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Thoughts on the Euro, Sterling and Yen

Euro: When the range breaks it could really break.

The euro has again frustrated the bottom pickers and the perma-dollar bears. It has again been turned back after flirting with the upper end of its month long trading range. This time it was concern that Europe appeared increasingly divided over whether there should be a regional solution or should the experienced IMF play a leadership role to the deficit/debt issues of members like Greece.

The trading range that has prevailed has corrected the technical over-extended condition created during the euro's 17 cent-3 ½ month decline from late November through early March. This is evident on stochastic and MACD's. On the other hand, market positioning and sentiment suggest a bearish view is well entrenched.

Medium term investors should take on the attitude of the state of Missouri, the Show Me State, when it comes to the euro. We should assume the ranges hold until proven otherwise, rather than to believe the breakout is imminent. It means as long as the euro is between roughly \$1.3500 and roughly \$1.3800, it has gone nowhere. Pay attention when the range is broken, but look for some confirmation, like a close of the NY session above the top end of the range, giving it some play.

Indications from the options market is that we might not have much longer to wait. Three month implied volatility has been trending lower since the euro peaked in late November. In recent days it has fallen to about 10%, a level not seen since Lehman's demise. Like a spring coiling, it tends to precede a large spot move.

The take away for medium term investors is that when the range does break, the technical conditions in the market suggest it could be a sufficiently large move that even those that regard the currency more passively would want to take into account. While we have a dollar positive outlook on the medium term, short-covering could see the euro rally a few cents first.

Sterling: Too Many Negatives to Trust Valuation Models

The British pound began the month of March with a 4 cent decline. It exhausted the selling pressure and sterling has spent the time since then recovering. The move has been sufficient to get the 5-day moving average to cross above the 20-day moving average, which is often a useful guide of the near-term trend, and thus encouraging some bottom picking.

Much bad news has been discounted by sterling's slide. And the negativity toward it may be illustrated by the fact that the net speculative position at the IMM has been short sterling since August 2008. Talk about a crowded trade. This net short position was a record in early-March.

Of the major foreign currencies, it may be the cheapest on valuation models, like purchasing power parity and fundamental equilibrium exchange rates. This may seduce some medium term investors to take another look at this beaten up currency.

The BOE has stopped buying gilts and the UK gilt market has generally under-performed. The yield on the UK 10-year gilt is comparable to the yield in Spain and Italy, just below 4%. A year ago, the 10-year gilt yield was around 140 bp less than Italy and almost 120 bp less than Spain. A year ago the UK paid a lower yield than Germany. Today it pays 83 bp more.

The risk lies in the direction of further under-performance of gilts in the period ahead. There is an unquantifiable risk that the BOE can resume its gilt purchases. Even though the currency is typically less important for equity investors than fixed income investors, maybe in this particular case, UK equities may be preferable to the bonds. The FTSE is the second best performing major equity market this year, close behind the US. Talk of cross-border M&A activity and new investment in UK real estate by foreign funds that helped buoy sterling lately may also have equity market implications.

The risks to sterling are considerable, and just like it was rich to valuation models for a number of years, it may have to trade cheap to value, to coin a phrase, for an extended period. The risks include the still real possibility of a hung parliament with a quirky Liberal Democrat Party positioned as the kingmaker, so to speak.

We have long argued that the lack of strong leadership exacerbates the difficulty in dealing with the unprecedented crisis. This is particularly true now in the UK. There is also a risk that if the next government does not put together a more convincing plan that addresses the fiscal challenges it may lose its cherished triple-A rating. And if it does put together a convincing plan, it risks a shock to the still fragile recovery.

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Sterling has largely met a retracement objective from its most recent leg down that began above \$1.58 on February 17th. A move above \$1.5450 could spur an advance back toward \$1.5800. Support now is pegged near \$1.5000. A break of \$1.50 could be an early indication of a retest of the month's lows below \$1.48.

Yen: Fundamentals are Poor

While the US and UK wound down their quantitative easing, the Bank of Japan just extended theirs. Reluctantly the BOJ doubled the size of the special three-month fixed rate facility announced in December. Japanese banks had largely used up the initial JPY10 trillion announced and there are some other liquidity measures that are due to roll-off soon.

The BOJ's balance sheet is likely to continue to expand at better than a 10% annualized rate while the Fed balance sheet stabilizes and may even shrink in the coming months. The BOJ's balance sheet is more than half the size of the Fed's, yet the Japanese economy is roughly a third of the US economy. And don't forget that the BOJ is committed to buying JPY1.8 trillion (~\$20 bln) of government bonds a month.

While it is true that dollar LIBOR is trading above yen LIBOR for the first time since last August, we do not put much stock in that. The spread is too small (less than a couple of basis points annualized) to be of much significance. But the kernel of value in that observation is that short term US rates are rising and although rumors on March 18th proved for naught, another 25-50 bp increase in the US discount rate seems likely in the period ahead.

The combination of the interest rate differentials and the relative slopes of the yield curve provide a powerful incentive for Japanese investors to continue to export capital. As one Japanese bank told its clients, a Japanese investor can buy the 30-year US Treasury bond, hedge out the currency and still secure a yield twice that of a comparable JGB.

Japan is the only major industrialized country still experiencing deflation. Consumer prices have fallen for eleven consecutive months and the Q4 deflator of -2.8% was a record. The appreciation of the yen adds to rather than offsets the deflationary forces. Yet we think the risk of intervention remains infinitesimal.

We have argued that the threat of intervention mentioned recently by both the prime minister and the finance minister was really aimed at the internecine bureaucratic struggle with the BOJ. At issue is deflation and how to best combat it. The DPJ, like the LDP before it, wants the BOJ to do more. The threat of intervention was meant to remind the BOJ who ultimately calls the shots. Implied (three-month) volatility is at its lowest level since September 2008 illustrating the orderly nature of the market. Ironically it is precisely the low volatility that is conducive for carry-trades. The risk-reversals, which often are skewed in favor of yen calls currently price in the smallest premium for yen calls (over yen puts equidistant from the forward strike) since early 2007, pointing to no major imbalance.

Exports are growing and the current account surplus is expanding. Although the yen is rich compared to valuation models, but it is not extreme, nor is it the most over-valued of the major currencies. We also note that over recent decades it appears that PPP has moved toward the prevailing dollar-yen exchange rate rather than the other way around. In any event, there does not appear to be a compelling case for intervention to weaken the yen.

The risk is that the yen may strengthen ahead of the fiscal year end. However, our reading of the fundamentals suggests the yen may come under renewed pressure as the new fiscal year gets under way. Look for dollar pullbacks toward JPY89.00-JPY89.50 as low risk opportunities to sell the yen.

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