New Minerva Report

Currency Conundrum

One of the oddities over the past couple of decades has been how currency markets have ignored one of the fundamental drivers. Most economic students would have been told that an economy with a higher level of inflation than another, would expect to see its currency depreciate compared with that of the other. The logic is simple. Suppose you have two countries, A and B, who have currency dollar and yen respectively. Suppose your one dollar equals one yen. In the beginning a computer costs 500 yen or 500 dollars. Now suppose that country A with the dollar currency has inflation at 50%, whereas country B with yen has no inflation. After a year the price of the computer will be 500 yen, but 750 dollars. So all things being equal we now have 500 yen equals 750 dollars or 1 yen = 1.5 dollars. This is the core to the theory of Purchasing Power Parity (PPP). In theory therefore, we should see currencies with a higher level of inflation fall against those with lower levels of inflation. We have not seen this happen. In fact quite the reverse. Money has flowed from countries with the lower inflation towards those with higher inflation. The main reason for this has been that countries with higher inflation also have higher interest rates. This has created a momentum of currency movement which has made investors forget about the fundamentals. They have cashed the yield differential instead. This has become known as the ‘Carry Trade’, as previously discussed.

The major currency most out of line is the Japanese Yen. The Economist magazine regularly produces its Big Mac Index. This looks at the price of a MacDonalds Big Mac in countries across the globe, and from this calculates the implied PPP of the dollar in each of those countries. In the last publication of the index it showed that the Yen was 33% undervalued, the pound was 18% overvalued, and the Euro was 22% overvalued. It did point out that an American visiting Japan would not find things as cheap as this index suggests. However, from a UK investors point of view there are some interesting points to draw from this information. In the short term, the problems in the credit markets have stopped the momentum of the ‘Carry Trade’. It is possible that fundamentals can now re-instate themselves, that would mean that if we invest in the US and Japan we have the potential kicker of a currency appreciation to enhance our returns. It is interesting to note that the Foreign & Colonial Investment Trust closed out their Japanese borrowing in June. All short term borrowing made by the trust in the last nine years has been in Japanese Yen.

US Dollar

It is very hard not to think that all the news is bad for the dollar. However, there are some interesting changes occurring which could be the first signs of a long term stabilisation of the dollar, and even dollar strength. The US Trade deficit, which is one of the main causes of dollar weakness, is beginning to shrink. In July, exports rose by 14.8% compared to imports, which rose by only 5.1%. That still leaves an overall deficit of $59.2bn. However, the last time that exports were rising that fast against imports was when the trade deficit all but vanished at the end of the 1980s. If this continues, in twelve months time the Trade Deficit will have fallen to 4% of GDP. The problems hitting the US consumer could make this change even quicker. As the US consumer represents 70% of US GDP, if they start to retrench we could easily see the growth in imports fall to zero. If that happened the Trade Deficit will be close to 3% of GDP. So don’t write the dollar off completely. Investing in a US fund which holds exporting companies could prove highly rewarding.

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