FXMonitor

Sailing With Currencies...Again

By Dori Levanoni

Before we start this month's FX Monitor article, a brief apology is in order. Typically, the April FX Monitor (published in May) contains our update of our (in)famous "Big Mac" study. Last year we were forced to delay publication of that update by a month, as the Economist magazine (the source of the raw data) did not publish the data until late May. As of May 10th this year, we are still waiting for the data, and so we expect to provide that update next month.

A couple of years ago, we wrote[1] about some "picturesque" descriptions of the behavior of the Currency Markets, using words like "choppy", "trending" and a favorite of some market prognosticators, "directionless".

We attempted, in that article, to define a bit more quantitatively what those words might actually mean, and how they might have applied to the recent past. Since we have seen those words in print again recently (in particular, describing the currency markets in 2004), we thought it might be time for an update of that article.

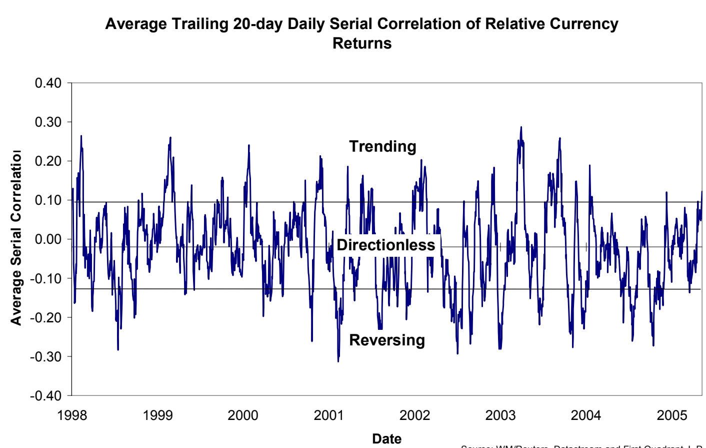
In the text below, we use the term "serial correlation". Serial correlation is the correlation of a series with itself (in the case below, lagged by one day). In other words, we are asking, "over the last 20 days, how does yesterday's return compare to today's return?" If they were identical, we would measure a serial correlation of 1.0. If, instead, it were exactly the opposite (i.e. –2% today as compared to +2% yesterday), we would measure a serial correlation of –1.0.

From that original article, our descriptions of the market were:

In more quantifiable terms, a "choppy" market is one that has low or negative serial correlation. The opposite, therefore, of "choppy" would be those markets with high serial correlation. Within that definition, however, are two more subsets of market behavior. Those markets with low serial correlation might be described as "directionless", while those with negative serial correlation are "reversing". To complete the picture, high serial correlation markets are "trending".

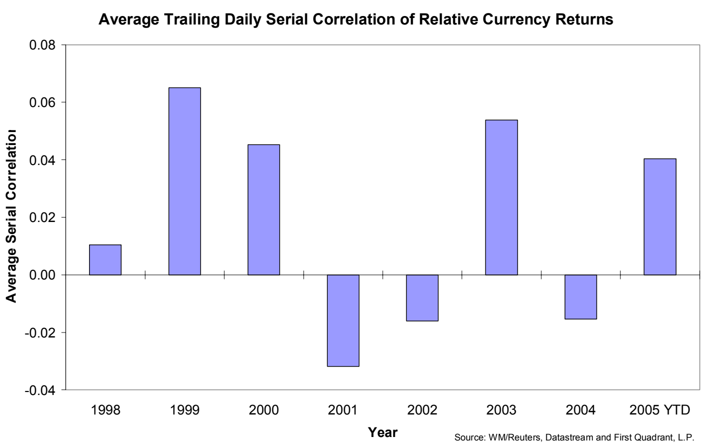
One last explanation is necessary before going to the chart. We looked at *relative* currency returns in the study. Now, currencies are, by definition, already "relative", but most commonly they are quoted relative to a particular currency (such as the US Dollar). The problem is, of course, that the US Dollar is always worth exactly one US Dollar. Hence, it never appears to move. Instead, we are quoting each currency relative to the World Currency Basket[2], which allows us an equal view on each currency.

Using those definitions, then, here is what the last eight years have looked like[3] in the currency markets:



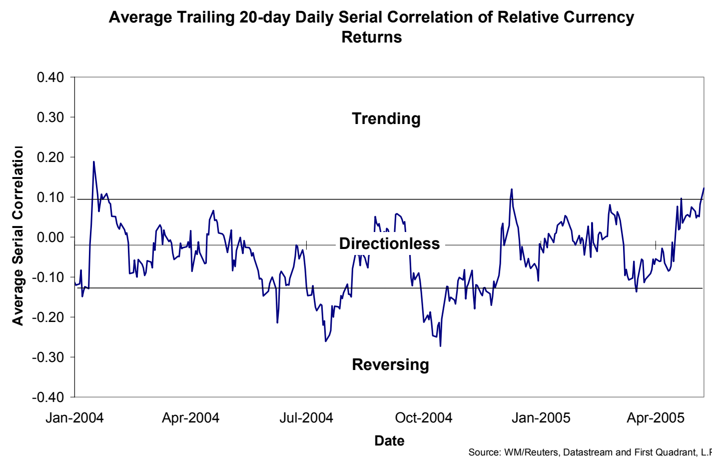
It does appear that 2004 has a few periods of strong reversals, and one period of trending, with much of the year spend on the "reversing-side" of directionless. It is, however, a bit difficult to characterize the whole year without looking at comparisons with other years as well.

To that end, we have looked at the same data on an annual basis (still looking at daily market movements, however). Rather than using 20 days of daily returns, however, we looked at the serial correlation over the whole year (i.e. approximately 260 days of daily data per year).

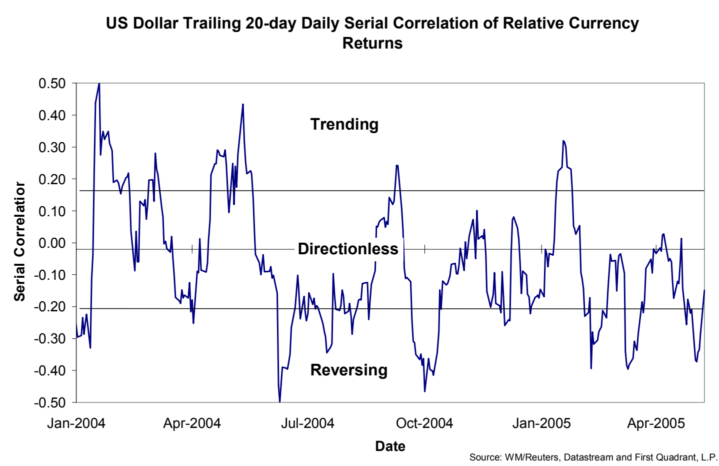


2004 does appear to be a bit more on the "reversing-side" of directionless than most other years (except for 2001), particularly compared to 2003 and the first few months of 2005.

Finally, we can "zoom in" on the last 16 months (from Jan-2004 through Apr-2005). The "directionless" or even "reversing" nature of 2004 is a bit more apparent, particularly the strongly "reversing" market conditions seen in May, from mid-June through mid-July and again from mid-September through mid-October. It is during the month of November that the markets shifted quite rapidly into a "trending" market, and have generally been "directionless" since, until this month.



In April 2005, we have finally seen a "trending" market again…though not in the US Dollar!



Returns and Expectations

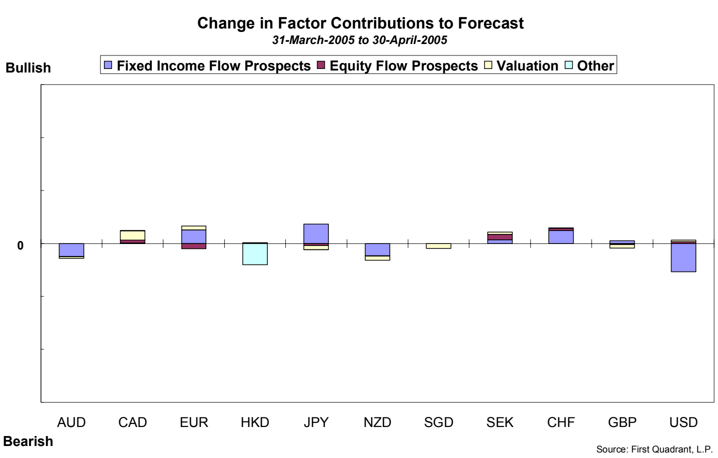
In April, nine different developed market central banks met, and in all ten[4] meetings, chose to leave monetary policy in each of their respective markets unchanged.

Cash yields were fairly stable on average (reflecting the quiet central banks, perhaps), with the average cash yield rising by 4bp. US yields rose 12bp, while Australian, Canadian, British and New Zealand yields fell by 22bp, 9bp, 9bp and 7bp, respectively.

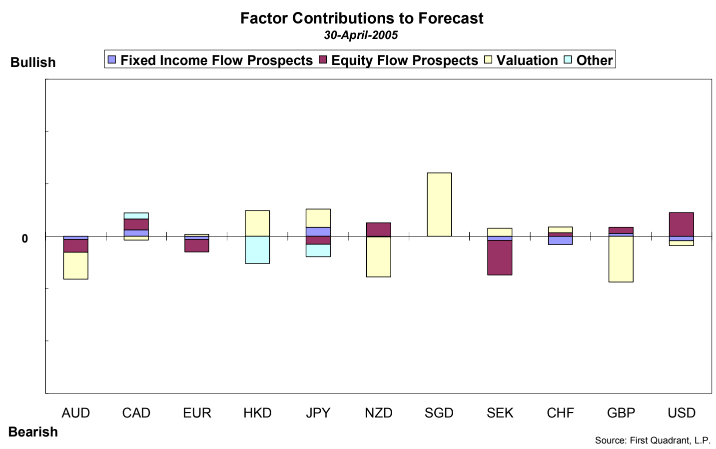
Bond yields were more active in April, falling around the world over the month, with the average bond yield falling by nearly 20bp. US, Australian and New Zealand bond yields fell by 28bp, 32bp and 33bp, respectively, while Japanese fell by only 9bp.

Equity markets had a difficult month, with the average falling by nearly 3.5%. Hong Kong equities were the exception, rising by over 4%. Norwegian equities were the worst performing market in April, falling by nearly 5.5%.

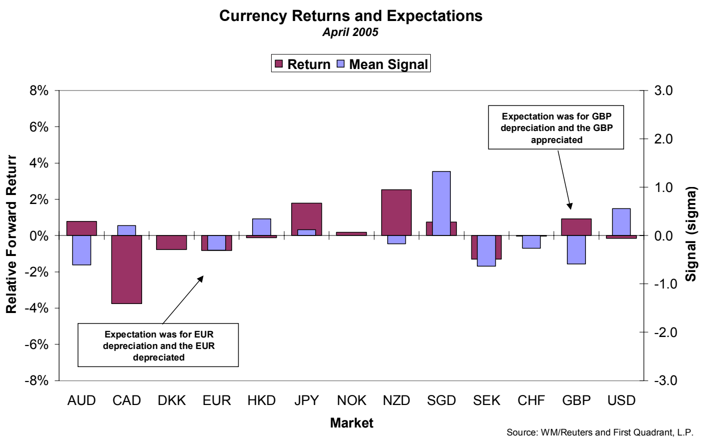
The currency markets were generally quiet, though the Canadian Dollar fell the most (by 3.75% versus the average currency) while the New Zealand Dollar was the strongest currency, rising by 2.5% versus the average currency. It was a quiet month for the US Dollar, down by only 0.15% (again, versus the average currency).

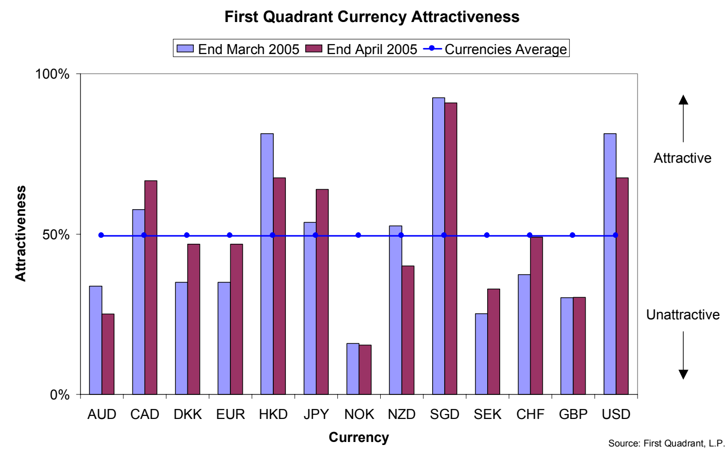


We continue to find the British Pound the most overvalued currency in the developed world, closely followed by the New Zealand Dollar, then by the Australian Dollar. The Japanese Yen continues to be the most undervalued currency of the "floating currencies" (both the Hong Kong and Singapore Dollars are either explicitly 'pegged' or 'managed'), while the US Dollar has moved even closer to fair-value (though it still retains a very slight overvaluation, which is entirely due to the large current account deficit). Prospective equity flows are expected to be strongest into the US and New Zealand equity markets, and strongest out of Swedish, EMU and Australian equities. Prospective bond flows are expected to be strongest into the Japanese and Canadian bond markets, and strongest out of the Swiss bond market.



April was a slightly difficult month, as gains from overweight Japanese Yen and New Zealand Dollar as well as underweight Swedish Krona allocations were more than offset by losses from underweight Australian Dollar and British Pound, as well as overweight Canadian Dollar and US Dollar allocations. Underweight Euro (through mid-month) and Swiss Franc allocations produced essentially zero gains or losses.





Our forecasts changed a bit over the month, as we have become increasing bullish on the Canadian Dollar and Japanese Yen, while becoming less bullish on the US Dollar. At the same time, we have become more bearish on the Australian and New Zealand Dollars (moving from close to neutral on the New Zealand Dollar) and less bearish on the Euro, Swedish Krona and Swiss Franc. We remain bearish British Pound by approximately the same amount.

(Endnotes)

[1] *First Quadrant FX Monitor, "Sailing with Currencies", January 2003.*

[2] *Which is the equal-weighted basket of the AUD, CAD, DKK, EUR, HKD, JPY, NOK, NZD, SGD, SEK, CHF, GBP and USD.*

[3] *We have placed horizontal lines at +1 and –1 standard deviation away from the average to demarcate the three regions of behavior.*

[4] *The Bank of Japan had two meetings in April.*

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