CURRENCYMONITOR

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Currency “Laws”

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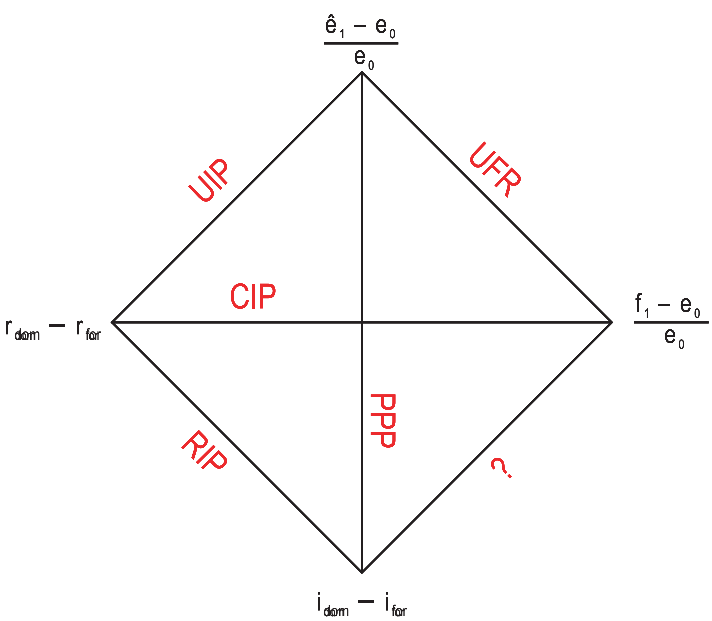
Last month, we introduced a comparison between the action of a desk toy (“Newton’s Cradle”) and two of the laws of the Universe, and how that comparison might work for the “action” of the currency markets and one of its laws.[1]

We wanted to continue the theme of our “occasional”[2] series on how the FX markets “know” their laws by looking at other “laws” in future articles (last time we investigated the “Law of One Price”, aka “strong-form PPP”), but first we wanted to put all the laws we expect to cover in one place for you to see. For that, we’d like to use a diagram first introduced to us by Professor Richard Lyons.[3]



Thanks to:
Professor Richard Lyons
Haas School of Business
UC Berkeley

The glossary for the diagram:

e_0	– Today’s spot rate	PPP	– Purchasing Power Parity
$\hat{e}_1$	– Today’s expectation of tomorrow’s spot rate	UIP	– Uncovered Interest rate Parity
f_1	– Today’s forward rate	CIP	– Covered Interest rate Parity
r_{dom}	– Domestic short-term nominal interest rate	UFR	= Unbiased Forward Rate
r_{for}	– Foreign short-term nominal interest rate	RIP	– Real Interest Parity
i_{dom}	– Domestic inflation rate		
i_{for}	– Foreign inflation rate		

The diagram connects relationships between four measures (spot rates, forward rates, short-term nominal interest rates and inflation). For example, the vertical line labeled “PPP” in the diagram indicates that the “law” of Purchasing Power Parity (PPP) is the connection between relative inflation (i.e. the difference between foreign and domestic inflation rates) and the evolution of spot rates (i.e. the expected change in foreign vs. domestic spot rate).

The specific definition of PPP is that higher inflation in one market[4] relative to another[5] should result in that market’s[6] currency depreciating relative to the other[7]. That was the topic of the last FX Monitor (and the first of this “occasional” series).

Sounds (and looks) pretty straightforward, right?

Note one key feature of the chart. It is setup in such a way that, if two “laws” hold that start from the same vertex (i.e. if

[1] June 2006 First Quadrant Currency Monitor, “The Cradle Will Rock…”.
[2] Which, as we’ve written two in a row so far, could be considered synonymous with “every month”…
[3] Professor Lyons is currently Executive Associate Dean & Coleman Professor of Finance, Haas School of Business, UC Berkeley. http://faculty.haas.berkeley.edu/lyons.
[4] Domestic, for example.
[5] Which would then be foreign, in this example.
[6] The domestic.
[7] Shockingly enough, the foreign.

UIP and CIP hold, both of which start at the "$r_{dom} - r_{for}$" vertex), the third "law" that would complete a triangle (i.e. UFR, in this case, which completes a triangle on the upper half of the chart), must also hold.

Of the six "laws" on the chart (each "law" is represented by a line connecting two of the vertices), we plan on skipping two of them. "RIP" connects relative inflation and relative short-term nominal interest rates, which isn't, strictly speaking, a currency topic. "?" is a "law" which has no name, and connects forward rates and inflation, which we would consider less "interesting"[8] as well.

Returns and Expectations

During the month not many central banks met to make monetary policy decisions, but those that did, chose to leave rates unchanged. Despite the lack of central bank activity, interest rates were active. Short term rates generally increased, while bond rates decreased.

On one end of the cash rate spectrum we have Australian rates increasing by 20bp and EMU rates increasing by 11bp. On the other end, Canadian rates decreased by 15bp and UK rates by 2bp.

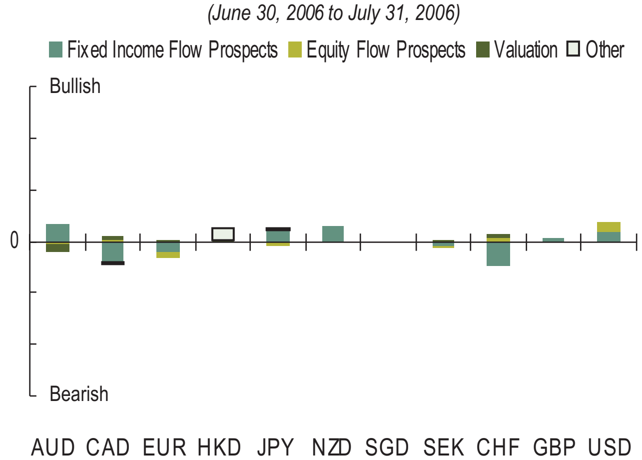
The only two countries with increased bond yields were Australia (6.2bp) and New Zealand (2.4bp). Canadian bond yields decreased by 27.6bp, followed by Sweden (17.5bp), EMU (14.2bp), and the USA (12.1bp).

The equity markets were split. Switzerland (+3.62%) had a strong gain and to a lesser extent, so did Canada (+1.53%) and the UK (+1.26%). These gains easily overcame Australia's (-1.88%) and Sweden's (-1.4%) losses.

The Australia dollar appreciated strongly (+2.88%) over the month, while the Canadian dollar declined (-1.86%). The other currencies were mixed, but relatively small returns.

Change in Factor Contributions to Forecast

(June 30, 2006 to July 31, 2006)

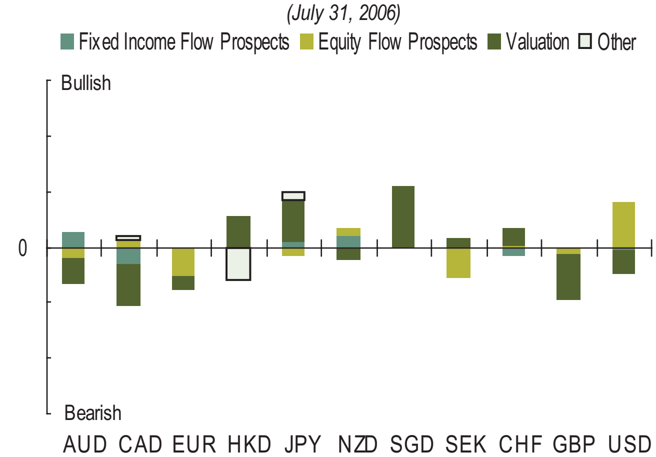


Source: First Quadrant, L.P.

The Japanese yen continues to be the most undervalued currency followed by the Swiss franc and the Swedish krona. The most overvalued currencies are the UK pound and Canadian dollar. Equity capital should seek out the US while avoiding the Euro zone and Sweden. Bond flow prospects remain small now favoring Australia, Japan and New Zealand over Switzerland and Canada. Cash flow prospects are even smaller and see Canada, the UK and New Zealand as slightly unattractive.

Factor Contributions to Forecast

(July 31, 2006)

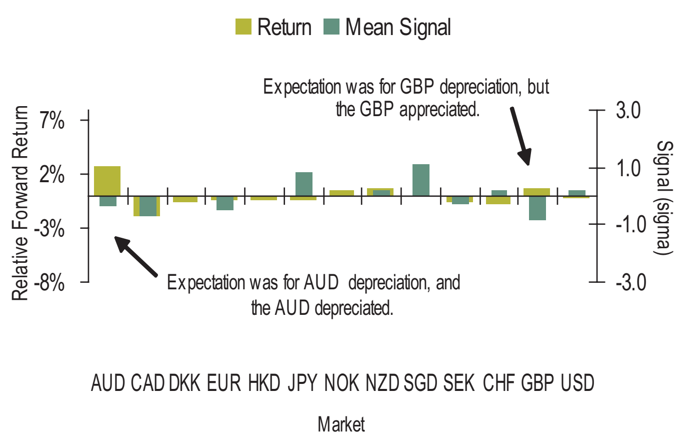


Source: First Quadrant, L.P.

Our currency strategy struggled in July. The only strong factor during the month was the Relative Valuation factor which resulted in a modest loss. There were small gains from the Prospective Equity and Bond Flow factors. Geographically, the strategies only performed well in Canada. Losses were more evenly distributed among Australia, Japan, Switzerland, the US and the UK.

Currency Returns and Expectations

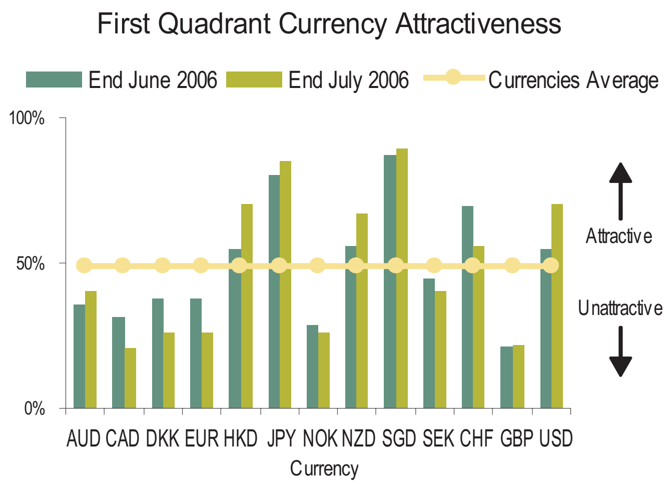
(July 31, 2006)



Source: WM/Reuters, First Quadrant, L.P.

[8] Pardon the pun.

In July our models continued to see more opportunity, causing positions to grow. The EMU and Canadian dollar short positions as well as the US and New Zealand dollar positions have increased. As a result, the Canadian dollar has now just surpassed the UK pound as our shortest position. The Japanese yen is our longest position with the US dollar close behind.



Source: First Quadrant, L.P.

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