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SPECIAL FX



# The Dollars State of Play

At the start of the summer, the two legs that had supported the dollar had given way. The European financial crisis eased and the U.S. economic momentum flagged. The summer months saw these developments extend.

European countries on the periphery have not been frozen out of the capital markets. They have sold their bonds (in Greece's case, bills) at higher, though not exorbitant rates. At the same time economic growth in the region accelerated markedly in Q2 over the near stagnation in Q1. On the hand, the vulnerability of the U.S. economy is sufficiently obvious that the Federal Reserve adopted what is essentially an easing bias and will resist a passive contraction of its balance sheet. The Obama Administration is in the process of a unveiling a new infrastructure renewal, business investment, job-creating package, which, if as suggested may be worth as much as $100 billion is thought too small to call a second stimulus. Its approval by Congress is not clear cut amid partisanship ahead of the November mid-term elections.

*Marc Chandler*
*Global Head of Currency Strategy*

**All is Not as it Seems**

The uncertain policy environment, and the volatility of both financial prices and economic conditions, has however may be creating gaps between appearances and reality, making the investment waters ever more treacherous.

It is in Japan, where contrasts may be the starkest. The Japanese yen has been the strongest of the major currencies, though hardly a reflection of the state of the Japanese economy or the confidence in policy makers. Japanese remains mired in outright deflation, with a fragile and uneven economy, and a revolving door in the Prime Minister's office. The government's debt stands at above 200% of GDP.

Despite Japan's prodigious export of portfolio capital the yen has appreciated by nearly 15% over the past four months on a trade weighted basis and 40% over the past two years. Japanese policy makers seem at a loss as to how to address the strength of the yen. Increasing lending facilities, which is what the BOJ has apparently reluctantly agreed to, is hardly sufficient given the surplus that corporations (retained earnings) and banks (deposits minus loans) continue to experience.

The BOJ continues to buy more than the equivalent of $20 billion a month of Japanese government bonds. It appears to be under some pressure to buy more. It is not clear that this would achieve very much either in terms of addressing yen strength or deflation.

While the risks of material intervention are perceived to have increased, the absence of international support and the poor track record of unilateral intervention (Japan's experience in 2003-4 and Switzerland's operation more recently) raise questions of its potential effectiveness. Intervention would also exacerbate another strategic challenge facing Japanese officials—the huge level—over $1 trillion—in reserves.

**Europe is Smoldering**

Just like the yen's strength does not reflect good strong positive developments in Japan, so too, the euro's recovery does not mean that Europe's fundamental problems have been truly addressed.

Through a combination of policy measures when possible and innovation when necessary, European officials, including the ECB, successfully addressed the dramatic liquidity crisis of the spring. That alone was worthy of some upside correction for the euro after its demise had been so broadly heralded.

The underlying solvency issue has not gone away. The premium peripheral European countries pay over Germany has widened, like Ireland, surpassing the spring highs. The price of insuring against default soared and by a record amount in several countries. The reliance of banks in the periphery on the ECB lending facilities appears to have increased.

Although the U.S. economy tends to run on a higher octane than Europe's, in the fires of the financial crisis, Europe has arguably become more sensitive to growth. The German economy remains the locomotive for Europe. Exporting about 40% of GDP, Germany is highly dependent on the demand of others.

In addition to the trade channels, recall that in several European countries, including Germany and the U.K., assets of the banking sector were 3-4 times larger than GDP (closer to 50% in the U.S.). Sustained strong growth provides the most conducive conditions to address this. The dynamics of the situation leaves the peripheral countries in Europe highly sensitive to world growth. It is needed to square the circle of fiscal austerity and stabilizing, let alone reducing debt ratios.

It is not just that Europe's problem is larger than appreciated, but its solution may be really smaller. Policy makers and many in the media continue to trumpet the €750 billion rescue fund. We argue that a closer inspection will reveal half the amount. First, the €60 billion the EU was to give is disputed by EU members who do not participate in monetary union (EMU). Second, the €250 billion said to be coming from the IMF is simply a manufactured number. There is no IMF program in place or pre-commitment to give, nor terms negotiated. This is a shill.

That still leaves €440 billion, not an insignificant sum. Yet upon closer examination, it is not likely to be that great either. Consider that the European Financial Stabilization Fund (EFSF) is to issue bonds to raise funds for a troubled member. It wants those bonds to be of the highest investment grade. Yet nearly three quarters of its members do not have such a rating themselves. The solution is to increase the guarantee to issue ratio; in effect, lend less. Reports suggest 20% less.

That reduces the €750 billion "shock and awe" facility to about €350 billion. A sum that if first announced would have likely underwhelmed investors, who in turn, would have taken out their disappointment on European asset markets. Should there be a renewed crisis in Europe, this amount could very well prove insufficient.

The combination of tighter fiscal policy looming, an increase in money market rates and a reduction of the amount of easing coming through weakness of the euro, warns that the spurt of growth in Q2 is unlikely to be sustained.

**Back to the USA**

The pace of the U.S. economy in Q4 '09 and Q1 '10 was not expected to be sustained by even the optimists. The inventory cycle would run its course. Fiscal stimulus was finite and was, in any event, diluted by the cuts in state and local spending; so that overall government spending was already a drag on growth in Q1. Yet the pace of the slowdown was unsettling to say the least. Fear of a double dip grew and there is widespread talk of a second round of asset purchases by the Federal Reserve.

The surprisingly poor July durable goods data may have very well marked the nadir of pessimism. The stronger than expected August ISM manufacturing report and the above consensus jobs report, coupled with back month upward revisions may be the first convincing evidence that the economic expansion is continuing. Financial conditions are improving on the margins and money supply growth appears to have picked up recently.

There was an import surge of historic proportions in Q2. The more than 30% annualized pace of growth in imports is an outlier. It seemed to have been exaggerated by the end a Chinese export subsidy scheme (VAT rebate) in mid-July. Of course, this needs to be monitored in the coming months, but that outsized drag on growth will not be repeated.

The combination of stronger Q2 Australian GDP and firm Chinese PMI (snapping seven consecutive declines) followed by the better than expected U.S. employment report may have initially weigh on the dollar as risk-taking rises.

Investors have shown a clear preference for fixed income and emerging market, especially Asian equities. However, with European challenges are poised to overtake the U.S. economy as the most urgent issue for investors. While there is key support for the euro in the $1.2580-$1.2600 area, a break could trigger a move back toward $1.2300. Sterling may fare better if the focus was exclusively on the EMU sovereign woes, but it also seems as if the UK economy has hit a soft patch. Sterling can fall toward $1.51 and possibly $1.49 in the come weeks. To the yen and Swiss franc it might not matter what is the focus of the market's angst, angst itself is sufficient to underpin them.

**Marc Chandler**

**Global Head of Currency Strategy**

**For more information, please contact our Currency Strategy Team:**
Marc Chandler, Global Head of Currency Strategy, 1.212.493.8800, marc.chandler@bbh.com
Mark McCormick, 1.212.493.8744, mark.mccormick@bbh.com
Jon Wetreich, 1.212.493.8543, jon.wetreich@bbh.com
Win Thin, 1.212.493.8867, win.thin@bbh.com