

## The Oval *Slant* — August 2009

### A year of volatility

We all know the last 12 months have seen tremendous volatility in stock markets and in such times of crisis, we have seen investors seek succour in short dated (i.e. 3 years or less) government gilts, cash (provided it wasn't in Iceland!) and gold. However, it is often overlooked that there has also been considerable movement in currencies as well and, in such difficult times, the currency of choice is the US Dollar. This is because it is issued by the world's strongest and biggest economy and, as such, is seen as least likely to default or devalue.

### The three ugly sisters

These are the three currencies generally regarded as the largest and strongest and, no, this does not include £ Sterling! They are in fact the US Dollar, the Euro and the Japanese Yen. The Japanese economy is still the second largest in the world (assuming we still treat the Eurozone countries separately) although this spot is likely to be stolen by China within the next few years.

The Japanese economy is still in trouble and will probably continue to suffer ongoing problems. An election is due and radical changes by a new government are unlikely. This does little to enhance the Yen's reputation going forwards. The Euro has been surprisingly resilient and has shown massive strengthening over the last year; particularly versus £ Sterling. Has this been overdone? Unlike both the UK and USA, the Eurozone has not resorted to printing money in the form of Quantitative Easing (QE), but will it at some stage need to, and is a reality check needed? The Eurozone itself has widely disparate components and whilst Germany remains strong, the so-called PIGS (Portugal, Ireland, Greece and Spain) have considerable problems and a single currency and interest rate is a blunt instrument to address this dichotomy.



### The greenback

The US Dollar (USD) is the so-called "world reserve" currency and, in times of crisis, people want to hold USD in preference to anything else. However, there are headwinds facing the USD; probably from three directions:

1. As market stability and confidence returns, investors are prepared to pay less of a "premium" to hold the security of USD
2. The massive twin deficits in both the US current account and government budgets need eventually to be paid for
3. The huge amount of QE undertaken by the US authorities undermines the attractiveness of USD for non-US investors.

We have seen this in the UK where the extensive use of QE has threatened the top AAA rating of government gilts. Nevertheless, with the lack of an alternative, the USD still remains the international currency of choice and this alone can offset a fair part of these headwinds. Let's not also forget that, worldwide, oil is priced in USD and this in itself is a considerable stabilising factor.

## East versus West

There is little doubt the economic power in the world is shifting eastwards. There is a tremendous entrepreneurial flair and work ethic in Asia and economic output and demand is growing substantially. Increasingly, the focus is on China v America - China needs a huge market for its products and the US needs to import vast numbers of goods too expensive to produce itself. This leads on to another issue – American consumers are spending too much whilst Chinese ones need to spend much more. China has accumulated the equivalent of over 2 trillion USD in reserves; which is actually about one third of the world's total reserves (as per Capital Economics). Of this, China has about 70% actually in USD and so has a vested interest in maintaining the value of the USD. They need each other or, as eloquently put by Justin Urquhart-Stewart of 7IM, China is the alcoholic and America the distillery!

## Esperanto—The new world currency!

Language is complicated and diverse; making international communication difficult. Most of us may remember Esperanto; that ill-fated language introduced as a simple communication medium for everyone. It was straightforward, easy and appeared to have great potential. Apart from a few diehards, we know this has withered on the vine and perhaps a replacement for the USD as “reserve currency” is still some way off. Over the years there have been many new currencies and whilst many have disappeared, there are success stories such as the German Deutschmark after the Second World War, and the Euro from 1995. Now, what is the currency of the world's fastest growing and, before too long, the largest economic power? No, I didn't know either! It's the Chinese Renminbi – and that must be a good pub quiz question! Could this be an alternative to the USD? Well, in theory this may ultimately be possible but, like Mark Twain's first obituary, reports of the death of the USD as the reserve currency are greatly exaggerated!

China has recently been in talks with the US about steps to maintain the value of the USD and we have also seen China in bilateral trade talks with various countries to trade in local currency – almost a type of barter. The number of fake dollar bills in circulation is believed to be enormous and this in itself may be a factor in the green-back notes remaining virtually unchanged for many years (so as not to cause a market tsunami when fake dollars are exchanged for the new ones). However, a free floating currency is a pre-condition for reserve currency status. So, for the Renminbi to have world potential, the political powers in China would have to hand much more power to the market and this seems unlikely in the near future.

## The Big Mac index

For some years, The Economist has run this light-hearted index using the cost of a Big Mac hamburger worldwide. This is based on the theory of purchasing power parity (PPP) which says that exchange rates should equalise the price of a basket of goods in each country. A fair value benchmark should then mean a Big Mac costs the same everywhere. Using current exchange rates, a Big Mac in China is half the cost in the US, Switzerland is the most expensive and the Euro is 30% overvalued. On the Big Mac Index, Sterling was a quarter overvalued a year ago but now seems close to fair value against the Dollar, and probably cheap versus the Euro. This index is hardly scientific; but who says it is not right?

## Lessons to learn

There are so many different factors and nuances affecting currencies that this is best left to the experts. Most portfolios with international exposure are likely to be partly or fully currency hedged to remove excessive risk. The most important thing is where do you live and what currency do you spend every day? Unless you are planning to move abroad, retaining assets in your home currency seems a sound option. If you see a bandwagon; it's already too late to jump on it. Remember those smug people who purchased Euro denominated mortgages? Well I bet they feel a bit sick now with the Euro having been at nearly parity with £ Sterling and even the recovery to 85p is still grim compared to the 65p constant price we had a year ago!

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