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Monthly Commentary 4th March 2013

Markets were less euphoric in February, with only government bonds doing well. World equities fell about 1%, with Emerging Markets falling almost 2%. Japan was a notable exception as equities there rallied 4%. Commodities, led by crude oil and precious metals fell more than 4%. In currencies, the USD gained more than 3%.

It was a necessary pause for risk assets, and we believe such consolidations are healthy. The macro environment is modestly improving in the US and China, even though Europe remains stagnant. This has led to less severe risk on/risk off episodes, which in turn attracts more investors into risk assets. Importantly we do not see an early exit from accommodative monetary policies, which is positive for equity markets. Though the odds favour higher prices by the end of the year, we shall not be surprised to see a pullback of 5-10% in equities somewhere along the way.

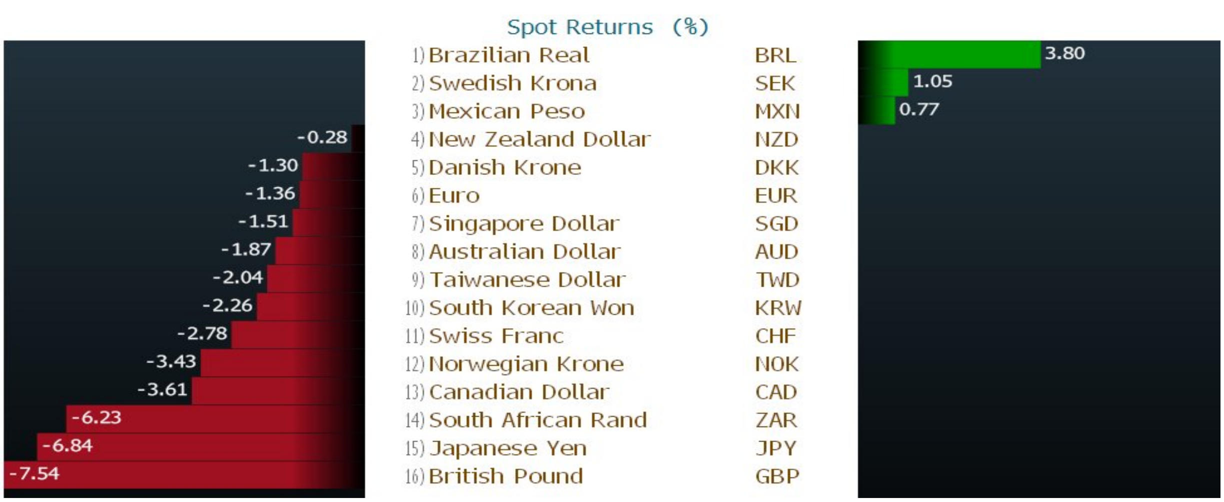
Currency Wars

There was much news in the media about “currency wars” as Japan took steps to weaken the Yen without much opposition from the G20 (group of 20 largest economies). Sterling has been the other notable loser so far this year, much to the apparent delight of the UK government. The Euro, that started off the year very strongly, made a U-turn when the ECB Governor commented on Euro strength - something that central bankers generally avoid talking about. Some developing countries are not happy seeing such falls in major currencies and have joined the chorus in crying foul.

So where is this “war” leading us, and which currencies are likely to be winners? We’ll ask, and attempt to answer a few questions.

1. How have major currencies fared so far this year?

The chart below shows changes YTD versus the USD. As you can see the Yen, at -6.84% and Sterling at -7.54% take the prize, while only the Brazilian Real has had a “meaningful” rise (of course this should be put into perspective as it had fallen by 30% since August 2011). Note that unlike equities where a 6-7% drop can easily happen in a two-month period, in currencies such a move is massive.



2. What is “fair” value for major currencies?

This is a very difficult question to answer. One way of measuring fair value is using the Purchasing Power Parity (PPP), which is a currency’s price in terms of what it can buy – typically prices of goods and services in the consumer price index are used. By this measure, the Australian Dollar is the most overvalued, and only the Yen and Swedish Krona are undervalued among major currencies. Unfortunately, relying on PPP’s to assess whether to buy or sell a currency is completely unreliable, and currencies almost never trade at, or even close, to their PPPs. Trade and investment flows as well as speculators have a major impact on what a currency is worth, hence their propensity to trade far from their PPP’s.

3. What do the experts say about currencies?

Below are the average expected gains/losses forecast for the end of 2013 by currency strategists at major banks. It is quite evident that they do not use PPP’s as a guide – AUD for instance, is expected to become even more overvalued. What strikes us about currency forecasts is that they are almost always very close to the spot price, as strategists rarely take risks. In fairness to the strategists, their is a reasonably large dispersion of forecasts. For example the Euro has yearend forecast of $1.40 from Credit Suisse and of $1.20 at UBS. They both have compelling reasons to reach much different targets. Both of them cannot be proven correct. From experience, they are not much better at predicting future values than an average Joe.

Bill Gross, who is a respected bond guru and not a currency expert has recently said that Quantitative Easing (QE) by central banks will have the single-biggest effect on currency levels. He makes a good argument for the debasement of the currencies where unconventional monetary policies are in full swing. While it is hard to argue against his reasoning, we still suspect that currency markets have too many moving parts to make them any more predictable.

Many consider gold as a currency. The argument in favour of gold is that unlike currencies, there is no printing press that can create unlimited quantities, thus preserving its value. It is easy to argue that the more currency wars escalate, the better the demand for gold should be. Yet financial markets have a habit of humbling the most reasonable assumptions and have punished gold, which has fallen quite sharply lately.

So what does an investor do? Yes, we have our house views on where we think currencies are headed. But unfortunately our house views on currencies, like those of UBS, HSBC, Goldman Sachs and hundreds of other banks will only be correct the minority of times, so it would be wrong to impose them on our clients. We have always advised our clients to be invested in currencies where their future liabilities will be. One can indeed take small risks in other currencies, but they should be well contained. After all, if you had USD and bought the FTSE100 at the beginning of the year, the currency loss would almost entirely cancel the 8% gain in the FTSE. And for a little insurance, you could hold some gold, but...