



BNY MELLON  
ASSET MANAGEMENT



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Pareto Investment Management is one of the world's foremost currency managers offering both overlay and absolute return strategies. Pareto does not attempt to forecast future currency returns. Instead, the focus is on utilising Pareto's proprietary models to systematically search for stretched market conditions. These opportunities are then implemented within the portfolio through the application of statistical techniques and pattern recognition models.



## Economic woes bring new opportunities for currency markets

The weakness of the US dollar continued to be a major theme in currency markets in 2009. Only twice since 2002 was the weak dollar cycle broken; briefly in 2005 and again in October 2008 and in the early part of 2009 following the 'safe haven' buying of the currency. Looking back, it is now obvious that the market had significantly underestimated the economic fallout which prompted the abrupt seizure of credit markets.

Some observers have pointed out that a mismatch between bond prices in the developed world and risky assets emerged in this euphoria. Even taking into account the potential price impact of quantitative easing (QE), current bond prices do not seem to reflect any imminent recovery. In addition, the implied volatility on 10-year US rates, which is one of the few volatility indicators that have not returned to normal, has remained stubbornly high. We think this situation is a reflection of the inherent risk to interest rates following a suspension of QE, future supply and demand balance, and the difficulty in forecasting the timing of when the underlying inflation threat might materialise.

As 2009 draws to an end, the main question is when the US will start hiking interest rates. At this point, the consensus view is that the Federal Reserve will wait

until a firmer economic recovery takes hold before increasing rates, for fear of 'killing it' off. As a consequence, the market has taken a view that US interest rates are likely to stay low in the short term, suggesting that the US dollar (and sterling) replaces the Japanese yen as the favourite funding currency for the carry trade. Currency valuations have reached levels close to where they were prior to the credit crunch and the key question for 2010 is whether this environment is sustainable.

### **A square root recovery?**

As we enter 2010, there will be more clarity as to the type of recovery and the likely responses from politicians and central banks. However, the most likely outcome seems to be some kind of square root looking recovery. In this environment, the economic recovery fizzles out in the developing countries as the private sector continues to provide the savings to the economy, while the cash strapped US and UK governments are not able to increase stimulus further. In such a scenario, emerging and commodity markets would be favoured as the market capitalises on their relative outperformance and cheap carry opportunities.

The only problem with this market view is that it is already largely reflected in current prices. As we have seen, valuation

levels are almost back to pre-crisis levels, therefore the ride from here is likely to be much bumpier as the obvious trade is coming to an end and profit-taking and short-term sentiment changes cause significant short-term volatility.

Common sense would suggest that emerging markets will outgrow western economies as average salaries converge. This consensus story, however, carries the relative risks that growth in domestic economies may disappoint and that fizzling western economic growth could create significant asset sell-offs, scenarios which for us would offer possible buying opportunities.

### The end of the carry trade?

As we enter 2010, major currencies have retraced most of the movements that were generated by the credit crunch. The current global economic situation would indicate

that there is still some room for the US dollar to fall further against most major currencies, but where a global adjustment is really required is against the Chinese renminbi and other Asian currencies.

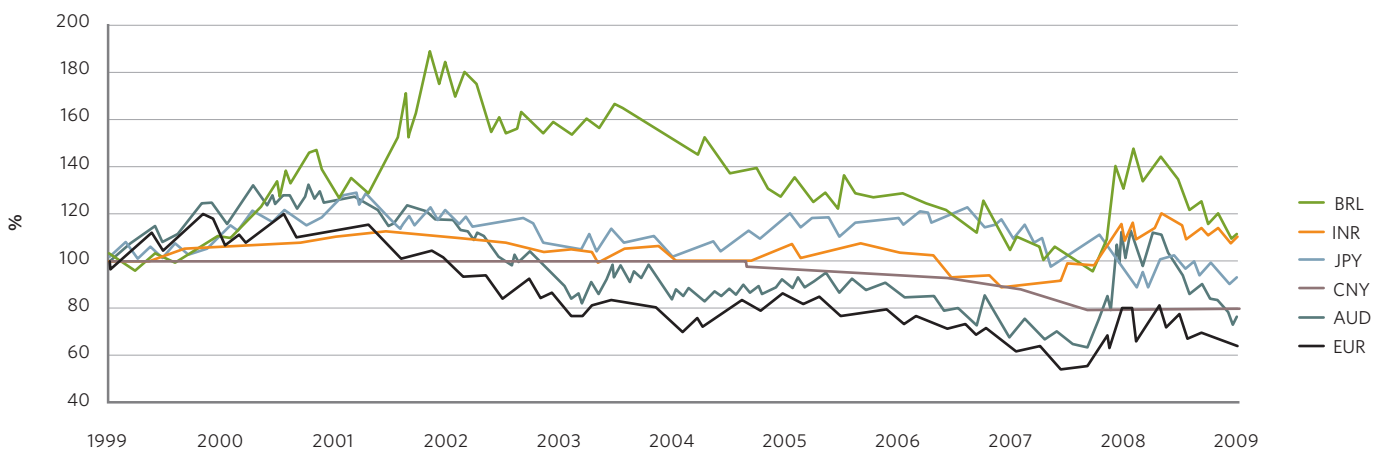
As many of the drivers of the previous asset bubble are still in place - excess liquidity (now provided by the central banks rather than the banks themselves), cheap funding rates, as well as significant global disequilibrium between surplus and deficit countries - even minor changes to the current consensus outlook could have significant impact on asset and currency markets.

As the market begins to forget that current valuations have been driven by excess liquidity and justified by optimistic growth assumptions, the bubble will again start to look very overinflated. It is, therefore, important to look out for any

policy surprises in 2010 that could affect the liquidity provision as stimulus measures in the US are running out. A significant positive surprise for the US economy would be an early indication of the end to the weak dollar cycle. Even a relative surprise in favour of the US dollar could signal a significant rally as global positions reverse.

Beyond 2010, it is reasonable to expect that, in the absence of an economic recovery, both the US and UK governments will try to create some inflation as a means to reduce their debt. Even in the absence of an inflation-based policy, the market may start charging extra in 2010 for taking on this risk. Therefore, long-term interest rates could increase, even in the absence of any economic recovery (as last seen in the 1980s). In such a scenario, one could easily imagine that increasing interest rates in deficit countries will be matched, or even exceeded by further currency depreciation.

CHANGE IN CURRENCY RATES VS US DOLLAR SINCE 2006 (REBASED TO 100)



Source: Pareto as at 30 Sept 2009

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