Challenging markets

TIM FOX LOOKS AT WHY VOLATILITY IN THE FOREIGN EXCHANGE MARKETS LOOKS SET TO INCREASE.

Currency markets remain one of the main sources of uncertainty facing corporations in the region given the fixed link to the US dollar of most currencies in the Gulf Cooperation Council (GCC). The events of this past year demonstrate the potential for sharp volatility in the foreign exchange (FX) markets as the world economy continues to recover unevenly from the financial crisis of 2008 and the economic downturn of 2009. From strength in the first half of 2010 the dollar endured a substantial set-back in the middle of this year, only for it to reverse many of these losses nearing its close. Talk of 'currency wars', quantitative easing (QE) and the emergence of sovereign debt crises have further complicated the FX market landscape. At Emirates NBD we have maintained an overall core bullish view towards the US dollar, particularly against major currencies, a call which has not always been easy to maintain. As we head into 2011 we believe that many of our key arguments remain pertinent and the dollar's recent performance has reinforced our sense that credible alternatives to it are few and far between. However, whatever the ultimate outcome may be, it seems likely that going forward FX market volatility in general will be on the rise, making the currency markets ever more challenging for treasurers and traders in the region.

BULLISH ARGUMENTS At the end of 2010 the bullish arguments for the dollar's potentially biggest competitor, the euro, appear particularly unimpressive. Having reached 1.42 in early November, just before QE2 was announced, the euro recently dropped below 1.30 dollars for the first time since mid-September, and looks poised to fall back further towards the 1.15-1.20 range last reached briefly in June. We continue to expect Europe's single currency to trade heavily in the coming year for a number of reasons. First, the Fed's decision to undertake further quantitative easing will probably come to be seen eventually as the right thing to have done to support the US economy. It is not inconceivable that the economy may even perform better than most have expected, and it should not go without notice that the recent improvement in US economic data has occurred almost simultaneously with the announcement of QE2. Second, fears of economic and monetary union (EMU) breaking up show no signs of abating and if anything these risks are likely to intensify during 2011. Third, expectations of tighter European Central banks (ECB) policy will likely be scaled back as the eurozone's economic recovery runs out of steam and as eurozone financing needs become more severe. This is already happening to a limited extent with the ECB recently indicating that it will maintain unlimited liquidity provision until April 2011 at the earliest, contrary to previous speculation that it would soon move to start withdrawing monetary accommodation.

ADDITIONAL STIMULUS The prospect of additional monetary stimulus by the Federal Reserve was undoubtedly the main reason for the dollar's slide against the euro between late August, when Fed chairman Ben Bernanke raised the possibility of more quantitative easing, and 3 November, when the Federal Open Market Committee announced the details of its $600bn asset purchase plan. However, this drag on the US currency already appears to have run its course. The dollar's recovery since that day has almost been linear and most strikingly it can be observed that the economic data has also performed consistently better more or less since that date. In turn rising real interest rates have provided the dollar with support. Looking back it is not beyond the realms of possibility that the Fed's announcement will be seen as occurring exactly at the point that the economy began recovering of its own volition. Nevertheless, despite criticism at the time from different parts of the world the Fed's policy

choice is increasingly starting to be seen by markets as the right thing to have done to support the economy. And as time goes by the realisation that the economy is on the mend will start to grow. Of course the Fed is keeping its options open to renew QE if necessary. But it might just as easily turn out that the full amount of the $600bn of asset purchases announced in November will not need to be made.

Of course, the dollar's slide against the euro began several months before additional QE was fully expected. To a large extent, this reflected reduced anxiety about the eurozone's fiscal crisis in the wake of the EU/IMF bail-out package in May and the subsequent publication of bank stress tests in July. This anxiety has, however, returned more recently. Were it not for the market's response to QE, the euro would probably have already fallen back much further against the dollar because of it.

THREAT OF CONTAGION Even after Ireland has been bailed out (following Greece earlier in the year), the threat of contagion remains with market speculation about the fate of Portugal and Spain likely to grow as 2011 gets underway and arguably affecting others like Belgium and Italy as well. The prospect of a permanent debt resolution mechanism that will see bond holders share the consequences of any eventual default will prevent a meaningful decline in peripheral bond yields and maintain market skepticism towards the single currency. More money will in all probability have to be added to bailout funds, and political discontent will likely mount. In the weak countries having to embrace further austerity measures the reason for this is obvious as standards of living will inevitably decline. But in the stronger countries that have to shoulder the burden of supporting the weaker ones, the protests will also become increasingly vocal. All the time the uncertainty about whether creditor countries like Germany will continue to bail out weaker member states will remain. The political will to prevent a break-up of the euro should probably not be doubted, but steps to strengthen the euro through centralising fiscal policy will be difficult to achieve and in many ways it is the uncertainty about this outlook that will be most corrosive.

For this reason it seems unlikely that the ECB will be able to move confidently towards normalising monetary policy any time soon. Germany may well desire a tighter monetary policy because it is growing fast but elsewhere in the eurozone this is not the case. And to the extent that higher interest rates would undermine the peripheral countries it could ultimately spell bigger problems down the road for the core including Germany as well. The prospect of fading growth combined with stubborn structural debt problems suggest that the euro will remain on the back foot over the coming year. The possibility of a return to parity for the euro/dollar exchange rate still appears a long way away, but it is not completely out of the question. Estimates of fair value for EUR/USD are usually put somewhere between 1.15 and 1.25 (its purchasing power parity level according to the OECD), but given the habit of the markets to overshoot for significant periods it should not be considered beyond the realms of possibility that there will be a test of parity, if not in 2011 then in the years beyond.

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Turning to other major currency pairs, clearly different circumstances apply to the likes of USD/JPY and GBP/USD than to the EUR/USD but a common theme remains in the prospect of a US recovery gaining traction ahead of that in either Japan or the UK. Lack of confidence in Japan's recovery prospects of course predates the recent global crisis, going back to the 'lost decade' of the 1990s. It is unlikely that optimism will return more quickly than elsewhere and the JPY appears vulnerable to any renewed strength in US bond yields. The UK also has a particular set of negative circumstances of its own to deal with in that it is one of the largest world economies with debt problems rivalling those of the eurozone. Fortunately, however, it has a floating currency, allowing it to gain a competitiveness boost unavailable to many of the eurozone's problem countries, by allowing (and even encouraging) the pound to remain weak. It has also taken pre-emptive action to ward off a debt crisis through bold spending cuts. However, the corollary of its austerity steps is likely to be that growth will remain subdued, with speculation about further Bank of England QE steps never likely to be far away in the first half of 2011 at least.

HIGHLY UNEVEN RECOVERY Apart from such country specific themes the common feature of FX in the coming year (and coming years) would seem to be a generalised pick-up in FX market volatility. This reflects, as we have highlighted above, that the global recovery will remain highly uneven. Divergence is not just observable within the developed world, however, but between the developed world and the emerging one. And even within the emerging world the path of recovery is far from uniform, making for intra-regional volatility as well. In the past, global expansions have been largely synchronised but this time is already proving to be different, creating the need for investors to be more selective in terms of which currencies to buy or sell and/or how and when to hedge. This also gives rise to another reason to be wary of renewed FX market volatility, the fact that policy-making is becoming harder to anticipate and analyse, and that policy errors are likely to become more and more common. Uncertainty over the direction of monetary, fiscal, exchange rate, regulatory and trade policies has already risen sharply this year and is likely to become more pronounced in the coming years as growth profiles remain uneven and as political interests clash. While anticipating FX trends at the start of each year is a favourite occupation of most market economists and strategists, going forward this process is likely to become significantly more complicated maintaining FX as one of the main sources of unpredictability for regional traders and treasurers alike.

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