SPECIAL FX

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The United States and Norway

It is a study of contrasts. About midway through the 24-hour trading day on Wednesday, 23 September, the Norwegian central bank announced that although it had considered raising its key rates, it decided not to. A few hours later, the Federal Reserve announced that not only would rates be left on hold, it anticipates the economic conditions that will allow its target rate to remain exceptionally low for an extended period of time.

Norway

This contrast may prove to be more dollar negative than krone positive. Outside of Australia and New Zealand, and allowing for the quirk in Denmark, which is unwinding last year's interest rate defense of the krone, Norway's short-term rates are above the other G10 countries. Norway's deposit rate is set at 1.25% and its lending rate is set 100 bp higher. In order to get 1.25% yield from the US Treasury, one would need to go out three years on the yield curve.

Since Norway's rates are already near the upper end of the G10, a rate hike before the end of the year, which looks likely though the ultimate decision seems highly data dependent, would not really change things very much. The krone has already rallied 20% against the dollar this year, having lost nearly 24% of its value in H2 09.

Investors already knew that last year's sell-off was overdone, oil prices have firmed, the Norwegian economy appears to be among the strongest among the major industrialized countries and policy makers have adopted a more hawkish tone of late.

Krone Valuation Stretched

While the US, the euro zone, Japan, and China are experiencing deflation as measured by a year-over-year decline in official measured consumer prices, Norway's headline inflation is running at a 1.9% year-over-year pace and the core rate stands at 2.3%. The mainland economy, which excludes the North Sea oil production, expanded in Q2, and appears to be entering a fairly typical cyclical upturn.

Over the past twenty years the dollar-krone exchange rate deviated from the OECD's measure of purchasing power parity by a maximum of 40% in 1990 and again in 2007. The OECD calculates the PPP annually. But if we make some reasonable assumptions, given the inflation differential (Norway's inflation is just below 2%, while headline US is about -1.5% year-over-year), the PPP level that OECD calculated last year may have shifted toward a somewhat higher dollar, but even allowing for this, the krone is probably still near 40% over-valued.

This does not mean one should buy the dollar and sell the krone. It does suggest on a valuation basis, the krone is historically rich. While momentum players may still want to participate in the long krone position, medium term investors that emphasize value may want to take the krone's over-valuation into account when trying to calculate expected returns on Norwegian investments.

Feeding the Fed

In the days before the FOMC meeting, the Federal Reserve allowed word to leak out that it was talking with dealers about reverse repurchase (repos) operations, under which it sells bills to its counterparties in exchange for a fixed period of time as one way to absorb some the liquidity. It is one of the tools that Bernanke had previously mentioned.

Some might take issue with the use of "allowed", but surely the Fed could have insisted on strict confidentiality if it had wanted. The discussions are said to be largely about technical issues like ensuring that the bilateral trading lines were of sufficient size and that sort of thing.

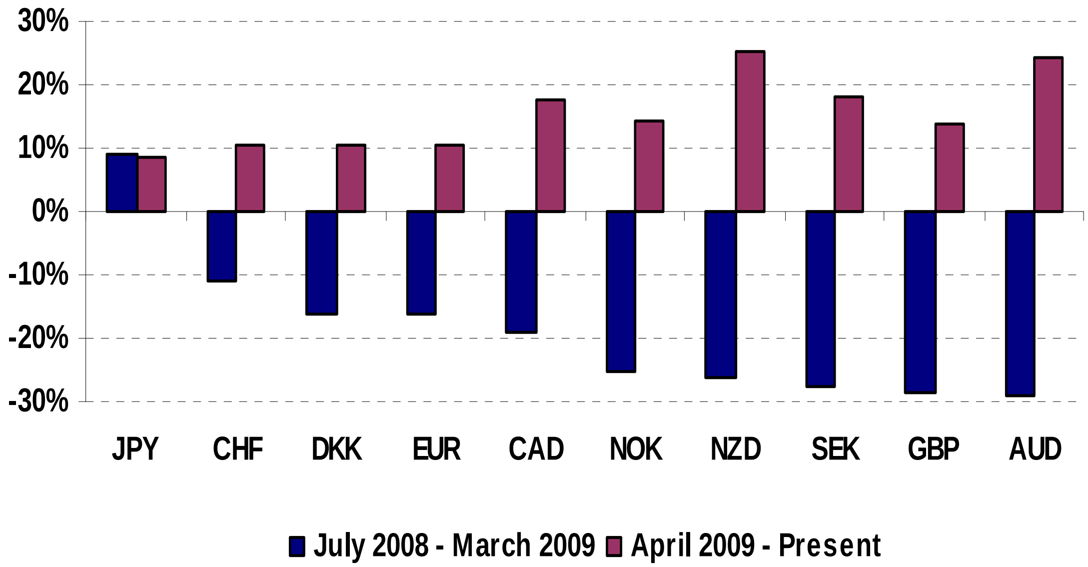
In any event, the statement after the FOMC meeting provided no hint of such an exit strategy and instead confirmed market expectations that it would stretch out the time it would take to finish the mortgage-backed securities and Agency bond purchases until the end of Q1 2010.

The FOMC was clear that despite the improved prospects for growth, the inflation environment remained benign. Indeed, by continuing to recognize the "substantial resource slack", the FOMC appears to retain a downside risk to its inflation. In this context then it makes absolute sense that it envisages that economic conditions would allow Fed Funds to remain at "exceptionally low levels" for "an extended period of time."

Dollar Implication

In word and deed, the Federal Reserve and US Treasury officials do not appear to have any great concerns about the dollar's decline over the past six months. Their benign assessment may be influenced by two considerations. First, the dollar's decline in the past six months can only be understood in the context of its dramatic rally in H2 08 through Q1 09.

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791



Source: Bloomberg/BBH

Second, and arguably more importantly, the dollar's decline reinforces the Fed's stance. That is to say a decline in the trade-weighted dollar is consistent with accommodative monetary policy. On the other hand, dollar appreciation would offset part of the easing of monetary policy and in this sense would be counter-productive.

Third, what this means is that the dollar's decline is fundamentally driven. Combined with the orderly nature of the price action in the foreign exchange market, this in turn means that the calls for the G7 coordination to support the dollar are misplaced. The absence of will is unmistakable.

This is not just a descriptive claim, but a normative one as well. The G7 should not intervene in the foreign exchange market. The only thing worse than intervention is failed intervention and the odds of success seem particularly low, with US interest rates so low in absolute and relative terms.

The mirror image of the dollar's weakness is the strength of the foreign currencies, but where is the case for intervening? The euro has appreciated a little more than 5% thus far in 2009 and the Japanese yen is off by about 0.5%. Yes, some countries like New Zealand and Canada have noted that their currencies strength (24.6% and 12.3% year-to-date) may hinder their recoveries. Yet the key to understanding the economic impact of currency movement is a trade-weighted index not the bilateral exchange rate and on that metric, the Canadian dollar is about 5% lower than a year ago. On a trade-weighted basis the New Zealand dollar is about 1% stronger.

Given the price of goods and services move much slower than the price of financial variables, such as currencies, it seems far too early for the recent appreciation of the Canadian and New Zealand dollars to impact their real economies. And even if they were, there are other policy tools that can be deployed more efficiently than intervention.

Conclusion

The cyclical pressure on the dollar stemming from low interest rates is set to continue., Although the Fed is winding down some of its emergency liquidity facilities, it is not inclined to lift the Fed funds rate from its "the Titanic hit an iceberg" setting of 0-25 bp for at least a couple more quarters.

Looking at the FOMC's historical performance, it is unreasonable to expect the Fed to tighten policy before unemployment peaks. Surveys of economists find a consensus expects unemployment to peak in the first quarter next year. The market need not wait for the Fed to tighten policy. The dollar will likely be bought as soon as the Fed begins preparing the market for that eventuality.
In the mean time, many foreign currencies will be approaching extreme over-valuation levels measured by the OECD calculation of purchasing power parity. This will present patient medium term investors with an opportunity to implement mean reverting strategies that anticipate a move back toward PPP levels.

Marc Chandler
Global Head of Currency Strategy