Weekly Market Commentary

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Currency War

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Highlights

The "currency war" is unlikely to end anytime soon. It will take evidence of significantly stronger growth or a rise in inflation and interest rates to put an end to quantitative easing in the United States.

The most likely outcomes of the currency war include more monetary stimulus around the world and increasing measures by emerging market countries to close their doors to inflows of capital.

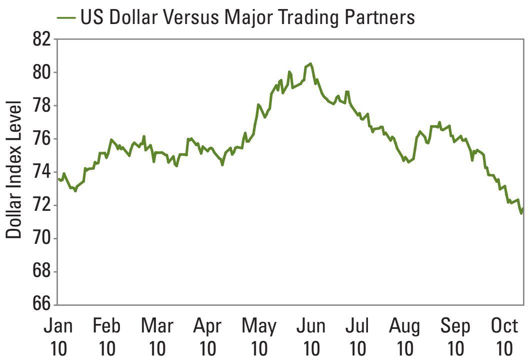
Emerging markets benefit from the greater global demand created by stimulative monetary policy, the rising value of their commodity-based exports, and the appreciation of their currency boosts dollar-based investment returns.

Fears of a "currency war," in which countries devalue their currencies to gain a trade advantage, dominated headlines last week ahead of the weekend meetings in South Korea of the finance ministers from the 20 leading economies that make up the Group of 20 (G-20). Last week, U.S. Treasury Secretary Tim Geithner, who also attended the meeting, publically commented that the U.S. desires a further depreciation of the dollar against the Chinese currency. He also noted that "the major currencies…are roughly in alignment now" a suggestion that he sees no need for the dollar to fall further against the euro and yen; however, U.S. Treasury Secretaries are notorious for stating an interest in a strong dollar while accommodating a slide. The dollar has fallen 13% against the major currencies since June.

Last week the dollar rose slightly for the first time in six weeks. Brazil's finance minister warned of "an international currency war" and called for "some kind of currency agreement." India's prime minister has expressed similar concerns and the governor of the Bank of England has warned of protectionism unless "the need to act in the collective interest" is recognized. While any major announcements would come from the November meeting of G-20 leaders in Seoul, it is unlikely that there will be any globally coordinated move on exchange rates.

Despite these calls for action, the "currency war" is unlikely to end anytime soon. It is primarily the result of the bifurcation of world economic growth. Many developed countries see further stimulative monetary policy, which lowers interest rates and pumps more currency into the system, as a necessary response to subpar growth. In the United States, a weaker dollar is a beneficial side-effect of the policy that can help boost inflation since a weaker dollar has less purchasing power as the Federal Reserve seeks to avoid the demand-destroying effects posed by the threat of deflation, or falling prices. However, these policies create challenges for the emerging market countries where growth is currently strong. They are increasingly pressured by a rising currency that threatens to reduce the global competitiveness of their exports and create a bubble in their economies as the world's capital increasingly pours into their borders.

1 Dollar Devalued



Source: Bloomberg 10/22/10

Potential Consequences

There are three primary potential consequences of the ongoing currency war.

1. **A global currency agreement.** We stated above that a globally coordinated move on exchange rates is unlikely. The framework suggested by some finance ministers for such an agreement would

follow that of the Plaza Accord of 1985, when France, Germany, Japan, and the other governments agreed to intervene to devalue the US dollar against the yen and the German deutsche mark. This devaluation was planned, done in an orderly, pre-announced manner and did not lead to a financial crisis or a currency war. Back then, the move was in response to a dramatic rise in the value of the dollar in response to restrictive monetary policy by the Federal Reserve as they hiked rates into the double-digits to curb rampant inflation. That situation is the complete opposite of today making the unique circumstances that led to the success of a global currency agreement such as the Plaza Accord extremely unlikely in the prevailing environment. However, emerging market countries have recently been allocated a larger percentage of voting rights and a bigger role at the International Monetary Fund when it comes to managing the global economy.

2. **More monetary stimulus around the world.** This seems to be the most likely outcome. In recent weeks, a number of countries have already started taking steps towards more stimulus as they follow the lead of the United States. Both the Bank of Japan and Bank of England have moved toward additional "quantitative easing", so-called because it increases the quantity of money in an effort to lower the value of the currency and boost growth. Nearly all of the world's major central banks are contemplating similar actions. Even the Bank of Canada, the first of the major central banks to begin to withdrawal stimulus with rate hikes that began this past summer, is likely to put a halt to their actions. However, there are likely to be some exceptions among emerging markets where more than 20 central banks are raising rates to prevent a further rise in domestic inflation (inflation is running in the mid-to-high single-digits in countries such as Brazil, Russia, and India). For these countries, a rising local currency is another way to slow inflation, as it keeps a lid on the prices of imported goods.
3. **Emerging markets try to close the doors.** The pressure on some emerging market countries to follow suit to reduce the strength of their currencies may lead to longer-term risks of bubbles becoming inflated due to the excessive stimulus from domestic actions in addition to inflows from abroad. This is prompting some emerging market countries to impose controls on the cross border flow of capital to weaken their currencies.
   - Brazil, which has the highest real interest rates in the G-20, is seeking to restrain its currency as investors seek higher-yielding assets in emerging markets amid near-zero interest rates in the United States, Japan, and Europe. Brazil recently raised the tax on foreigners' investments for the second time in a month. The Brazilian's first attempt to stem the currency gains via a tax on inflows was outflanked by an announcement from the Bank of Japan reducing the overnight call rate target to a range of zero to 0.1 percent, the lowest since 2006.
   - South Korea is also preparing further measures to counter capital inflows triggered by low interest rates overseas such as reviving a withholding tax on foreign investors' bond holdings, and may impose further limits on currency forward trading.

- Indonesia's central bank said it plans to offer deposit rates with longer maturities of three, six, and nine months to slow the flow of "hot money" in and out of the country.
- Thailand last week re-imposed a 15% withholding tax on foreign bond holdings.

It is possible that we could see more aggressive moves if these countries become desperate to stop the appreciation of their currencies.

How Long Will It Last?

The currency war cannot go on forever. There is a limit to the benefit of currency devaluation. President Obama has a stated goal of growing the U.S. economy by doubling U.S. exports over the next five years. The United States is already the world's largest exporter by a wide margin. Accomplishing that magnitude of an increase in global market share for the U.S. in such a short amount of time would likely require further substantial devaluation of the dollar. However, that large a devaluation would hurt consumer spending, since it would push up the prices of oil and other imported goods, in addition to the interest rates consumers use to finance their spending making everything more costly. Since consumer spending makes up about 70% of the U.S. economy, it is highly unlikely the gain in exports would offset the potential drop in consumer spending, which is many times larger. A rise in inflation and interest rates would put an end to the benefits of quantitative easing in the United States.

What to Do

Because of the incentive to weaken currency value by lowering interest rates, global monetary policy will be more aggressive than it would be otherwise. This is good news for investors in emerging market stocks and bonds. Emerging markets benefit from the greater global demand created by stimulative monetary policy, the rising value of their commodity-based exports, and the appreciation of their currency boosts dollar-based investment returns.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors is the premier forum for our international economic development that promotes open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability. By contributing to the strengthening of the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions, the G-20 helps to support growth and development across the globe.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Currency Forward is a forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date. Also known as "outright forward currency transaction", "forward outright" or "FX forward".

The Plaza Accord is a 1985 agreement among the G-5 nations (France, Germany, the United States, the United Kingdom, and Japan) to manipulate exchange rates by depreciating the U.S. dollar relative to the Japanese yen and the German Deutsche mark. Also known as the Plaza Agreement, the Plaza Accord's intention was to correct trade imbalances between the U.S. and Germany and the U.S. and Japan, but it only corrected the trade balance with the former.

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