MARKETS

The new "new normal" in FX

BY DANIEL P. COLLINS

Forex markets have hinted that they may be returning to normal and central banks have agreed to leave their mitts off currency values. What will this mean for forex in 2013?

To paraphrase Jerry Garcia, it has been a long, strange trip for markets, particularly foreign exchange markets, in recent years. But traders and analysts believe 2012 was somewhat of a watershed with the Eurozone getting a handle on, if not solving, its sovereign debt issues, the yen coming back down to earth and the U.S. economy growing, albeit slowly.

What this has meant for foreign exchange is a move toward the market following more normal fundamentals instead of simply being whipsawed by the risk-on/risk-off trade that has been the driver of choppy markets for much of 2010, 2011 and the first half of 2012. "Currencies are following more normal fundamentals after spending the last two years flipping from risk-on to risk-off," says Paul Chappell, chief investment officer of U.K.-based C-View Ltd.

G7 makes pledge
Japan's lost decades

Mikkel Thorup, principal of Capricorn Currency Management, agrees. "I do see the markets as being a little more fundamentally driven and less political, which is a good sign."

But what does normal mean at this point? Well, first, it probably doesn't mean the euro will be able to sustain its strong move from the second half of 2012 and early part of this year (see "A good run," right). Although most of our experts agree a major catalyst for forex moving toward more normal fundamentals was the Eurozone getting its house in order in the summer of 2012, that move has gone as far as it could go. While the Eurozone appears more stable, it certainly is not in line for strong growth.

Chappell says there is more stability in the Eurozone, but it is not out of the woods. "There will be bumps along the way and worries about the [Eurozone] sovereign crisis and U.S. fiscal cliff."

Although the Eurozone sovereign debt crisis has been in abeyance since mid-2012, it is not necessarily over. "A large amount of debt still exists. There is a way to go; we don't think it is going to be a smooth ride," Chappell says.

He sees the mid-February level around 1.33-1.34 in the euro as fair value but says it could sell off to the mid-1.20s and he sees 1.40 as the top of the range for 2013.

Andrew Wilkinson, chief economic strategist at Miller Tabak & Co., says the European Central Bank (ECB) prevented a potential contagion but growth will be slow. "The measures the ECB [have] drawn up widely are perceived to be sufficiently strong to snuff out any contagion. So we have seen rising government bond yields and the flow of credit. That in itself is a big factor in creating [an] economic [recovery] in the Eurozone," he says. "Now the recovery is going to be very slow, we should probably expect no growth in the [first half]. In the second half of the year, it seems reasonable for the German economy to grow, and it will flow through, albeit slowly, to the peripheral areas of the Eurozone."

Wilkinson adds, "We now have seen some independent currency movement, which is great because you no longer can predict volatility. So currency trading has come full circle, back to trying to predict which economy is going to outperform the next."

In terms of performance, Wilkinson sees a widening growth differential between the U.S. and Eurozone to keep the euro down most of the year, targeting the 1.24 range. "It has more to do with dollar strength than euro weakness. Euro weakness is isolated to outperformance

of the U.S. economy and growing expectations that the Fed at some point will alter its official policy stance," he adds.

Thorup says the euro is too high at current (1.33-1.334) levels. He targets 1.25 for the euro by mid-2013. "Right now it is seeing some technical momentum. It was very risk driven," he adds.

A GOOD RUN

The ECB's intervention this past summer into Eurozone sovereign debt ended fears of contagion and set the euro off on a solid rally.

Source: eSignal

Markets rule; really

The risk-on/risk-off trade and the perception, if not the reality, that governments and central banks were becoming too active in the markets have so rattled the markets that liquidity has suffered.

"Forex thrives on volatility, and not when everybody is running from the same side of the ship to the other," says Wilkinson. "When they are rocking the boat in the same manner, it becomes difficult for everyone to make money. Now you are back to the situation where you are pitting your wits against everybody else."

Not that Wilkinson agreed with the perception that governments were manipulating exchange rates, but he acknowledges that there had to be concern for the G-7 to commit to not doing it. On Feb. 12 the G-7 stated, "We reaffirm that our fiscal and monetary policies have been and will remain oriented toward meeting our respective domestic objectives using domestic instruments, and that we will not target exchange rates (see "Group of 7 make promise," right)."

The announcement came a week ahead of the Moscow G-20 meetings. It was G-20 members that expressed concern over currency valuations, particularly with Japan. The G-20 made a similar commitment in Moscow.

Wilkinson says, "The perception of a currency war is purely a figment of the market's imagination and the beneficiaries are those that are speculating on the financial markets."

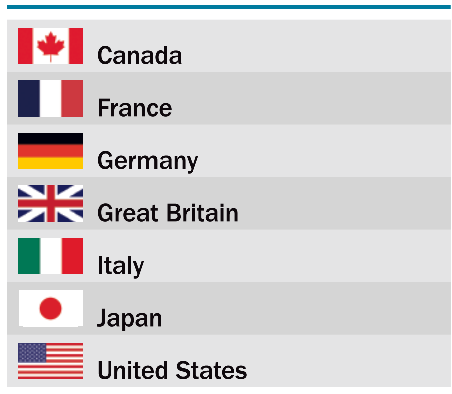
And he is not alone in that opinion. "If you talk to people about currency wars, some say it is an actual conflict, others say it is a misnomer," says Jim Conklin, director of research at QFS Asset Management. "It is natural for countries to ease monetary policy. Stop whining about the degree that G-4 has been pursuing financial [policy]. To some degree this has been strong monetary intervention. I don't see G-4 countries changing policy. All are running near zero interest rates (plus QE). Everybody is pursuing their own interest through monetary policy; that is not a change from historical practice."

But he sees a definite distinction between loose monetary policy and currency manipulation. "With the exception of the Swiss and China, central banks are not expressly intervening in currency markets; they are conducting loose monetary policy. Some say it is the same as currency intervention, others say no, loose monetary policy is loose monetary policy," Conklin adds.

Wilkinson says, "[The G-20 commitment] helps assert confidence that the world's largest nations are trying to restore domestic and global growth through prudent policies rather than through currency devaluation."

GROUP OF 7 MAKES PROMISE

There are a whole host of "G" groups. The G-7 first began meeting in 1975 but was officially established in 1985 to facilitate economic cooperation among the world's largest industrial nations. It includes:



Yen finds its mojo

Concern over currency manipulation centered on new Japanese Prime Minister Shinzo Abe's commitment to improve the Japanese economy and consequently devalue the yen through multiple policy initiatives, including possibly buying foreign assets.

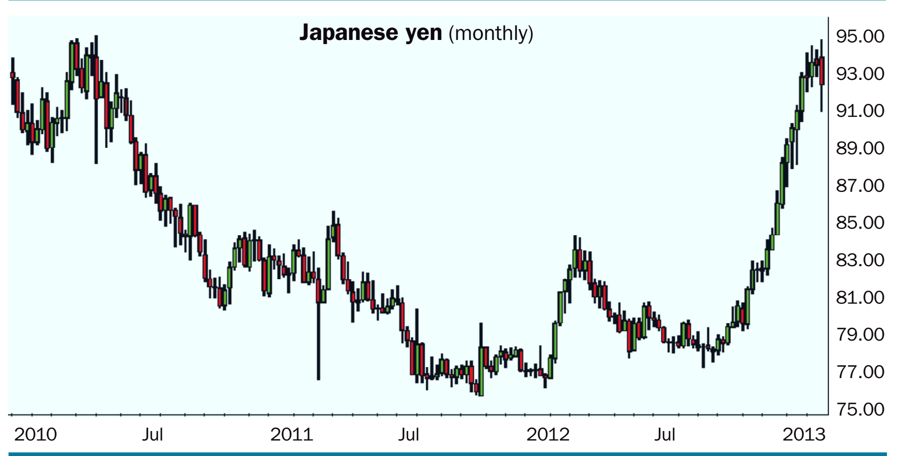
While the rally in the euro was a sign that the worst may be over for the Eurozone and things may be returning to normal, it was nothing compared to the yen depreciation vs. the dollar as measured by both its velocity and its meaning (see "Yen hits stride," page 18).

"It would be a sign of global health if the yen continued its current path of weakness," Wilkinson says. "I firmly believe the market is reacting to its expectation of what it feels the Japanese authorities can manage through loosening monetary policy. Everybody wants to see a weaker yen. The more the Japanese yen weakens, the stronger the Japanese economy. The earlier strength of the yen crippled its economy."

At the heart of yen weakness is Abe's efforts to improve Japan's economy. "The Japanese finally have come to terms with inflation and are trying to stimulate the

YEN HITS STRIDE

The 2011 low (high vs. the dollar) in the yen took out a 16-year move dating back to the apex of the Japanese lost decade. That yen strength has harmed its manufacturing base and has kept Japan's economy weak.



Source: eSignal

economy," Chappell says.

"The Japanese had been in an extended period of appreciation because it played into this [risk-on/risk-off] fear largely dominated by this worsening global outlook," Wilkinson adds. "The stronger the yen became the weaker demand for its goods. When it was perceived that a change in the Japanese government might be able to target something more special, traders really got the bit between their teeth."

But the move in the yen has been substantial given it has not been backed up by tangible policy moves, and it has been reported that Abe has recently backed off of an earlier pledge to buy foreign assets to help devalue the yen.

Conklin says the current yen move may not be sustainable and points out that Japanese financial markets are not as deep and do not offer as many tools for the BoJ to affect interest rates. "The JGB market is not as deep and liquid [as U.S. Treasuries]," Conklin says. "In the U.S., the Fed is tapping into [mortgage-backed securities]; there is no such market for the Bank of Japan to tap."

He adds that the end of the yen rally could extend to other currencies. "What happens to the rest of the FX markets when the yen starts appreciating again? A lot of the optimism on Asian markets will [take] a hit," Conklin says.

However, Wilkinson believes yen weakness will continue and targets 100 by mid-2013 and 110 by year-end.

Dollar days

Most analysts see the dollar as the strongest of the Western currencies, but acknowledge that the end of risk-on/risk-off means the dollar is flying solo. Chappell says the U.S. economy is strong relative to Japan and the Eurozone, but the move toward more normal fundamentals is a two-edged sword for the dollar. "It has to stand on its own two feet — no returning to people rushing [into the dollar] for risk aversion. [But] compared to other G-7 currencies, the U.S. economy is doing better," he says.

Wilkinson sees the appeal of the U.S. dollar. "The Fed's QE policy has helped the economy recover further and faster than a lot of people appreciate," he says. "And on one hand, you could expect a weaker dollar because of the Fed adding liquidity, it makes more sense for the Fed to stop in its tracks sooner rather than later."

However, he says an early exit from QE would support the dollar. "I would sug-

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gest that the Fed's activity has created financial market stability and at some point they will be forced to reassess the policy," Wilkinson says. "[We] probably have reached take-off speed, and the Fed does not need to buy bonds — not to say yields won't surge."

More interesting perhaps are the commodity currencies, which have been a mixed bag.

Chappell says the commodity currencies are a little overvalued. "The dollar will do better than the commodity currencies. We see the Aussie doing worse than the Canadian dollar [because the Canadian] economy will benefit from expected growth in the U.S."

Wilkinson adds, "I am somewhat surprised that the Aussie and Canadian have both weakened relative to the U.S. dollar. It plays into a bigger picture of contained inflationary pressures around the world. Even as the Chinese economy begins to feel the benefit of a turning point for the Eurozone, it has not stoked any inflationary fears."

Global demand and inflation are key drivers of commodity-linked currencies, but their value also is based on their stability. Conklin is bullish commodity currencies but does not necessarily see commodities rising. "Broadly, in the short-term they will be correlated with the price of commodities that may be coming down," he says. "Over the long run, those currencies have far better fundamentals. Their banks are more in control. When you look at the Fed, they are doing monetary experiments. I respect what they have done, but they are forced to conduct monetary experiments."

Conklin simply points out that the Aussie, Canadian and New Zealand dollars along with the Norwegian Krone have more productive economies.

All our analysts were more bullish on the BRIC currencies in general and the Brazilian real in particular, which is the consensus pick to have the largest move in 2013.

The concept of "normal" is a tough one as it relates to markets. The extraordinary events involving the 2008 credit meltdown have led to more government and central bank meddling, but this always has been an issue for markets, particularly forex. But when it gets to a point where traders avoid markets instead of trying to exploit those normal policy initiatives, markets become less liquid and fail to perform their role of risk mitigation.

There are signs that forex markets have become more robust in the last few quarters but the fact that the U.S. could not come to an agreement before initiating the sequester is a sign governmental dysfunction could roil markets. It is the type of thing that has led to some of the market dysfunction we have seen since 2008. Although there is no guarantee that governments and central banks will "let the markets decide," it has proven more difficult, if not impossible, to manipulate currency values in this unpredictable world, which is probably a good thing because that fact will keep folks in the market despite the efforts of some. F