The Phony Currency Wars

By Jan Dehn

Why are currencies so volatile?

Currencies move in response to relative fundamentals and speculation. Speculation requires a good story that gains credibility, but is then either validated by subsequent events in which case the currency moves permanently, or disproven in which case the currency reverts to range. Absent support from fundamentals, the ranges for speculative trades are constrained by the volumes in the traded markets.

By contrast, relative growth rates, relative inflation, and relative interest rates are all fundamental drivers, and when they move they tend to move currencies directionally. Ranges break because trading is not constrained by positioning parameters.

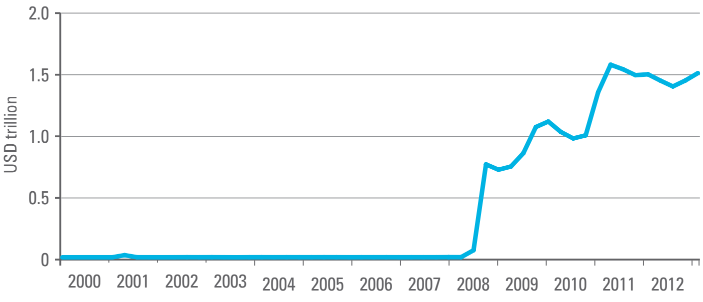
Unprecedented volumes of cash have been printed in the past five years by central banks in the HIDCs (Heavily Indebted Developed Countries). Ordinarily, money printing would be a fundamental driver, because money printing accelerates the velocity of circulation and causes prices to rise. Thus, money printing changes relative inflation rates as the Quantity Theory of Money predicts.

But today's copious Quantitative Easing (QE) in the HIDCs has not had much effect on inflation or anything else in the real economy. For example, the ratio of M2 (broad money) to M1 (narrow money) still hovers near lows last seen more than a decade ago.

Why is money printing not causing inflation? The answer is that money does not go shopping on its own. Transactions demand for money in the US remains depressed due to household deleveraging. Investment demand is weak because of uncertainties about monetary and fiscal policy. Other HIDCs also face serious structural challenges; Europe has zombie banks, institutional deficiencies, and excessive debt. Japan is stuck with deflation and an enormous public debt burden.

So where does all the QE money go if it does not go into the real economy? Some of it finds its way back to the central banks that printed it in the first place. The volume of excess reserves kept at the Fed by US depository institutions has recently begun to tick higher again.

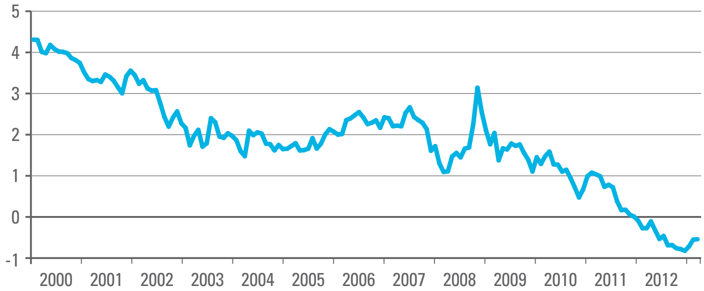
Fig 1: **Excess Reserves held by depository institutions at the Fed**



Source: Bloomberg.

The rest of the money finds its way into the financial markets, where some of it has helped push bond prices in the HIDCs deeply into bubble-territory. This is why, for example, real ten-year yields in the US Treasury market are now negative. Other bits of the money go into stocks, which now trade at levels last seen prior to the 2008/2009 crisis.

Fig 2: **US 10-year TIPS yield**



Source: Bloomberg.

Finally, a good chunk goes into the global currency markets, particularly into the big global currencies, where it chases big global stories. Banks are particularly happy to put QE money to work in the big currencies, because they are (a) super-liquid, (b) have low capital requirements, and (c) can are easily moved by good stories. The broad macroeconomic backdrop of fundamental weakness and elevated asset prices due to QE lend themselves to good stories. And when politicians weigh in they only enrich the narrative.

Currencies are volatile today because there is a lot of QE money chasing a lot of stories, and a lot of nervous politicians in countries with major structural problems worrying about losing competitiveness.

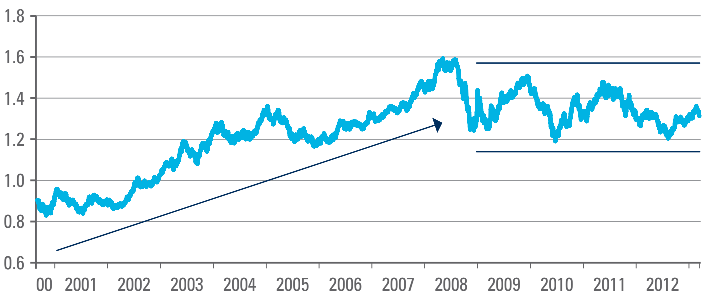
Welcome to the global currency wars.

Real and phony currency wars

Phony currency wars are political conflicts, which arise in response to speculative currency moves. They are relatively easy to defuse by unilateral currency intervention or minor capital controls, or joint statements, such as the recent statement from the G20. Real currency wars are far more serious, because they are conflicts, which arise from changes in the fundamentals. Changes in fundamentals require fundamental adjustment, and fundamental adjustment is scary to politicians.

The real currency wars are still a couple of years away, in our view. So far, the world has only experienced the phony variety of currency wars, skirmishes ahead of the real thing. Since 2008/2009 trends in global currencies have diminished rather than becoming more pronounced. For example, the rapid trend appreciation of EURUSD prior to 2008/2009 has given way to range trading, precisely what one would expect when currencies are driven by speculation rather than fundamentals. Volatility has increased, but within clearly defined and stable ranges.

Fig 3: **EURUSD**



Source: Bloomberg.

The most important speculative trade in the past five years has been EURUSD. EURUSD has traded between 1.20 and 1.50 over this period. Fundamentals did not account for this range. Sure, the US economy grew faster than the European economy, but the ECB paid 75bps more than the Fed. Besides, the ECB sterilised its QE operations and obeys a single inflation-fighting mandate, while the Fed does not sterilise and cares a great deal about unemployment. Net net, there has not been much in terms of the fundamentals to choose between being long Euros or US Dollars.

What then explains the volatility in EURUSD over the past five years? The answer is: a good story, the Euro-breakup story. It was a simple story: Go short EURUSD. Sell enough periphery government bonds to drive sovereign yields to unacceptably high levels. Then wait for the country in question to pull out of the Eurozone in order to get relief from devaluation. Let contagion take care of the rest. The Euro crashes.

At its full stretch, the short-EURUSD speculative trade pushed the cross from 1.50 to 1.20. EURUSD was free to move in this range without any changes whatsoever in relative growth, inflation, and rates. And it did not matter that Europe did not split up and that it accelerated integration by setting up the European Stability Mechanism (ESM), the European Financial Stability Facility (EFSF), and a single European banking regulator. Europe also found a way to share the cost of the Greek default. When Mario Draghi launched the Outright Monetary Transactions (OMT) program, he further reduced the downside risk for the cross, though Europe's fundamental economic and political challenges have by no means gone away. Alongside the US Dollar, the Euro is very much still in one of the contestants in the global currency 'ugly contest'.

USDJPY: The Latest contestant in the currency 'ugly contest'

The recent G20 meeting failed to censure Japan, not because Japan is not manipulating its currency, but because acknowledging manipulation by Japan would require G20 to acknowledge the problem. Acknowledging the problem would require a framework for the dealing with currency manipulation. No such framework exists. Rather than admit to this, the G20 opted to ignore the problem. Other HIDCs may also eventually want to weaken their own currencies, so it makes sense to not burn bridges this early on.

This attitude is of course a carte blanche for Japan to weaken the Yen further. It is also a blessing for speculators in the global currency markets. The Japanese Yen has now joined the Euro and the US Dollar in the global currency 'ugly contest', meaning currencies you buy not because you love them, but because you hate them less than others. Like the Euro-breakup trade, the short-Yen trade will not be a straight-line trade by any stretch of the imagination, but USDJPY has certainly now joined the range of potential targets for all the QE money slushing around in the global currency markets.

Prime Minister Abe's Roosevelt-style attack on deflation makes a great story. Roosevelt devalued the US Dollar from $24 per ounce of gold to $35 per ounce of gold. Positioning going into the election was very long JPY. USDJPY is a huge liquid currency cross (accounting for about 14% of global currency trading, or about half the size of EURUSD). If the same amount of money goes into long USDJPY as went into short EURUSD the cross could go as far as 110, taking it back to its pre-crisis average (and thus still obeying the broad range). And all of this can happen entirely on speculative flows, without any change in fundamentals whatsoever. Like EURUSD, it does not really matter whether Prime Minister Abe succeeds or not. It is about generating trades, all the way up, and ideally all the way back down.

Fig 4: **USDJPY**

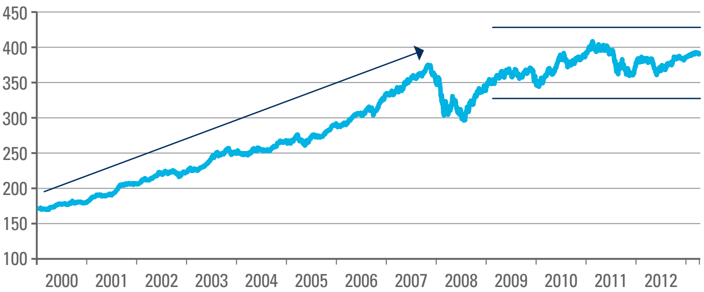
Source: Bloomberg.

Yet it is obviously extremely important whether Prime Minister Abe breaks his country's deeply entrenched deflation expectations. Japan is 15 years further down the road of crisis than the other HIDCs. If Prime Minister Abe succeeds, his policies will be emulated by other HIDCs. The move higher in USDJPY will then be amplified beyond 110, though there is also a risk that his 'controlled recklessness' gets out of control, pushing USDJPY far higher still. On the other hand, if Prime Minister Abe fails to destroy the deflation dynamic in Japan – which is our base case, because we believe Japan's problem is a structural one, not a nominal one – then it is only a question of time before the currency reverts back to previous levels. And confirms that we are still only in a phony currency war.

The phony currency war and Emerging Markets

How has the phony currency war impacted Emerging Markets currencies? Flows into Emerging Markets have slowed since 2008/2009 on account of elevated levels of risk aversion. Some countries such as Brazil have put in place high profile measures to deter inflows, which can stem appreciation temporarily as long as flows are modest. Currency trading by banks has shifted towards the bigger more liquid HIDC currencies. Emerging Markets central banks have continued to act as good global citizens by aggressively purchasing US treasury securities (and US Dollars) over the past few years to help the US government finance the cost to the public sector arising from the sub-prime and banking crises. Emerging Markets currencies have continued to appreciate since 2008/2009 but more slowly and with greater volatility.[1]

Fig 5: **ELMI+**



Source: Bloomberg, J.P. Morgan.

Emerging Markets do not face the same structural growth impediments and excessive debt burdens faced by the HIDCs. The money printing policies, which will eventually prove inflationary in the HIDCs will likely be disinflationary in Emerging Markets. This means that the current hiatus in flows into Emerging Markets currencies is temporary; flows will catch up with the better relative fundamentals in Emerging Markets and re-accelerate the pace of appreciation of their currencies, particularly versus the US Dollar.

How and when does the real currency war begin?

The question of when the phony currency wars turn into real wars depends on how it happens. There are at least four potential candidates for triggering a real currency war. We run through these and explain which trigger we think is more likely.

First, there is the market itself. We have seen how the market has been able to push EURUSD between 1.20 and 1.50 over the past few years, and has pushed USDJPY from 80 to close to 95 in a few months.

However, it is difficult for the market alone to support more sustained directional moves. Absent changes in the fundamentals – such as the Eurozone actually breaking up or Japan actually defeating inflation – currency moves are typically going to be limited to the combined firepower of the world's major macro hedge funds and banks. Also, as Draghi's intervention last year and numerous examples of Fed intervention show, markets can also struggle to sustain trades in the face of central banks intervention, verbal or otherwise.

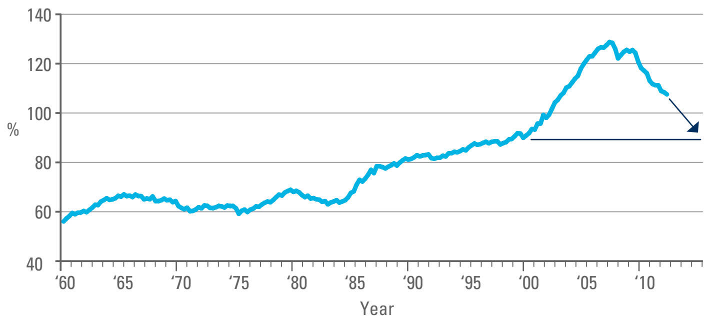
Can HIDC governments more likely trigger the directional moves that could set off a real currency war? Is Prime Minister Abe's experiment in Japan, for example, going to succeed? Again, we think it is difficult absent changes in the fundamentals. Europe, the US, and Japan are all struggling to create inflation, they have limited foreign exchange reserves, and they all face major impediments to growth. When US Treasury Secretary John Connally in 1971 famously remarked, "the Dollar is our currency, but it is your problem" he did not cause the subsequent collapse of the US Dollar from $35 per ounce of gold to $185 per ounce per se, it was caused by the surplus countries of the day, which were mostly in Europe.

Today the surplus economies are all in Emerging Markets. Emerging Markets central banks today control 80% of the world's foreign exchange reserves. There should be no doubt whatsoever that these institutions have the power to control the direction of global currencies. By way of illustration, Nomura estimates that the net speculative short in EURUSD around the time of maximum Euro bearishness in 2012 was about $35bn. This compares to a stock of Emerging Markets foreign exchange reserves of $8.7trillion as of the end of 2012.

Despite their undisputed power, however, we believe that Emerging Markets central banks would be loath to trigger a major realignment of global currencies. Central bankers generally do not like instability and Emerging Markets policy makers have particularly strong reasons to not cause instability.

That brings us to the final potential trigger for a resumption of directional currency moves and potentially real currency wars, namely economic fundamentals. The current inactivity in growth, inflation, and interest rates across the HIDCs will not last forever. Time will slowly heal the HIDCs. For example, we estimate that by Q2 2016 household debt to income in the United States will be back to pre-crisis levels. A subsequent pick-up in spending around would almost certainly raise not only growth expectations, but also inflation expectations.

Fig 6: **US Household Debt as a percentage of disposable income**



Source: U.S. Treasury, Ashmore. 2012.

A tightening cycle starting in, say, 2015 would take place against the backdrop of US public debt to GDP of more than 100% of GDP, a much lower starting point for interest rates, and an enormous volume of outstanding QE money, much of it sitting in so-called 'safe haven' assets in the financial markets.

In that context, the risk of a bond market collapse akin to 1994 is not immaterial. To avoid a rout, the Fed may well be forced to control the pace of normalisation of rates with more QE. But more QE at a time when the market is worrying about inflation and

[1] ELMI+ volatility has more than doubled from 1.5% in 2000-2008 to 3.3% since 2008.

wants to see higher yields means only one thing for the US Dollar – it goes down. And the resultant move lower in the US Dollar has implications for everyone on account of its reserve currency status.

When growth and inflation begin to put pressure on yields and the US Dollar, Emerging Markets central banks are likely to protect themselves by hedging duration, but they can only limit their currency losses if they actually get rid of their US Dollars. The risk is that a large Emerging Markets central bank embarks on active selling of US Dollars into the market. This would cause others to do the same. The market would jump on the trade. The resulting price action in turn would prompt other HIDCs to try to weaken their currencies too. Everyone becomes a seller at the same time. Liquidity could even dry up.

Hence, the return of fundamental drivers is likely to bring about currency realignment and a potential transition from phony to real currency wars.

Can a real currency war be avoided?

Emerging Markets cannot avoid the approaching appreciation of their currencies. The mirror image of the excessive accumulation of debt in the HIDCs is the excessive accumulation of foreign exchange reserves in Emerging Markets. Emerging Markets reserves are overwhelmingly invested in HIDC government bonds and currencies. When these turn bad Emerging Markets will pay the price. It is not just that the real value of the reserves will decline. Years of benign export conditions will also come to an end. As China has shown, transitioning from export to domestic led growth is politically challenging, slows the economy, and causes inflation to decline.

Currency appreciation is an external shock to which Emerging Markets must adjust or perish. Resistance is futile in anything but in the short run, because sustained intervention creates inflation, while closing capital markets kills growth.

Given that most Emerging Markets currencies have to appreciate against the US Dollar, the single most important challenge is how Emerging Markets avoid fighting currency wars against one another.

Avoiding an Emerging Markets real currency war requires that their central banks coordinate US Dollar sales with purchases of each other's currencies in such a way as to not seriously distort the relative value of their respective currencies versus each other as they appreciate against the US Dollar. For example, all Emerging Markets central banks (or the biggest ones) could agree to sell 10% of their US Dollars over a period of time in exchange for buying 10% of each other's currencies.

There is much to gain from working together. Coordination would preserve currency valuations versus one another, thus reducing the risk of competitive devaluations. It would also reduce the risk to their reserves significantly. And it can have a very significant positive impact on the liquidity of each country's bond market as other central banks become active participants for the first time, especially if their purchases and the subsequent management of the bonds are outsourced to active specialist Emerging Markets fund managers.

Big Emerging Markets countries will experience the strongest currency appreciation on account of the greater liquidity of their currencies. Emerging Markets central banks would therefore do well to buy into the local bond markets of large Emerging Markets countries, whose central banks would almost certainly cut rates as their currencies appreciate. Small Emerging Markets countries on the other hand will experience less appreciation because their currencies are less liquid. This means that equity markets should do better in smaller economies, such as Frontier Markets. Small cap companies, which, in general, are less exposed to exports and more exposed to domestic demand should do better than large cap companies during this adjustment phase.

Contact Information

Head Office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000

www.ashmoregroup.com

Other Locations

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Melbourne
T: +61 0 3 9653 9524

Moscow
T: +74 9566 04258

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Washington
T: +1 703 243 8800

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Bloomberg Page
Ashmore <GO>

Fund Prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper