THE OMNIVEST MARKET VIEW

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Central Banks Risk Diverging

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Though Central Banks around the world continue to be biased towards easing, we may be seeing signs that they are not all moving in the same direction. Last week, European Central Bank (ECB) President Draghi stated that Europe is experiencing "positive contagion," a far cry from the European economic environment of 6 - 12 months ago.

The euro has now moved back to the levels last seen in the early spring of 2012, defying almost all forecasts. In fact, the average of 54 forecasters for the euro for the first quarter of 2013 was 1.27, as of November 2012. Today that average forecast has risen to only 1.29. It seems quite clear that investors and forecasters remain negative towards the euro.

Similarly, most forecasters do not believe that the Japanese yen will weaken significantly over the course of this year. To this point, the average forecast is for the yen to weaken in an orderly fashion to 89.00 by the end of this year, as compared to a current price of 88.60. In Japan, both fiscal and monetary policies are designed to weaken the yen and promote economic growth. However, the lack of economic growth in Japan over the last 10 years (real GDP has averaged 0.64% annually) has created a very large pool of skeptics as to Japan's ability to generate reasonable economic activity.

It is this skeptical view that keeps the foreign exchange forecasters from predicting much movement in the yen, despite the vocalized intentions from the newly elected Japanese government to mount a weakening campaign on the yen.

In the US, there is a growing fissure at the Federal Reserve between those that want an early end to quantitative easing versus those that believe in a continuation of current polices. This rather public debate has pushed 10-year Treasury yields from 1.58% in mid-November to nearly 1.90% just a week ago. This upward movement in yields has fostered a stronger US dollar vs. the yen as US/Japanese 10-year yield spreads have widened from 96 basis points (bps) at the start of the year to 107 bps currently.

It is our belief that the yen has substantially more room to weaken and even quite abruptly so, should US economic data continue to surprise on the upside. It is clear from the forecasters that very few, if any, anticipate a material weakening of the yen this year. Consequently, the surprise would be for a meaningful decline in the yen to, perhaps, 115 vs. the US dollar.

If Mr. Draghi is correct in his assessment of "positive contagion", then the path of least resistance for the euro would be much higher than forecasters are currently predicting. A pronounced weakening of the yen and strengthening of the euro would be consistent with a substantial upside move for risk assets.

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