

## Let's Get a Quick Bite at the Exchange

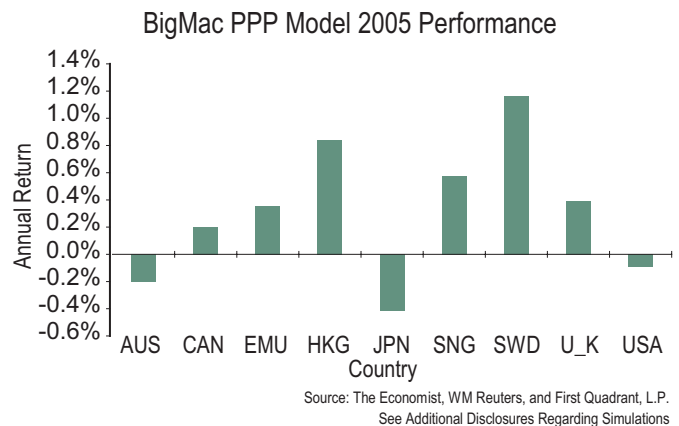
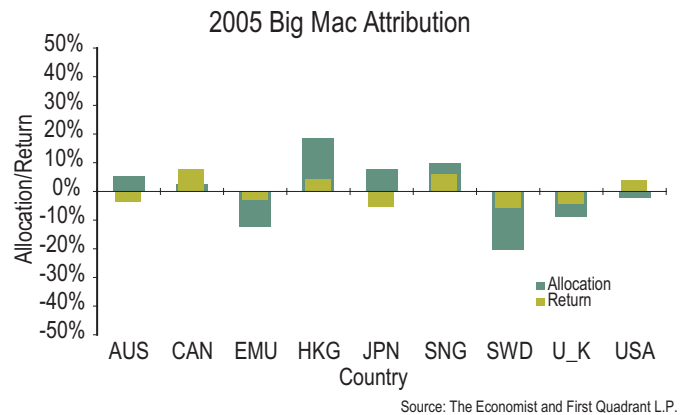
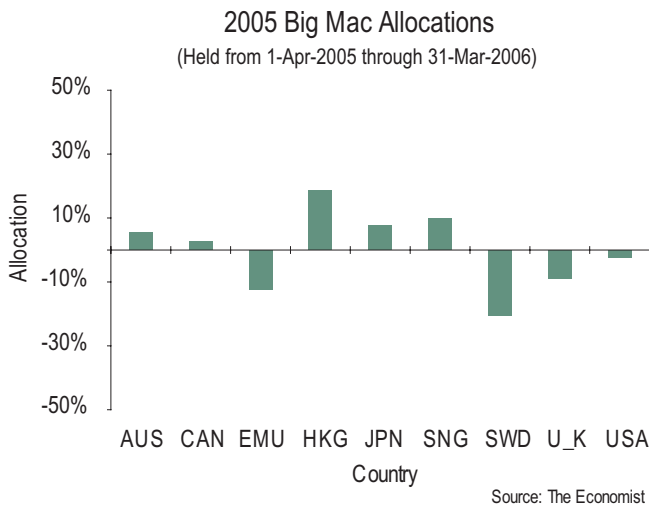
Ghene Faulcon

It is now that time of year again when we shop for a cheap meal. A year has gone by since the last update of the Economist's Big Mac Index<sup>1</sup> and since they have updated the index we can finally update our quirky Purchasing Power Parity Model. We will also look at how well we did last year.

We shall begin once again by highlighting the basic idea of Purchasing Power Parity. The prices in two different countries of the same item should be the identical once converted to the same currency. Since this is rarely the case, we work on the premise that there will be convergence of the prices through changes in the exchange rate. We must recognize however that this convergence could also occur through changes in prices.

Last year we continued to have a strong preference for the Hong Kong and Singapore dollars – the pegged and managed currencies in our portfolio. In addition, we disliked the Swedish krona and the euro.

inside this happy meal are the returns we received from Swedish Krona and Hong Kong dollars. Overall it was a good year to trade in Big Macs earning a return from most countries. In total our 2.82% return was a better return than the average year.



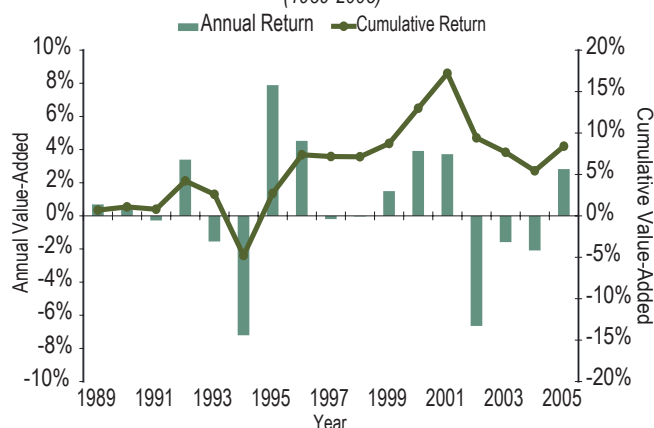
### Did we get a happy meal or just a burger?

The 2005 Big Mac portfolio was a successful one for us. We had only three small disappointments. The US, Japanese and Australian currencies all moved against our positions. The prizes

We have improved our overall long term results to a cumulative 8.4% (0.48% annualized). We have achieved this with only 3.83% tracking error. This means that we have a 17 year annualized IR of 0.14. Though this is not a fantastic result, it is still good performance for such a crude model.

<sup>1</sup> BigMac Index can be found on the Economist website at <http://www.economist.com/markets/bigmac/>.

Big Mac PPP Model Value-Added  
(1989-2005)



Source: The Economist, WM Reuters, and First Quadrant, L.P.  
See Additional Disclosures regarding simulations

### Is this really fast food?

Our model by its very nature tells us how much profit potential there is for our portfolio. So how much of this potential did we realize? If all of the currencies moved to fair value over the course of the year, we would have earned 28.5% return. In reality, we earned one tenth of this total. At this rate we would need 10 years to fully capture the potential in the model.

Does our profit mean that we are closer to purchasing power parity? No, we are not actually closer to parity. In reality we are nearly 10% further away from parity on average. Last year, each currency was on average 23% away from fair value, but now currencies are 25% away from fair value. Instead of having just the exchange rate movements – which we were trying to predict – we also have changes in the price of Big Macs – which we know can happen, but cannot profit from.

Country	Under (-) / over (+) valuation against average Big Mac 2006	Under (-) / over (+) valuation against average Big Mac 2005	Change in valuation 2005 to 2006	Exchange rate change 2005 to 2006	Price change of Big Mac in local currency 2005 to 2006	Combined price change and exchange rate change
Australia (AUD)	-17.60%	-11.50%	-6.00%	-4.70%	1.60%	-6.30%
Canada (CAD)	6.00%	-6.90%	12.90%	8.20%	-5.40%	13.60%
Euro Area (EUR)	26.90%	26.70%	0.20%	2.30%	1.30%	0.90%
Hong Kong (HKD)	-47.80%	-45.50%	-2.30%	-0.60%	2.80%	-3.40%
Japan (JPY)	-24.70%	-17.20%	-7.50%	-7.30%	1.50%	-8.80%
Singapore (SGD)	-23.60%	-23.20%	-0.40%	2.60%	2.40%	0.20%
Sweden (SEK)	52.90%	47.60%	5.30%	0.20%	-4.40%	4.60%
United Kingdom (GBP)	23.00%	21.70%	1.30%	1.10%	-0.80%	1.90%
United States (USD)	4.60%	8.30%	-3.70%	-1.80%	0.90%	-2.70%

Source: The Economist and First Quadrant, L.P.

The changes in the prices of Big Macs are the inflation in our one product world. This illustrates that it is important to track the inflation as well as the change in the exchange rate. This combination results in the total movement towards or away from fair value.

Country	Big Mac price in local currency	US dollar price	Implied PPP of the US dollar	Foreign exchange rate	Under (-) / over (+) valuation against US dollar	Under (-) / over (+) valuation against average Big Mac 2006
Australia (AUD)	3.25	2.44	1.05	1.33	-21%	-17.60%
Canada (CAD)	3.52	3.14	1.14	1.12	1%	6.00%
Euro Area (EUR)	2.94	3.77	0.95	0.78	21%	26.90%
Hong Kong (HKD)	12	1.55	3.87	7.75	-50%	-47.80%
Japan (JPY)	250	2.23	80.65	112	-28%	-24.70%
Singapore (SGD)	3.6	2.27	1.16	1.59	-27%	-23.60%
Sweden (SEK)	33	4.53	10.65	7.28	46%	52.90%
United Kingdom (GBP)	1.94	3.65	0.63	0.53	18%	23.00%
United States (USD)	3.1	3.1	1	1	0%	4.60%
Average Big Mac	1	2.96	0.32	0.34	-4%	0%

Source: The Economist and First Quadrant, L.P.

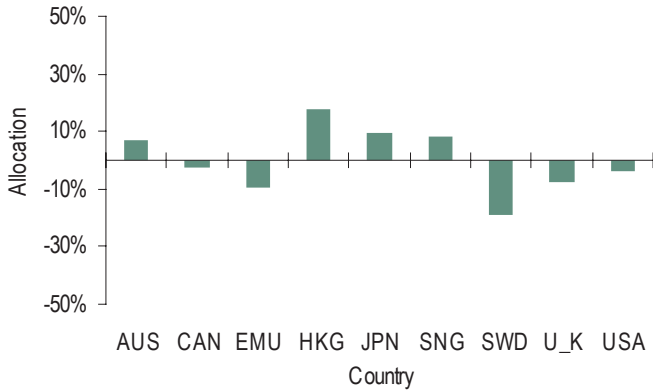
### What's on the menu today?

Our new Big Mac portfolio really doesn't look that different from last year's portfolio. The only major difference is the reversal of our Canadian dollar position from long to short. Overall the message is still the same – If you live in Sweden and you love your burgers, pack your bags and go to Hong Kong; you'll pay 1/3 of the price.

<sup>2</sup> An increase in the price of a Big Mac means a weakening of the currency. Therefore, changes in prices contribute negatively to the change in over or under valuation.

**2006 Big Mac Allocations**

(To be held from 1-Apr-2006 through 31-Mar-2007)



Source: The Economist

**Returns and Expectations**

In May, Australia, Canada and the United States continued the trend of tightening monetary policy each raising rates by 25bp. The ten remaining central banks either made no policy changes or did not meet.

Cash yields around the developed world on average rose by almost 9bp, with Japan leading the charge with a 21bp increase. New Zealand (-5bp) was the only developed country with a freely floating currency that had cash rates decline.

Long-term yields, however, were much less uniform actually decreasing by about 0.5bp on average. The greatest gain in bond yield was posted by the US (4bp). Despite having the largest increase in cash yields, Japan had the largest decrease in bond yields (10.5bp).

May was a very tough month for equity markets around the world. All of the developed markets suffered losses, on average

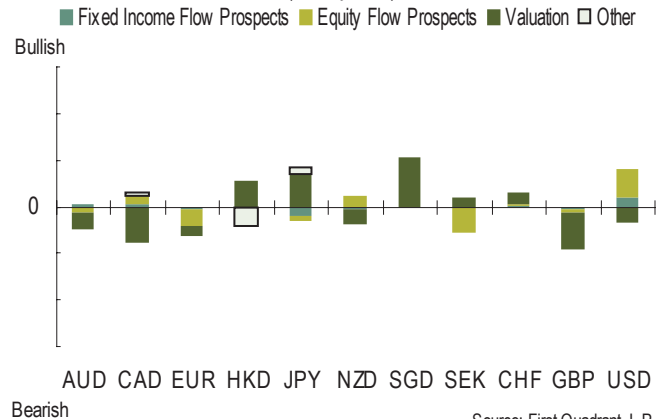
losing 6%. The smallest loss came from the US where equities declined 3%. The largest loss of 9% came from Sweden.

The currency markets were saw mostly modest changes. A few currencies did however make some significant moves. The depreciating currencies during the month were the AUD (down 2.44%) and the NZD (down 1.69%). The GBP (up 1.34%) and the SEK (up 1.27%)

We find the British pound and the Canadian dollar most overvalued currencies in the developed world, followed by the Australian and New Zealand dollars. The Japanese Yen continues to be the most undervalued currency of the “floating currencies” followed by the Swiss franc and the Swedish Krona. Prospective equity flows are expected to be strongest into the US and moderately into Canada, and strongest out of the EMU and Swedish equities. Prospective bond flows are expected to be strongest into the US bond market, and strongest out of the Japanese bond market.

**Factor Contributions to Forecast**

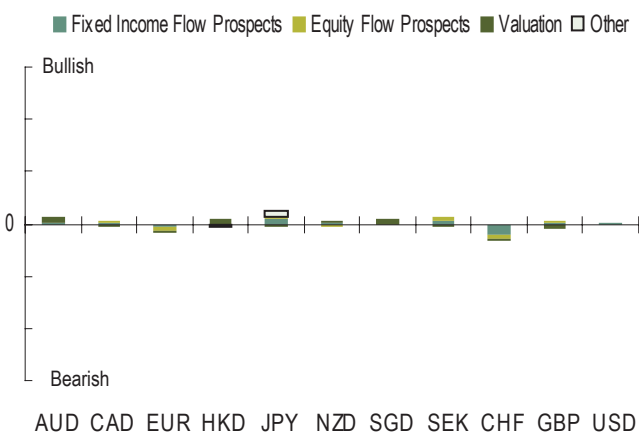
(31-May-2006)



Source: First Quadrant, L.P.

**Change in Factor Contributions to Forecast**

(30-April-2006 to 31-May-2006)

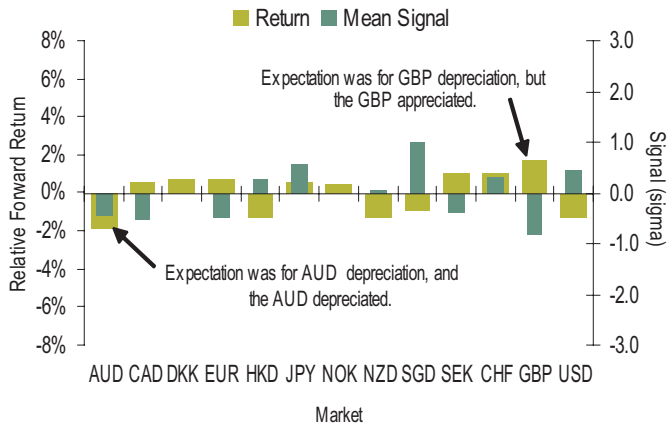


Source: First Quadrant, L.P.

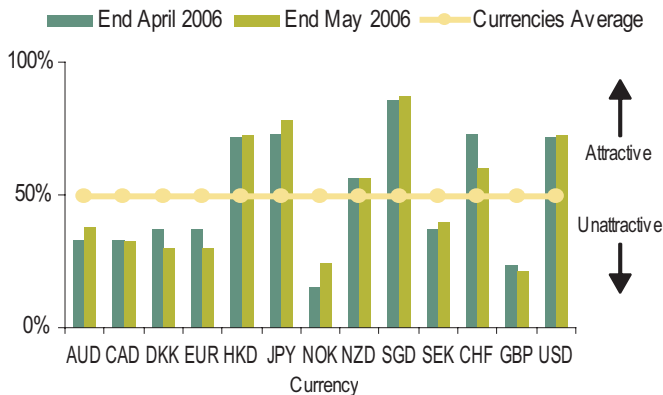
May was a month of moderate losses in an environment of increased currency market volatility. There were a few bright spots in the form of the Swiss franc and Canadian and Australian dollar positions. Losses from our positions in the UK pound and the New Zealand dollar were however more typical during the month. (See Currency Returns and Expectations chart on next page.)

During May, positions generally grew slightly, with the short euro and long Japanese yen positions growing the most. The notable exceptions were the significant decreases in the Swiss franc long position and the Australian short position. Overall, these movements leave us with the Japanese yen as our longest position followed by the US dollar and the Swiss Franc. Our shortest positions are the UK pound, the euro and the Canadian dollar. (See Currency Attractiveness Chart on next page.)

**Currency Returns and Expectations**  
(May 2006)



**First Quadrant Currency Attractiveness**



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