Absolute Return Partners LLP

The Absolute Return Letter
November 2010

Four Rather Sick Patients

"If I were BoJ, I would set a trap for all the currency speculators in the world. I would intervene in the currency market, appearing unsuccessfully, to lure speculators to commit more and more funds. I would get into a spit fight with the US Treasury and appear scared from time to time, egging the speculators on. I would quietly sell ¥10 trillion per day, not completely offsetting the speculative inflow and allowing dollar-yen to drop slowly with rising trading volume. I would play the game for two months and let dollar yen drop to low 60s until ¥500 trillion of speculative funds are sunk at an average price of 75. I would then announce unlimited supply of yen at 120. The speculators would suffer losses of ¥ 312 trillion instantaneously. They have to unwind their positions to stop losses. Just in case that they don't unwind, I would announce the price would be raised to 130 one month later. I would use half of the profit to retire 16% of the national debt and donate the other half to Melinda and Bill Gates Foundation for helping Africa. I would refloat the currency, after all the speculative positions have been closed, and impose 0.1% Tobin tax on yen currency trading to stop future speculation."

Andy Xie, 12th October, 2010, in China Finance

Currencies on the agenda

Earlier in the year I had the pleasure of having lunch with hedge fund manager John Paulson. When asked what he anticipated to be the main driver of investment returns over the next few years, he responded without hesitation: "Currencies". I thought long and hard about that answer and haven't been able to get the discussion out of my head since.

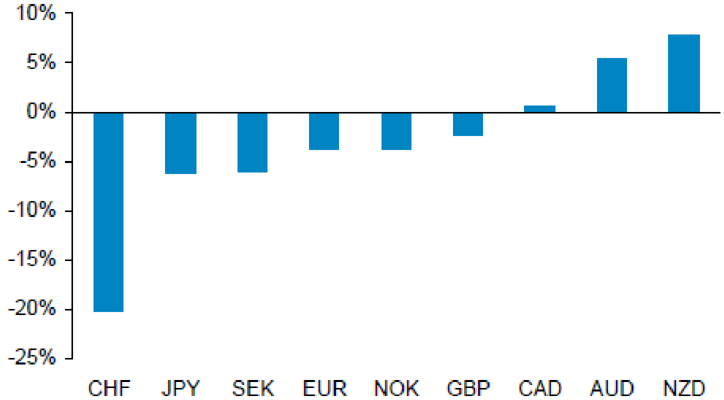
John Paulson's logic is simple. The world is in the unprecedented situation of all four major trading currencies (EUR, GBP, JPY and USD) facing their unique set of challenges. But not all four can fall at the same time. Currencies are unique in the sense that they are relative as opposed to absolute trading objects. You don't just buy dollars. You buy dollars against some other currency which is why *they can't all fall at the same time*.

The world has already caught on to this, with the financial media falling over themselves in recent weeks, competing to present the goriest story about how competitive devaluations will take down the world as we know it today. The scaremongers may have their day in the sun, but ultimately common sense will prevail and currency traders will have to go back to focus on housing starts again.

Morgan Stanley published a very interesting research report only last week[1] in which they produced estimates of how much the major trading currencies of the world need to appreciate (depreciate) vis-à-vis USD in order to bring their current account surplus (deficit) within 4% of GDP, which Morgan Stanley have used in their model as the threshold level. Please note that the changes in exchange rates suggested by Morgan Stanley's model do not reflect their actual views on those same currencies – the model is purely theoretical but provides a good illustration as to how much out of whack many currencies are today.

[1] *FX Pulse, 28th October 2010*

Chart 1: G10 Misalignment from Model (2011-15)

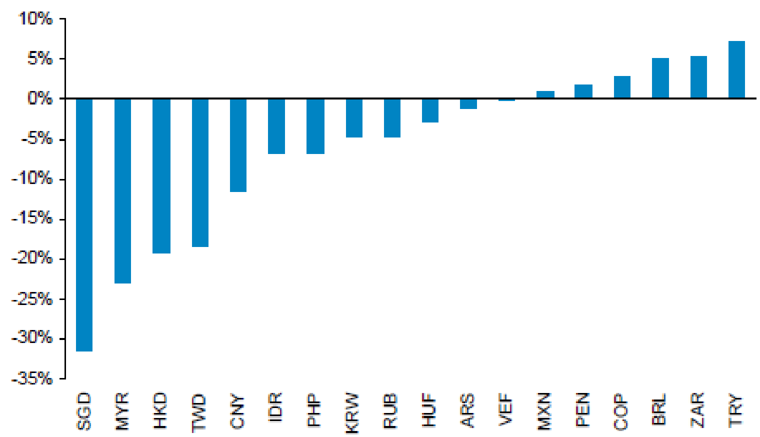


Source: Morgan Stanley Research

EM currencies are undervalued

As per Morgan Stanley's work, in the context of G10, only CHF is seriously undervalued vis-à-vis USD with a 20% appreciation required in order to bring the Swiss current account surplus down to a more reasonable 4% of GDP – see chart 1. On the other hand, outside G10, many emerging market currencies are currently significantly undervalued, with SGD standing out as the worst culprit, being over 30% undervalued - see chart 2.

Chart 2: EM Misalignment from Model (2011-15)



Source: Morgan Stanley Research

For a world which continues to be on life support – in the form of unsustainably large fiscal stimulus and near zero interest rates – policy makers are fast running out of options. One of the options left is quantitative easing and rumours are rife that the Fed and the BoE are both contemplating another round. But how effective is QE? Evidence from Japan suggests that, as a central bank continues to expand its balance sheet, the law of diminishing returns kicks in. Japan has been at it for years to the point where total central bank assets are now ¼ the size of the overall economy (see chart 3), but the results have been less than impressive. There are several reasons for this, but the most important lesson learned from Japan is that you cannot stop de-leveraging with lower interest rates.

QE2 around the corner?

Inside the vaults of the Federal Reserve Bank, this fact does not seem to have sunk in yet with Bernanke seemingly prepared to initiate another round of QE shortly. He has even stated publicly that equity and bond markets are far more sensitive to monetary policy than is the real economy; hence the most effective way to stimulate the economy is through boosting financial markets. One problem with such a policy, though, as pointed out by Edward Chancellor in the FT earlier this week[2], is that it requires for consumers to draw on their savings to be successful. America needs *higher* savings and investments, not a continuation of recent years' reckless spending.

Chart 3: Central Banks' Total Assets as % of GDP

US Federal Reserve	
2007 (end of year)	6.4%
2010 (October)	15.8%
Bank of England	
2007 (end of year)	7.3%
2010 (October)	16.7%
Bank of Japan	
2007 (end of year)	20.9%
2010 (October)	24.5%

Source: Financial Times

Another problem is that it distorts currencies, but the Fed clearly doesn't care. Not that they have said so in so many words, but their actions speak their own very clear language. I also find it remarkable that the Fed suddenly seems to be applying inflation targets. In the past, the Fed has always stayed clear of such policy. Now they are stating publicly that QE is necessary as current inflation is too low. Maybe it is, but relative to what? Officially, the Fed does not have an inflation target. The only conclusion I can draw is that they want the dollar to go lower, and equity prices to go higher, in order to fix the economic mess they have created themselves in the first place.

One of my favourite financial journalists, Ambrose Evans-Pritchard, phrased it quite eloquently in the Daily Telegraph last week:

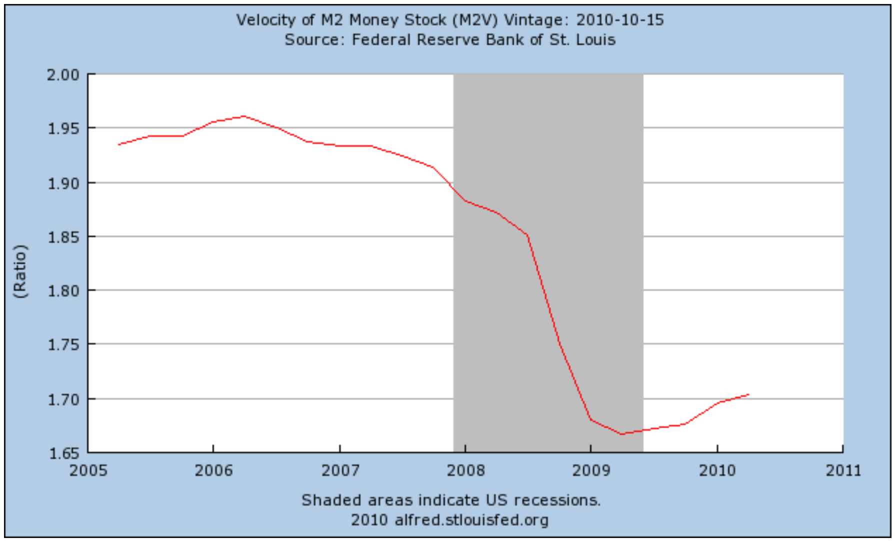
"*We are no longer in a systemic financial crisis, and the Fed's motives have become subtly corrupted. Having argued during the boom that it was not the business of central banks to stop asset bubbles – and specifically that any fall-out could "safely" be cleaned up later – Bernanke now seems too determined to validate this absurd doctrine, bending all the sinews of the US economic and financial system to this end. One error leads to the next.*"

Is QE2 justified?

There is no question that the US Fed worries a great deal about the ongoing downtrend in US inflation. With an economy leveraged to the hilt, falling into Japan-style deflation would be an unmitigated disaster, and Bernanke, rightly or wrongly, sees QE as the most effective tool against that. A large part of the problem for the US economy has been the steep drop in the velocity of money, which again is a function of the reduced lending in the banking system. Now, unbeknown to many, velocity has actually picked up since May (see chart 4), and launching QE2 when velocity is already on the rise, arguably as a result of QE1, is a very risky strategy indeed.

[2] *"Capt Bernanke on course for icebergs", FT fm, 01/11/2010.*

Chart 4: US Monetary Velocity

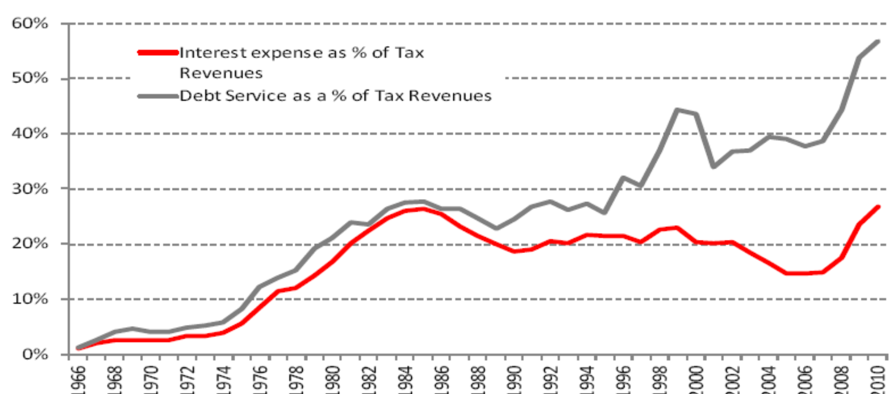


Notes: Nominal GDP/MZM, Nominal GDP/M2 (ratio scale). Source: St. Louis Fed.

The sinking ship of Japan

The Fed does not hold a monopoly on policy mistakes. On that account, Japan is in a league of its own, although many other countries are doing their very best to catch up. The Japanese combination of very high debt levels combined with outright deflation is a lethal cocktail, and one which the Americans are clearly desperate to avoid. I have borrowed (with plenty of gratitude) two charts from Dylan Grice at SocGen to illustrate the enormity of Japan's fiscal problems. Almost 60% of its tax revenues now go towards servicing its rapidly growing debt (see chart 5), and tax revenues no longer cover even the bare necessities – debt service, social security and education (see chart 6).

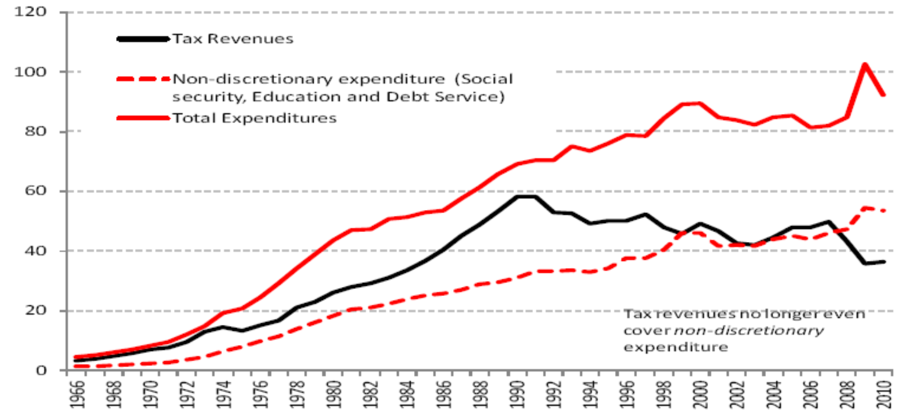
Chart 5: Debt Service in Japan



Source: SocGen Cross Asset Research, Japan's MoF

With the savings rate in free fall, and with record low bond yields, how much longer can the Japanese finance their debt domestically? Eventually, when they have to go to international capital markets to fund their out-of-control deficit, will there be any buyers of 10-year JGBs at 0.95%? I very much doubt it. On that account, I have noted that the tide has already turned. As you can see from chart 7, there has been a substantial capital outflow from Japan this year.

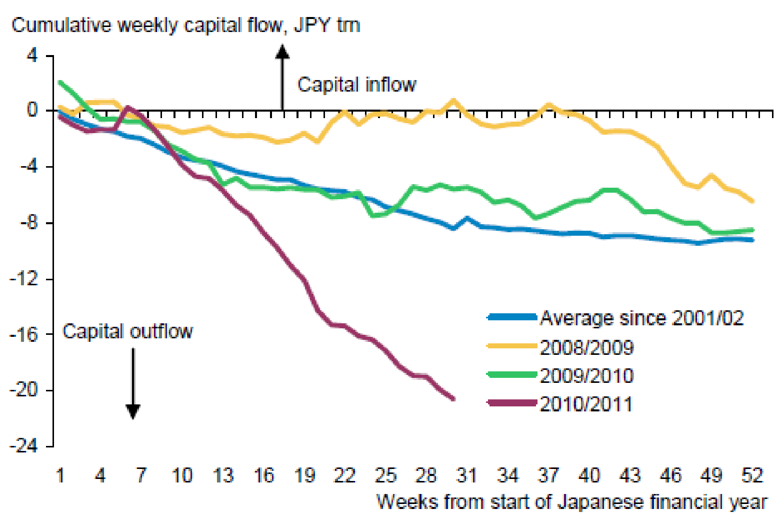
Chart 6: Tax Revenues in Japan



Source: SocGen Cross Asset Research, Japan's MoF

You may ask, if investors are fleeing Japan, why is JPY not weakening? I only know one possible explanation (courtesy of Morgan Stanley). Much of the capital which is leaving Japan is finding its way into US Treasuries, and most of those investments are fully hedged, which neutralises the effect on the currency. In short, when you take money out of Japan to invest in the US, you sell JPY against USD; when you subsequently hedge your currency risk, you sell USD against JPY.

Chart 7: Japanese Resident's Activity in Foreign Bonds



Source: Morgan Stanley, Japan's MoF

But the conclusion remains the same. If (when) there are no longer enough investors to buy the JGBs, or if (when) Japanese investors stop hedging their currency exposure when investing abroad, the pressure on JPY could become immense.

Yet so far the yen has refused to capitulate. As friend and business partner John Mauldin puts it, the streets of London and New York are littered with people who lost their jobs on prematurely predicting the demise of the Japanese currency. However, sheer logic suggests that this cannot go on indefinitely. Sooner or later something will have to give.

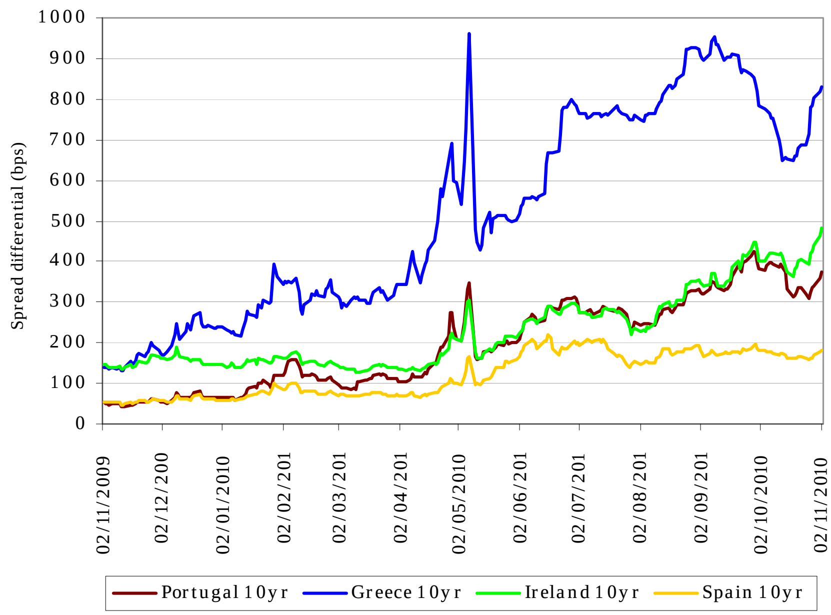
When researching for this letter, I came across a blog by Andy Xie in China Finance (see the opening quote of this letter). I have followed Andy's work for many years, both during his stint at Morgan Stanley and subsequently.

Andy's credentials are very strong; he has a PhD in Japanese economics from MIT. When Andy suggests that Japan needs to take drastic action, investors should sit up and listen. I certainly do.

Euro markets unsettled

Meanwhile, in Europe, the situation is not exactly hunky dory. Although the problems in peripheral Europe have momentarily moved from the front pages to the business pages, by no stretch of the imagination have they gone away. Germany's insistence that bond holders must share the pain in future bailouts has caused widespread havoc in European bond markets in recent days and reminded investors that the weaker credits in the eurozone are still very risky investment propositions (see chart 8).

Chart 8: Selected Eurozone 10-Year Bond Spreads over Germany



Note: Germany 10-year yield ~ 2.47% as at 02/11/2010. Source: Bloomberg.

Obviously, faced with a very fragile economic situation, the last thing the governments of Greece, Portugal, Ireland and Spain now need is rapidly rising borrowing costs and all the talk of debt restructuring emanating from Berlin at the moment[3] could ultimately prove self-fulfilling.

Interestingly, and despite all the well publicised problems in peripheral Europe, the ECB has been tightening by stealth over the past few months by shrinking the monetary base in the eurozone by a whopping 19% since mid year, and has managed to do so without too many people paying any attention. This is the main reason the G7 monetary base is now in decline, a fact which has been pretty much ignored by the stock market – see the growing gap between the monetary base and the MSCI World Index in chart 9.

I take my hat off to the boys at the European Central Bank. Tightening monetary policy - and driving up the euro as a result - at a time where many eurozone members face a long-lasting structural recession is a very gutsy move. Some would even call it foolhardy, but let's not go there. At least the men in charge at the ECB seem to understand the meaning of the word 'responsible'. I am not sure their colleagues in Washington do.

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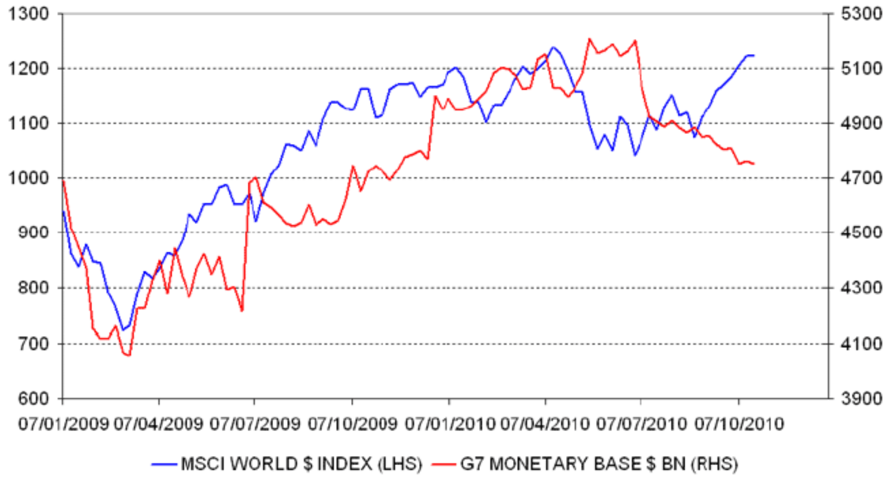
[3] *See for example this article on Telegraph.co.uk.*

Chart 9: G7 Monetary Base vs. MSCI World Index



Source: Henderson Global Investors

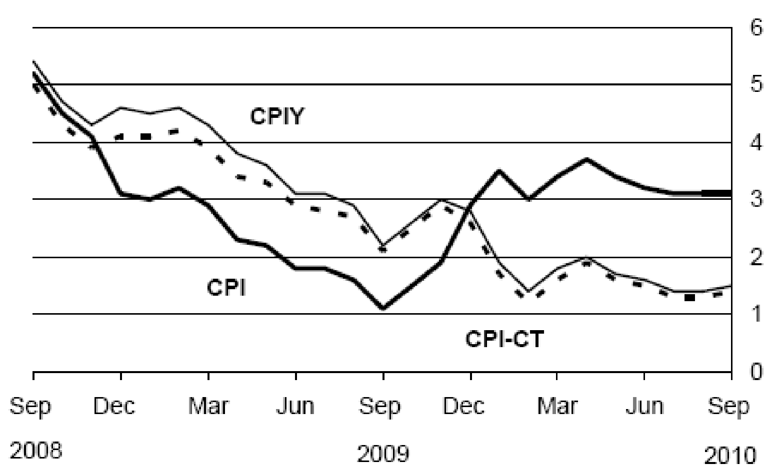
UK CPI not as bad as it looks

Here in London the pros and cons of another round of QE are still being discussed but, given the surprisingly strong GDP report the other day, my guess is that QE has been put on the backburner by the BoE, at least for now. That leaves us UK residents to speculate as to the future path of inflation – a subject which more than anything else (with the possible exceptions of 'The X Factor' and 'Strictly Come Dancing' TV shows) seems to be able to divide the nation.

I have long maintained that the current bout of inflation in the UK is temporary and that the BoE will keep rates low for longer than most people expect. Although I have had the odd anxiety attack over this prediction, let me share a chart with you (chart 10) which supports my thesis. The fact is we have had a lot of changes in direct and indirect taxes in this country in recent times. The Office for National Statistics therefore produces an inflation chart which adjusts for those changes. As you can see, a much more benign picture emerges.

With the economy firing on only half of its eight cylinders at present, and with the newly announced austerity programme likely to cut 1.5-2.0% off UK GDP over the next year, the BoE will look at *any* excuse not to raise rates. This chart provides the ammunition the BoE needs.

Chart 10: UK Consumer Price Inflation Not As Bad As It Looks



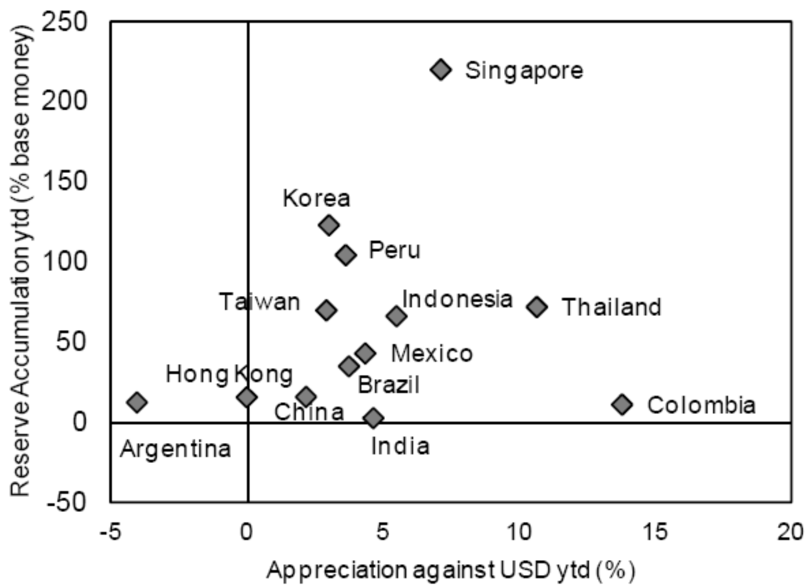
Note: CPIY ~ CPI ex indirect taxes. CPI-IT ~ CPI at constant tax rates.
Source: http://www.statistics.gov.uk/pdfdir/cpi1010.pdf

EM currencies will go higher

So what does all of this mean for exchange rates? The easy bit first. Emerging market nations all over the world are now finding that US monetary policy is causing mayhem for them, as capital - of which there is plenty - is fleeing the US to go to higher yielding markets around the world. This flow of funds, which is largely unwanted, is driving emerging market currencies up, much to the consternation of governments in Asia and Latin America. According to the IMF, at least 10 nations have already taken steps (and many more are considering it) to at least partly control their exchange rate.

If you intervene in FX markets to keep your currency from rising, as many countries have done in recent months, your foreign currency reserves grow. As you can see from chart 11 below, in many emerging market nations around the world, domestic currencies have appreciated against the US dollar year-to-date and, at the same time, FX reserves have also grown substantially - a clear sign that plenty of intervention has taken place.

Chart 11: Emerging Market Currencies on the Rise



Source: Goldman Sachs

The problem in a nutshell is that many EM currencies are either explicitly or implicitly tied to the US dollar, and US interest rates are *far too low* to suit the fast growing economies of Asia and Latin America. Hence the lax monetary policy in Washington is not only creating asset inflation in the US (and therefore also by implication elsewhere), but consumer price inflation in emerging market countries across the world.

...before they go lower

This is *no different* from the benefits enjoyed by countries such as Ireland and Spain when they joined the eurozone. They feasted on low interest rates for years but, ultimately, reality caught up. Governments in many emerging market nations are now repeating those mistakes, and it can only end in tears; however, it will take time. In the meantime, there will continue to be considerable upward pressure on EM currencies.

Gold should benefit

Gold is another potential beneficiary of the calamities in the old world. Increasingly treated as a currency by investors, a consensus is building that governments in both the UK and US will continue to choose the path of least resistance – i.e. letting the money press run. Ultimately, this will create inflation, or so the argument goes. As I have stated in previous letters, I am not even convinced that gold needs inflation to rise from current levels to appreciate further. The anxiety, and the risk of another financial meltdown, will probably prove sufficient. John Paulson is reportedly holding 80% of his considerable assets in gold. I wouldn't go that far, but gold offers an effective insurance against future misfortunes and deserves to fill out a corner of your asset allocation.

The ugly contest

Now to the more difficult one. Of the four contestants in the ugly contest – EUR, GBP, JPY and USD – who will prevail and who will sink? I will stay away from short-term predictions as I think they are ill-advised at best. Nobody really knows, although many pretend to. Longer term, the outstanding candidate to sink, as I see things, is JPY. There is no other way out for the Japanese government, and its currency should depreciate significantly against the three other major trading currencies. Timing it is the difficult part. It may happen next year, or a yen crisis may take five years to unfold. I simply do not know.

Between EUR, GBP and USD, the winner in my book is EUR, and this is really down to the DNA of the ECB relative to that of the BoE and the Fed. Twelve months from now, ECB President Trichet will have to retire, and the most likely successor at this juncture is Alex Weber from the German Central Bank. Weber's biggest enemy is himself. He is very outspoken and often very critical of the ECB, so he may not get the job in the end, but he is a central banker of the old school. Do not expect QE on his watch unless the world is literally falling apart.

Even without Weber at the helm, the ECB should continue to deliver a monetary policy which is considerably tighter than that of the BoE and the Fed, but also too tight for peripheral Europe. Precisely for that reason the problems in Greece, Spain, Portugal and Ireland will resurface. It is only a question of time. But that is not necessarily negative for EUR/USD or EUR/GBP. Remember – it is still an ugly contest, not a beauty contest.

Finally, between the UK and the US, my money is on the UK to prevail, so GBP/USD should strengthen over time. Much to the credit of the new coalition government, decisive action has now been taken to combat the excessive level of public spending here in the UK. Longer term, it means that the UK is far more likely to get back on its feet again than many give it credit for.

Meanwhile, in the US, there is no reason to expect a significant improvement in the federal budget deficit any time soon. Even the Republicans have promised restraint on defence and old age spending. These two factors combined with interest payments account for over 70% of the federal budget, so the Americans will face a large fiscal deficit for several more years to come to the detriment of the US dollar.

Niels C. Jensen

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