FirstQuadrant

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FXMONITOR

The Great Compression...?

By Dori Levanoni

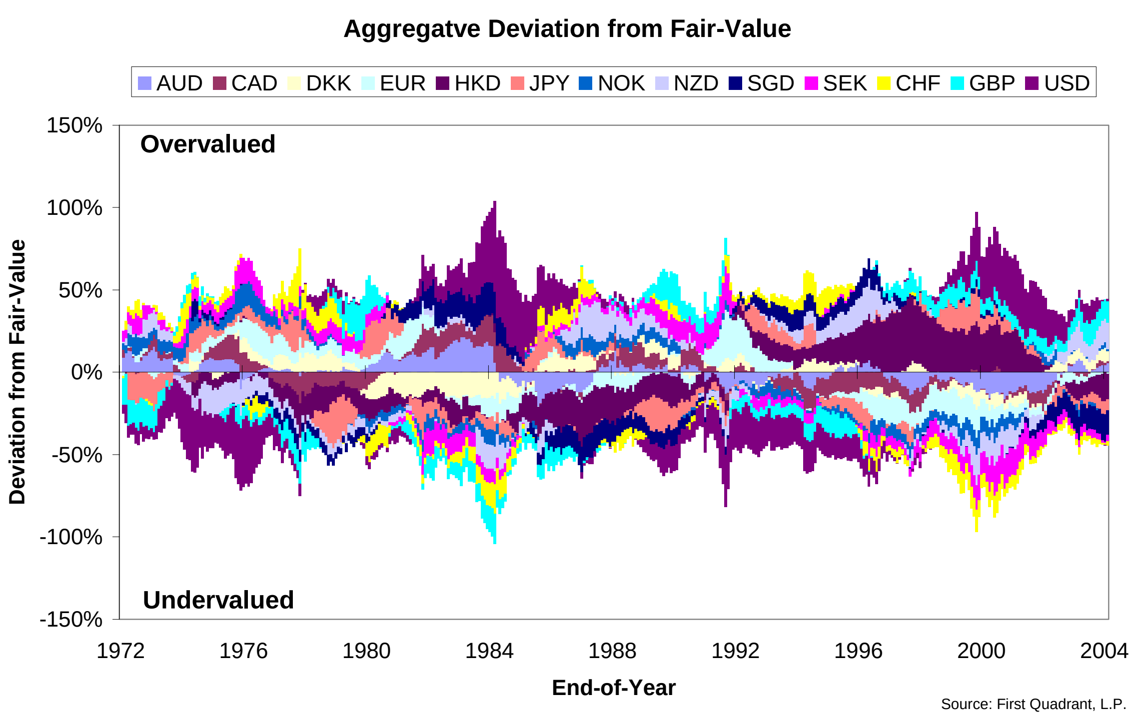
Economic conditions around the World have become more similar, Monetary Policy in most markets looks similar, and even inflation around the world is generally low and stable across most markets. In some ways, differences around the World have become smaller over time, in effect "getting compressed".

One could say the same of currencies. However, instead of thinking of them as moving together[1], we can look at how far they are from "Fair-Value"[2]. Have currencies all generally moved towards their individual "Fair-Values"?

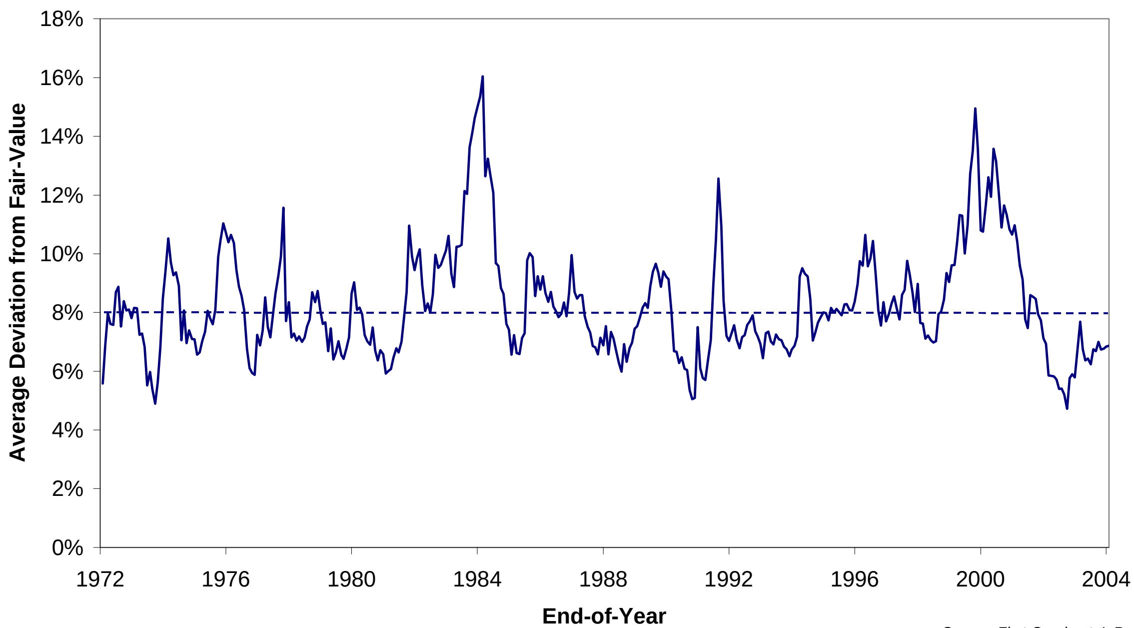
Compressing Fair-Value...

Below we plot the month-by-month deviations from Fair-Value for each currency[3], overlaid on each other as an area chart.

We can certainly see that, since late 2000, average deviations from Fair-Value have certainly decreased, reaching their recent minimum in September 2003. If we plot just size of the average deviation from Fair-Value, the evolution may be a bit clearer as shown in the graph on the next page.



Average Deviation from Fair-Value



Source: First Quadrant, L.P.

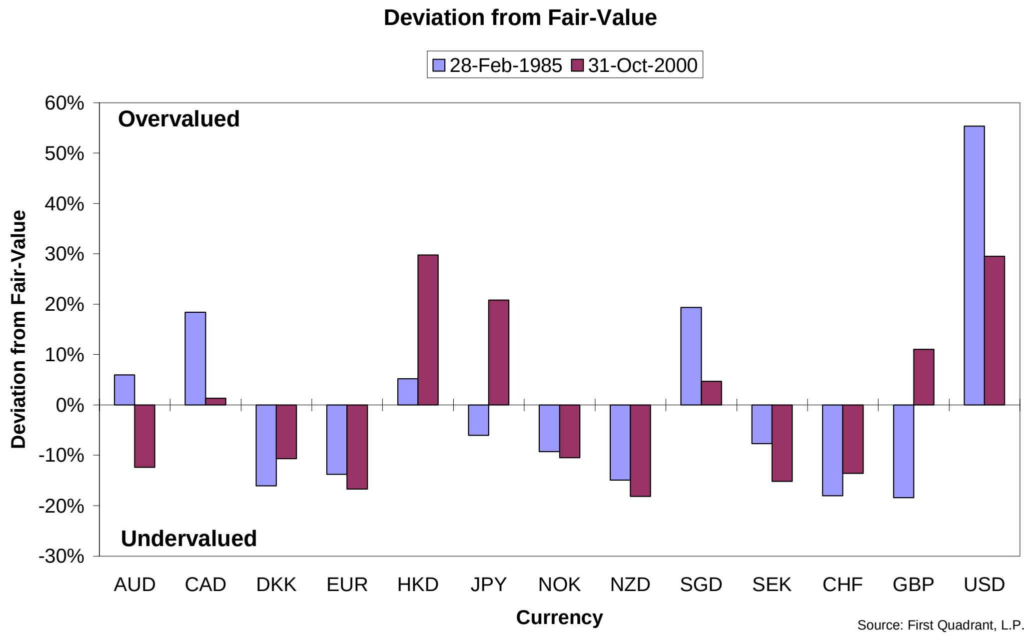
Historic Minimums...

The September 2003 minimum represents not only a recent minimum, but also a historic minimum. The average deviation of 4.73% is the lowest reached in the "modern" (i.e. post-Bretton Woods) era, lower than the October 1991 5.05% or the September 1974 4.89% minimums. "Great Compression" indeed!

We have also plotted the median[4] level of Average Deviation on the chart as a dashed line. It is clear that the drop from the recent peak to the minimum has since reversed slightly, though it is still (as of 31-January-2005) slightly below the median.

Great Expansions...

The maximum average deviation reached just prior to the minimum, 14.95% in October 2000, was the second highest peak reached, only surpassed by the February 1985 peak of 16.04%. The fall from the February 1985 peak was also rather a bit faster than the recent fall from October 2000. One might attribute that to the Plaza Accord[5], but note that the Accord was signed on September 22, 1985, well after the mean-reversion had begun. That may simply indicate that the global economic and monetary pressures on the currency markets had already begun the "compression" sought by the policy makers, we will leave that to a graduate course in economics and not this short commentary.

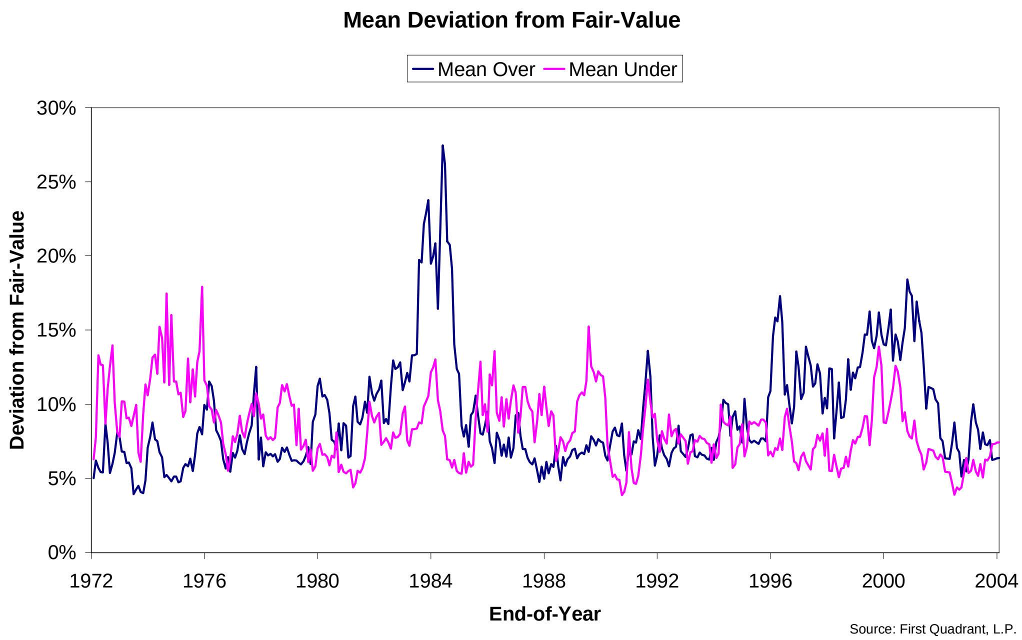


When we compare how the world looked at those two peaks, there are some marked differences.

While the US Dollar was over-valued in both periods, amongst the other G-7 currencies, the Canadian Dollar was much closer to Fair-Value than in 1985, both the Japanese Yen and British Pound were overvalued (in 2000) rather than undervalued (in 1985).

Perhaps more importantly, the deviations from Fair-Value were more evenly spread in 2000 than in 1985. Rather than being largely a "US Dollar vs. the World" picture in 1985, 2000 included the Japanese Yen and British Pound in the "overvalued" camp as well.

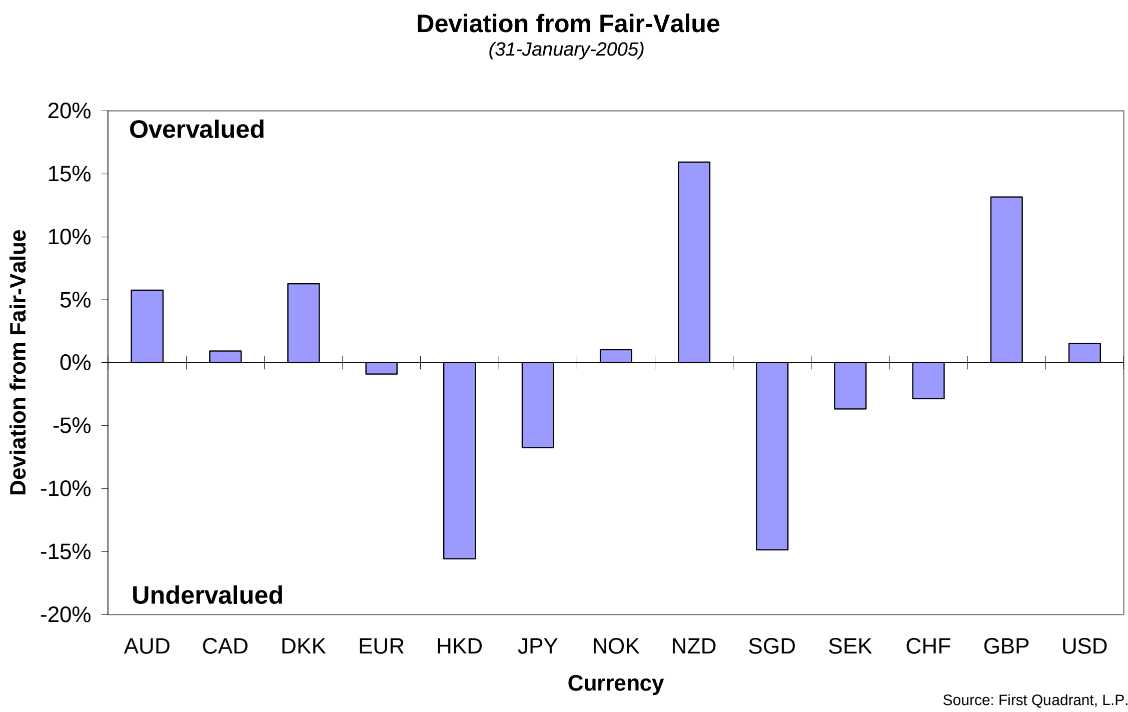
We can compare that "diversification" over time by plotting the mean deviation from fair-value of the overvalued and undervalued currencies separately. February 1985 stands in clear distinction from October 2000 in that chart.



Where are we today?

Today we are still "diversified", with the Australian Dollar, Danish Krone, New Zealand Dollar and British Pound the most Overvalued currencies (dominated by the New Zealand Dollar and British Pound), and the Hong Kong and Singapore Dollars the most Undervalued (largely due to the deflation both markets have experienced over the last few years).

Where is the US Dollar? Around 1.5% Overvalued...



Returns and Expectations

January saw seven of the 13 developed market central banks meeting, with all seven "on hold" in terms of monetary policy.

Yet, interest rates around the world (both short-term and long-term) were not quite as "on hold". Cash yields rose on average 9bp over the month around the world, with six rising (Australian up 7bp, Danish up 1bp, Japanese up 2bp, Swiss up 2bp, British up 2bp and the US up 27bp) and five markets' yields falling modestly (Canadian down 2bp, EMU down 1bp, Norwegian down 5bp, New Zealand down 1bp and Swedish down 9bp). The most significant change was in the US, with an 18bp relative rise.

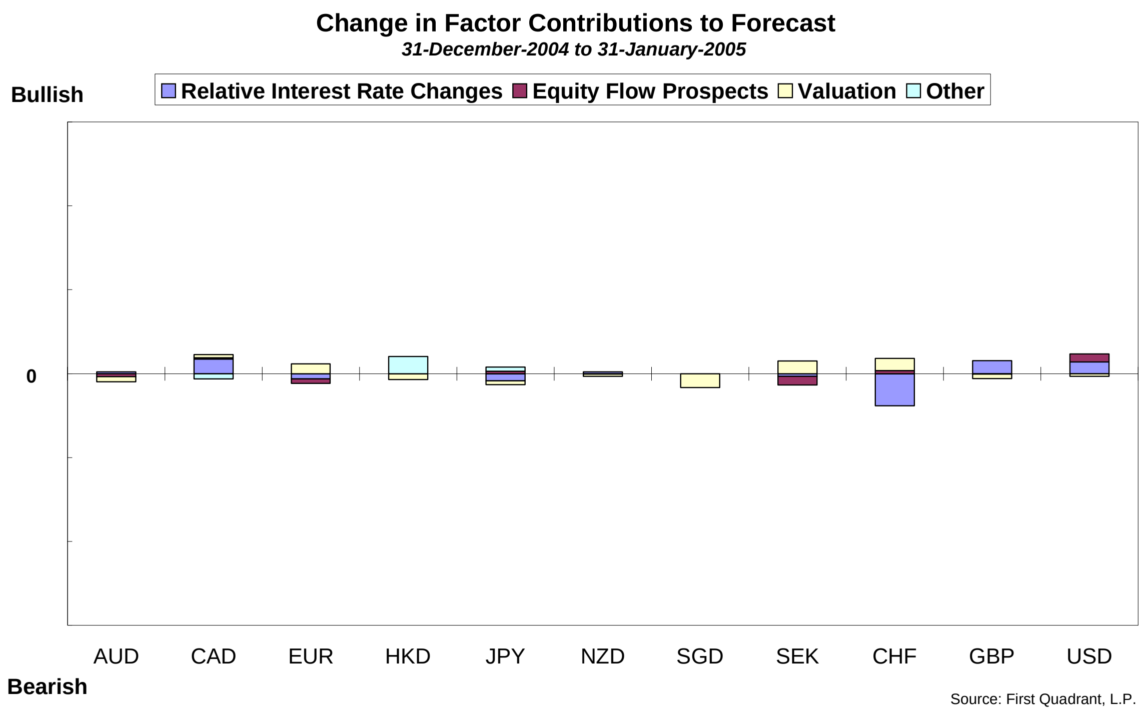
Bond yields generally went the other direction, falling by an average of 15bp over the month around the world. Only three markets' bond yields rose (Australian up 7bp, New Zealand up 11bp and British up 6bp), while the other eight markets' bond yields fell (Canadian down 9bp, Danish down 16bp, EMU down 13bp, Japanese down 12bp, Norwegian down 13bp, Swedish down 23bp, Swiss down 17bp and US down 19bp).

Globally, that represents an average 24bp flattening of yield curves around the world, with Australian, New Zealand and British curves either flat or slightly inverted.

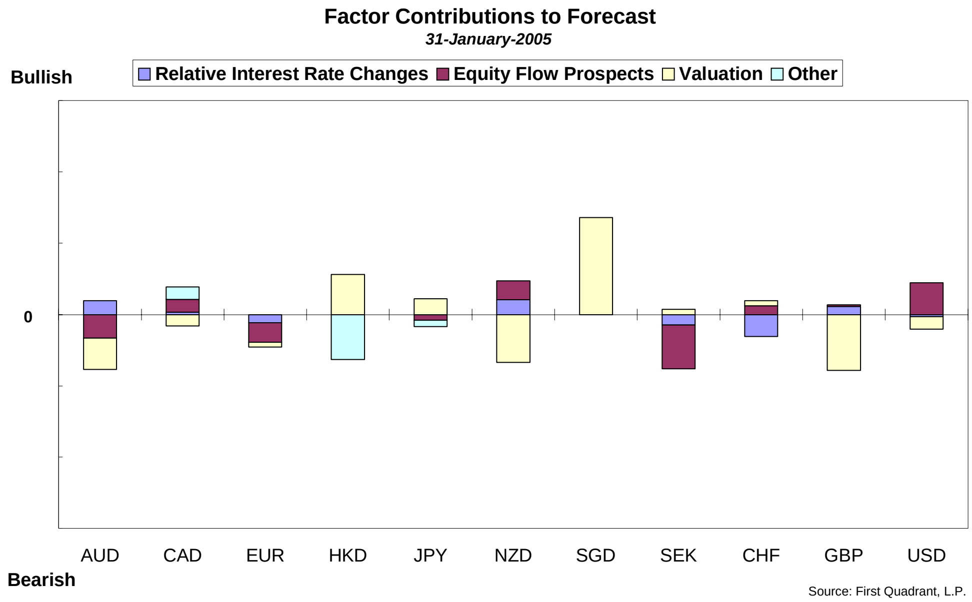
Equity markets were on average flat over the month, though two markets were noticeably down (US down 2.4% and Hong Kong down 3.6%), and two up (Australia and Singapore both up 2.2%).

The US Dollar was the strongest currency in January, rising 2.5% versus the Equal-weighted World Currency basket, while the Swedish Krona was the weakest, falling by 2.5% versus the same basket. Other than the British Pound, European currencies generally faired poorly, while Asian-Pacific currencies (and the US Dollar) did well.

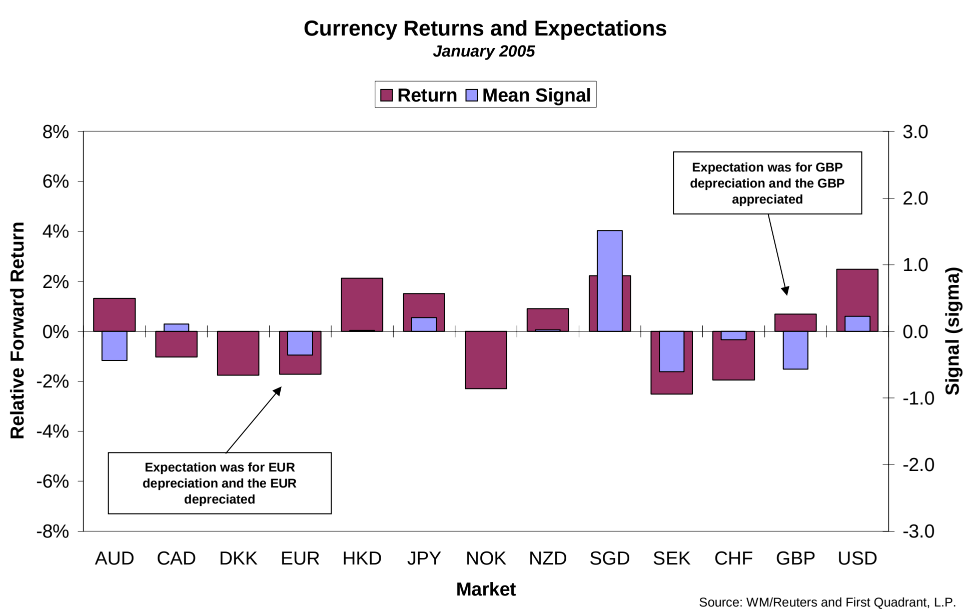
Interest rates (both short-term and long-term) continue to drive the bulk of the changes to our forecasts for the Canadian Dollar, Swiss Franc and US Dollar, with the change in relative cash yields the larger effect for the US and the change in relative bond yields dominating the changes to the Canadian Dollar and Swiss Franc forecasts. Changes in long-term valuation (largely in response to the currency movements over the month) provided some additional changes to forecasts, most notably for the Euro, Swedish Krona and Swiss Franc.



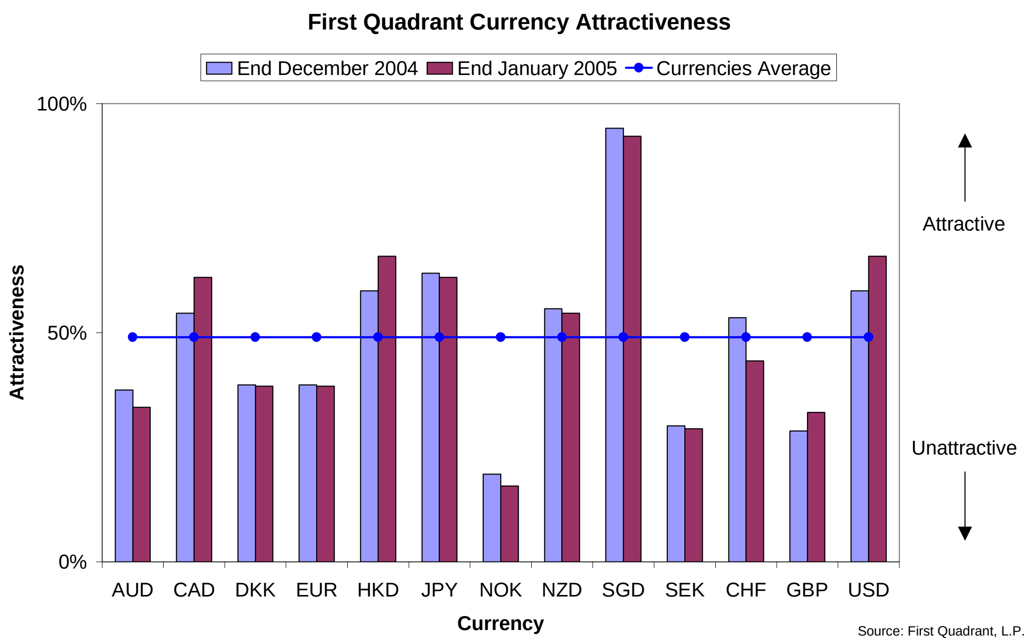
Long-term valuation continues to play a moderately sized role in forecasts, with prospects for cross-border equity flows the next largest contributor, followed by prospects for cross-border fixed income flows (based on the relative changes to yield curves for both short-term and long-term instruments). Currencies are, in general, still closer to fair-value today than they have been in the past few years, particularly for the US Dollar.



January was a good month for our forecasts, particularly for bearish forecasts for the Euro and Swedish Krona and a bullish US Dollar forecast. Forecasts for the Australian and Canadian Dollars as well as the British Pound were less successful, but did not offset much of the success in the other currencies.



Forecasts changes modestly over the month, as we are more bullish Canadian and US Dollar, while we have switch from bullish to bearish Swiss Franc. We have slightly moderated our bearish view on the British Pound, and our forecasts have changed relatively little for the other currencies we study.



(Endnotes)

[1] *Which would be the same as saying that exchange rates are unchanged, since currencies are quoted relative to each other!*

[2] *For "Fair-Value", we use the deviation of each currency versus First Quadrant's proprietary measure of Fair-Value, which is based on the tenets of Purchasing Power Parity (PPP). For more information, please see our February 2003 FX Monitor, "How 'Fair' is 'Fair-Value'?"*

[3] *To make it a simpler chart we have created a "synthetic" Euro, created by aggregating the legacy EMU countries by GDP weights. That does modestly* decrease *the apparent deviations before 1999, as the intra-EMU deviations are largely ignored. Caveat Emptor!*

[4] *We use Median and not Mean as the average deviation data is not "symmetric". There is no value below zero, so we've used the median (i.e. 50th percentile) to indicate the "average" level of the average deviation.*

[5] *The Accord agreed to by the G-5 (France, Germany, Japan, the United Kingdom and the United States) at the Plaza Hotel in New York City, "that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful." (paragraph 18), Funabashi, Yoichi.* ***Managing the Dollar: From the Plaza to the Louvre****. Washington, D. C.: Institute for International Economics, 1988.*

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