein in this new lending, the officials' measures spurred profit-taking in the regional equity markets, with the greater China bourses (Shanghai, Hong Kong and Taiwan) suffering pullbacks greater than 10% from the month's highs. India's market fell just shy of 10%, while Korea and Singapore fell closer to 8% and Malaysia less than 4.5%.

Next month is bound to be better. Sentiment remains constructive toward Asian equity markets in general and many medium term investors are likely to view any significant pullback as a new buying opportunity. Moreover, there is a sense shared by many that there is a Chinese Put—reminiscent of the old Greenspan Put, where big declines in the stock market are countered by policy measures. While PRC policy makers may not object to the elimination of some speculative froth in the market, they want to avoid any potentially destabilizing serious destruction of wealth. New equity buying may help the regional currencies pare January's declines.

Renewed buying by foreign investors, perhaps, after the Lunar New Year (mid-February), may also underpin the regional currencies. That said, Chinese officials appear to have made it abundantly clear that they see their own interest and the world's interest in a stable yuan despite protests to the contrary.

Global imbalances have been reduced, and emblematic of this has been the near halving of the US and Chinese current account imbalances. Even if the decline is more a result of cyclical forces than structural adjustments, there are, or should be, more salient issues for policy makers than the value of the yuan's nominal bilateral exchange rate.

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