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Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

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FOREX RATES: G3 AND SELECT ASIANS

Summary

Given their respective monetary policies, the USD should now be strengthening with the prospects of a relatively stronger economy and higher rates and yields, the EUR weakening for exactly the opposite reasons, as should the JPY pressed by a pursuit of inflation and zero rates. From the start of 2014 the trends were the opposite for the EUR but progressively flat for the JPY, and their reversal from mid 2014 onwards have left the currencies on uncertain trajectories. As for the Asian surveyed here, the INR which should have been the weakest is now the strongest, while the THB, IDR and PHP are all weakening despite stellar equities performance. No clear short term trends here

Investment Conclusions

We expect that the EUR will maintain its weakening trend till yearend and into 2015 moving then near 1.30 and then falling in the upper 1.20 range. The JPY will also weaken during the rest of 2014 and into 2015 starting from there a faster decline from about the 110 mark. All the Asian covered here are expected to stay within narrow, weakening ranges reflecting the, eventual, rises in USD interest rates. Political events in Thailand and Indonesia may cause spikes. Eventually falling interest rates in India may cause the INR to weaken during 2015 and test the 65 level.

Strange but explainable

As Chart 1 shows, the trade-weighted index of the USD (red line) fell from the start of 2014 to early summer and then strengthened. Its performance during 2013 was erratic falling steeply after the May 2013 announcement that tapering would start and then recovering to yearend. The EUR, despite the poor performance of the EU economy throughout 2013-14, kept strengthening till late spring 2014 and then weakened following the further ECB loosening including "negative" interest rates. The JPY weakened, as expected for most of 2013, but then stayed basically flat withstanding all policy measure to let inflation accelerate as well as the continuation of an extremely loose monetary policy. All these movements can be explained as follows

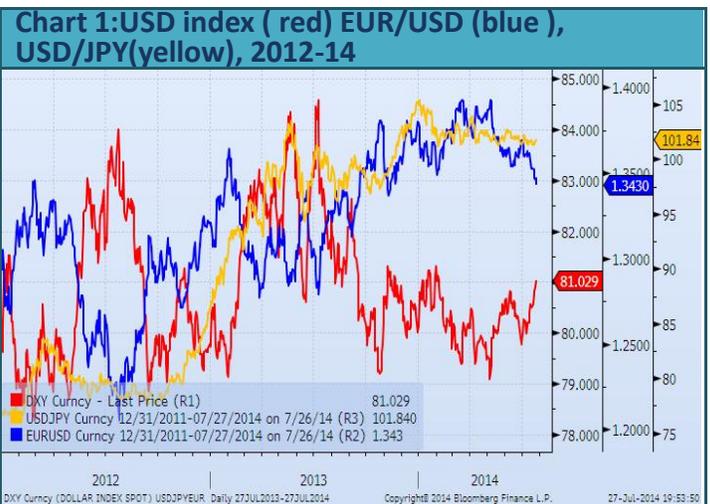
The **USD**, after the shock of tapering, has and will stay stronger because of the better performance of the US economy and the near certainty that USD interest rates will be the ones first to rise in the G3

The relative strength of the **EUR** could be justified by the small rate differential advantage till June 2014 when ECB measures reduced it, and the guarantee by the ECB that sovereign crises would not be allowed happen.

The **JPY** story is more difficult to explain to the extent that the JPY should have continued to weakened under the threat of inflation (which has not happened) and by

disappointment of Abe's third arrow which was long on promises and short on implementation details.

The road from here to yearend 2014 and the first half of 2015 should be more of the same. A stronger USD with relative weaker JPY and EUR. Any signs of earlier than later hikes in US rates (which we do not believe or expect, mid to end 2015 being a sensible point to aim for) and these trends would strengthen,



Meanwhile in Asia.....

We have focused here on the four economies with the best equities market performance precisely because there seems to be a slight disconnect with their forex movements. All four rates got hit in May 2013 but then made quick recoveries. The military coup in Thailand caused little damage to the THB which, as Chart 2 shows, is on a strengthening tack as is the PHP and the IDR. In India, after the INR strengthened at the end of 2013 to mid 2014, the political uncertainty, despite the excellent equities performance, caused the unit to weaken. India's current account deficit has made a remarkable recovery, partially due to slowing economy, and this has helped the INR. The political vagaries of the Indonesian presidential elections had little directional impact on the IDR. As for the Philippines the relative strength of the external sector

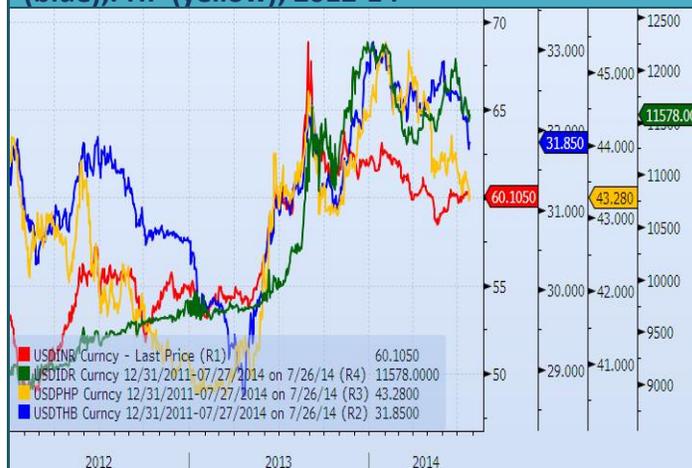
ACTBOX :The USD and Asian forex rates

There is a widespread-held notion that Asian forex rates are somehow linked to the USD. There is ample evidence that this is not so with the exception of the pegged HKD and the CNY which is not fully convertible and managed. The rest of the Asian currencies can, and do, follow market trajectories given, however, the fact that Asian central banks do intervene. The proof that Asian currencies are not linked to the USD is provided by the behaviour of official interest rates, all of which have decoupled a long time ago from the Fed. Most recently India and Indonesia hiked rates. See also main text.

as well as the sound fiscal position will support the PHP for now. None of these four economies are likely to face funding issues if US yields rise faster and earlier than expected. This was shown to be broadly true during the mini-crisis in May 2013.

As the text in the Factbox indicates, there is significant difference between believing that Asian domestic interest follow closely US policy rates, from claiming that a stronger USD versus the G2 may lead to some weaker Asians, precisely because their domestic rates **do not** follow USD rates !

Chart 2: Rates to USD, INR (red), IDR (green) THB (blue), PHP (yellow), 2012-14



Source: Bloomberg

Investment implications

The “weak” JPY has been the cause of frustration and of losses as clearly the unit did not go the way 101 Economics would have to it, not because collectively the market was “wrong”, but because there were too many other factors involved including absence of significant capital outflows, nor truly accelerating inflation. The failure of the third arrow of Abenomics to deliver, may imply reliance on the monetary levers for much longer, as fiscal retrenchment is inevitable. Hence the growing likelihood of the weaker JPY.

The case for going short on the EUR is easier to see in view of the weak economy, absence of inflation and slow and timid application of monetary policy as an instrument of supporting economic growth rather than accelerating inflation (See our detailed views in Econote No.4, 26/6/14 on the inability of the EU and Japanese monetary policies to deliver what they promise)

As for the Asians, given our expectations indicated above over an overall weakening trend, the two currencies likely to produce some volatility and hence trading opportunities are the THB and IDR both driven by politics than policies, at least for now? As the RBI will cut rates in 2015 the INR will stay under some pressure.

(Completed 28/7/2014)