

12 October 2007

## WEEKLY RESEARCH NOTES

## Talking cure

The statistics make gloomy reading. Depression, anxiety and other mental health issues account for more lost working days in the UK than any other illness, including the ubiquitous flu and common cold. An estimated 91 million working days are lost annually with the cost to the economy estimated at £12 billion. The government this week announced a new strategy to tackle this epidemic – pledging £170 million for so called “talking cures” such as cognitive behaviour therapy.

European politicians have also placed their faith in the power of talking this week. At the Ecofin meeting in Luxembourg, ministers agreed on a statement on foreign exchange markets. Reaching any meaningful consensus at a meeting of European finance ministers might be likened to herding cats. But foreign exchange markets and the perceived strength or weakness of the euro is an unusually divisive issue amongst this often divided group. Any sort of statement, especially a clear and unequivocal one, is significant.

Eurogroup chairman Jean-Claude Juncker said, “we have noted with great attention that the US authorities have reaffirmed that a strong dollar is in the interest of the US economy”. He added: “In emerging countries with large and growing current account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments will occur”.

French president Nicolas Sarkozy has been complaining about the strength of the euro for months. He is no longer a voice in the wilderness. His finance minister, Christine Lagarde, declared that she was very content with the Eurogroup statement. Even the usually Delphic Rodrigo de Rato, outgoing managing director of the International Monetary Fund and supposed arbiter of global imbalances, called the dollar “undervalued” in an interview with the *Financial Times* this week.

EU leaders certainly have a case. The euro has risen more than 10 percent against the dollar in the last 12 months. Worse, though the Chinese yuan has appreciated modestly against the dollar (perhaps as a result of political pressure), it has fallen against the euro. Juncker made it clear that exchange rates will be discussed “with our partners in the G7” when it next meets in Washington on the weekend of October 20<sup>th</sup> and 21<sup>st</sup>.

The default response of the G7 on exchange rates in recent times has been “no comment”. When it met in September last year, again on the fringes of the IMF/World Bank meeting, the yen carry trade was creating huge swings in currencies. The New Zealand dollar soared 7 percent in August against the yen in spite of the country running a deficit equal to 9 percent of GDP. Speculative investors tracked by the CFTC in the US had built a then record yen short of more than \$9 billion and the real effective exchange rate of Japan’s currency was at a 21-year nadir. The G7 reaction was one of deafening silence.

This year it is far from a given that the Europeans will be gagged. There is more at stake than the (still) weak yen. Investors in foreign exchange have enjoyed some rewarding trends in recent years, a weak dollar, a strong euro and reliable returns from carry strategies. However, policymakers still have power. The days of one-way bets may be coming to an end.

## Our Research

State Street Global Markets, the investment research and trading arm of State Street Corporation, develops proprietary research using information aggregated from more than 15 percent of the world’s tradable assets.

By aggregating and analyzing the holdings, flows and borrowings of institutional investors around the world, the research provides unique insights into institutional investor behaviour and its interaction with global financial markets.

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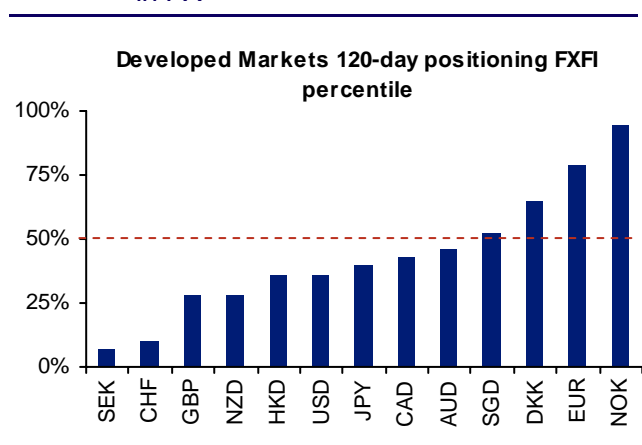
This is reflected in positioning among institutional investors tracked by the Foreign Exchange Flow Indicator. In February positioning was extreme. Among developed markets, the yen and Swiss franc languished in the bottom decile. The Aussie dollar, Canadian dollar, New Zealand dollar, euro and Swedish krona all had top quartile 120-day flows (our positioning proxy).

Now, only the Swedish krona has bottom decile positioning. The euro and Norwegian krona have top quartile 120-day flows. Both the Swedish krona short and Norwegian long positions are being unwound, though flows into euro remain strong (see Chart 1). Institutional investors are currently wary of establishing a big US dollar short, with positioning in the 38<sup>th</sup> percentile. Bond markets are now far more optimistic about the US economy (see Chart 2). This makes a further cut in interest rates at the next meeting of the Federal Reserve less likely and provides some short-term support for the dollar.

Further, despite rising correlation between flows and yield, positioning in the yen remains broadly neutral, in the 42<sup>nd</sup> percentile. Carry bulls might rub their hands in glee at this. They can put on trades without the fear of a rapid reversal that is often precipitated by extreme positioning. The yen looks particularly vulnerable as there are already established short positions in other favoured funding currencies, such as the Swiss franc and Taiwanese dollar.

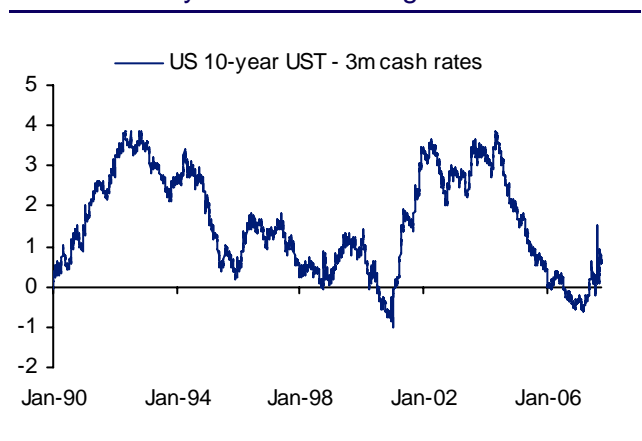
The noises off from policymakers may yet stay the hands of currency players. Nobody expects a new Plaza Accord to emerge from the G7 meeting in nine days time. However, currency misalignment is simmering away as a political and economic issue. Currency markets are far calmer than in August when implied volatility of dollar/euro peaked at 8.5 percent. However, this is still not an environment for unbridled risk-taking. Investors will be listening carefully to what policymakers are saying in the coming weeks. They will be cognizant that sometimes talk can induce anxiety rather than cure it.

Chart 1: Investors reluctant to take position risk in FX



Source: State Street Global Markets

Chart 2: US yield curve no longer inverted



Source: State Street Global Markets

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