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2010: A year in currency markets

Clive Dennis, Fund Manager – Currencies, looks ahead to 2010



Unprecedented injections of capital, abundant liquidity and historically low interest rates: Western central banks and governments have responded to the financial crisis with an extraordinary deployment of firepower. However, in spite of dramatic fiscal and monetary intervention, credit remains hard to come by in the developed world. As a result, it seems likely that the fledgling recovery in these economies will be anaemic and the authorities will be forced to maintain ultra loose monetary policy for the foreseeable future.

- Anaemic recovery likely in the developed world with ultra loose monetary policy anticipated for the foreseeable future
- While concerns about recent dollar weakness have been overdone, the long-term prospects are poor
- Sterling is likely to remain under pressure on concerns about the UK's fiscal and monetary backdrop
- Abundant opportunities amongst emerging market currencies as developing world stages a strong, sustainable recovery from the downturn.

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By contrast, developing economies are staging a strong and sustainable recovery, emerging from the crisis in far better shape than their developed counterparts. Low levels of household and corporate debt, a healthy banking sector and rising domestic demand are underpinning this.

The chasm between the fortunes of the West and the emerging world has already had a powerful effect. Investors in search of higher yields have flooded into emerging markets, leaving traditional currency powerhouses looking vulnerable. We look beyond this year's headlines to the longer term and reflect on the best opportunities for currency investors over the coming years.

Is the dollar dead?

The US dollar has been at the eye of the storm, weakening significantly against a host of other currencies over the past few months. Having strengthened dramatically at the height of the crisis – benefiting from its status as a ‘safe haven’ – the greenback has given up its gains since the rebound in investor confidence in March.

The media has been quick to sound the dollar's death knell although, in reality, the nature of its recent depreciation has been orderly rather than dramatic and has returned the currency to pre-crisis normalised levels.

However, the depth of the US fiscal problem is hard to ignore and it is difficult not to feel sceptical about the dollar's long-term prospects. The Federal Reserve has undertaken an enormous expansion of its balance sheet – and it's not over yet. It is estimated that, over the next ten years, the number of US Treasuries in general circulation will balloon from six trillion to around 17 or 18 trillion. In our view, the extent of leverage within the economy holds serious long-term implications for the strength of its currency.

We're not the only ones who are concerned. Serious questions have been raised over the past year with regards to the dollar's status as the world's reserve currency. Saudi Arabia, Venezuela, South Korea, Russia and, most significantly, China have all taken steps to replace the dollar in their FX reserves. There have even been suggestions that the dollar could be removed from its reserves throne by the International Monetary Fund's SDR currency, the euro or, eventually, even the renminbi.

The pound: a less than sterling performance

2009 was also a bad year for sterling as the currency took its biggest slide since 1931. The pound has been kept under pressure by concerns about the UK's monetary and fiscal environment as the government and Bank of England unleashed an unprecedented policy response to the financial crisis.



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Clive joined Schroders in 2009 having previously worked for seven years as an Executive Director, Foreign Exchange Sales at Morgan Stanley.

Prior to this, Clive spent 15 years at Deutsche Morgan Grenfell Investment Management, where he was Chairman of the Currency Committee and a member of the Group Investment Policy Committee.

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The Bank of England has even been accused of targeting sterling weakness in a bid to stoke export growth. Speculation that the Bank is actively seeking to drive down the pound reached fever pitch as Mervyn King hinted at the possibility of applying negative interest rates on excess bank reserves to encourage a resumption of lending.

The UK’s failure to exit recession during the third quarter of the year – as had been widely anticipated – further underlined the belief that interest rates may have to remain at ultra-low levels for longer than the rest of Europe and, indeed, the world. This, coupled with the government’s immense deficit, has created a difficult environment for sterling – one which is unlikely to improve over the coming months and is likely to create problems for the victor of the upcoming General Election.

Exciting opportunities emerge

While the long-term outlook for the dollar and sterling may be bleak, it’s not all bad news. In fact, their decline is creating some exciting investment opportunities – particularly in the emerging world. Indeed, foreign investors have already begun flooding into a number of emerging market currencies over the past year, in search of higher yields.

The speed of the dash for these currencies has been such that some countries have resorted to implementing some form of capital controls to protect against further appreciation. The Brazilian authorities, for example, have imposed a 2% tax on all foreign portfolio investments to slow the pace of real appreciation. There has subsequently been talk of Turkey and Taiwan taking similar steps.

China – arguably, the lynchpin of the emerging world – has staged a dramatic recovery from the downturn – a trend we expect to continue, albeit at a far gentler pace. While future policy on the Renminbi is uncertain, we believe that, sooner or later, China will have to yield to the overwhelming pressure for appreciation.

Indeed, upward pressure on Asian currencies generally – including the Korean won, Indian rupee and Malaysian ringgit – looks set to continue as those economies benefit from strong growth in domestic demand coupled with accommodative monetary policy.

Elsewhere, we are also encouraged by developments in eastern Europe. Earlier this year there were a lot of concerns about the health of the region’s economy but, we think the extent of the collapse in the value of these currencies was overdone and since it appears that worst of the crisis in the region is now over, these currencies are looking extremely cheap.

The case for active currency management

The volatility of currency movements we’ve seen over the last year is a trend that is here to stay. In fact, we believe it is a trend which is likely only to intensify from this point as global authorities tackle the issue of unwinding monetary and fiscal policies implemented during the credit crisis.

With the global role of major currencies like the US dollar likely to change over the coming years, there is a significant opportunity for investors to benefit from these shifts. Moreover, with inflation likely to rise again, threatening individuals’ global purchasing power, investors have rarely had more reason to consider their currency exposure.