

Schroders

Economic and Strategy Viewpoint

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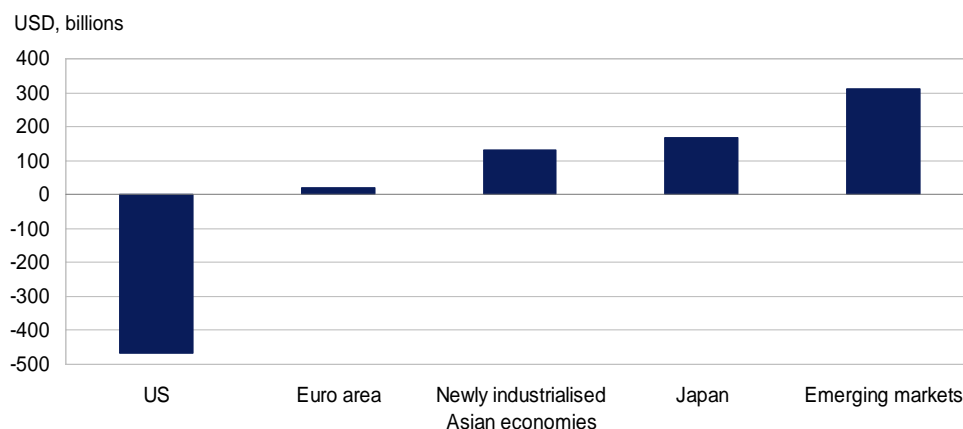
Global: Popularity has its price

- The past month has seen significant capital flow into the emerging markets driving asset prices higher. However, such capital flows bring problems to countries with fixed exchange rates that must sterilise the inflow to prevent inflation – an increasingly onerous task. Meanwhile, the US and Europe see the currency policies of countries like China as protectionist.
- Prior to the financial crisis, the advanced economies were prepared to accept the currency policies of many emerging countries, as credit driven consumer spending drove strong growth. Now that this has come to an end, the advanced economies are increasingly looking to external demand for growth and are questioning the mercantilist policies of their emerging counterparts.
- As protectionist legislation begins to emerge in the US and more countries resort to capital controls, there is scope for relations amongst the G-20 to deteriorate further. In the meantime, capital is likely to continue to pour into the emerging markets as interest rates remain low in the west. Quantitative easing in the US will give an extra push to this in coming months, creating the risk of a bubble in both emerging market equities and Treasury bonds.

Eurozone: Losing the currency war

- In a world where the printing presses rule, the ECB is doing all the right things to lose a currency war. Hawkish comments from ECB members, a removal of liquidity from money markets and success in calming sovereign debt markets, are costing Eurozone exporters through the recent recovery in the Euro.
- Future gains in the Euro present a risk to our Eurozone growth, inflation, and interest rates forecasts. A stronger Euro will undoubtedly dampen growth particularly in export-orientated economies, and will bring back the risk of deflation once again. With little left in the ECB's armoury, interest rates may have to remain on hold for even longer.
- Can Europe do anything to fight back? Ironically, it may be that a resumption of the sovereign debt crisis is needed to reverse the Euro's appreciation. In such a situation, perhaps we may see a little schadenfreude from German exporters.

Chart: Global imbalances persist – current account balances – 2010 projections



Source: World Economic Outlook Database (October 2010), IMF
Newly industrialized Asian economies are composed of 4 countries: Hong Kong SAR, Korea, Singapore, and Taiwan.



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Global

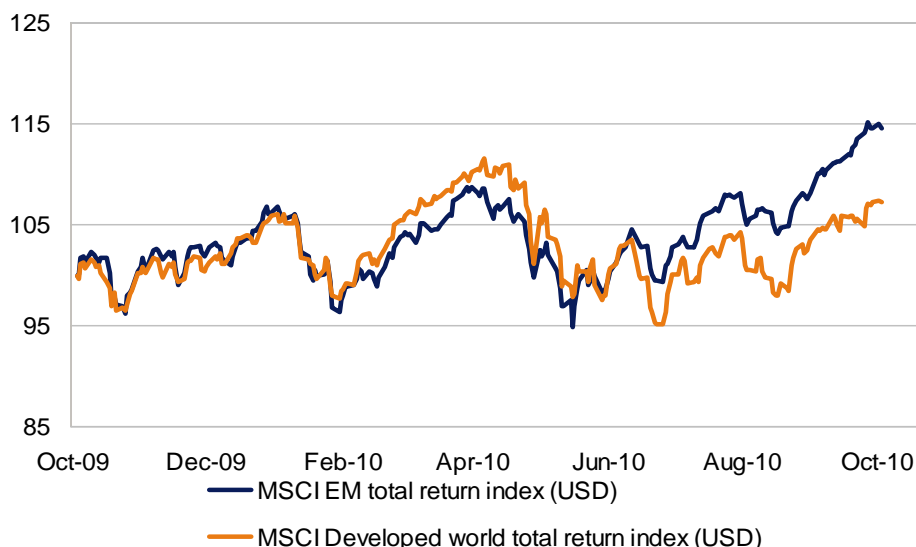
Capital is pouring into the emerging markets

Popularity has its price

The current enthusiasm for risk assets and all things emerging market has generated massive investment flows. For the emerging equity markets, 2010 looks set to match the record capital inflow of \$64 billion seen in 2009¹. By contrast, developed market equities could see net redemptions of around \$37 billion and emerging market equities have significantly outperformed their developed counterparts over the past year (see chart 1).

Chart 1: Performance of EM vs. developed equities

Index (Base 100 = 12 October 2010)



Source: Thomson DataStream. Updated 13 October 2010.

Tensions amongst the G-20 build, with talk of currency wars

Investors see a developed world weighed down by debt, struggling to recover from the financial crisis, whilst the relatively unencumbered emerging economies continue to enjoy growth. Such a scenario might be seen as a healthy re-allocation of capital from the rich world to the developing, helping to raise global living standards. However, as can be seen from the International Monetary Fund (IMF) meetings in Washington, recent developments have exacerbated tensions between the developed and emerging economies with talk of currency wars and fear of protectionism.

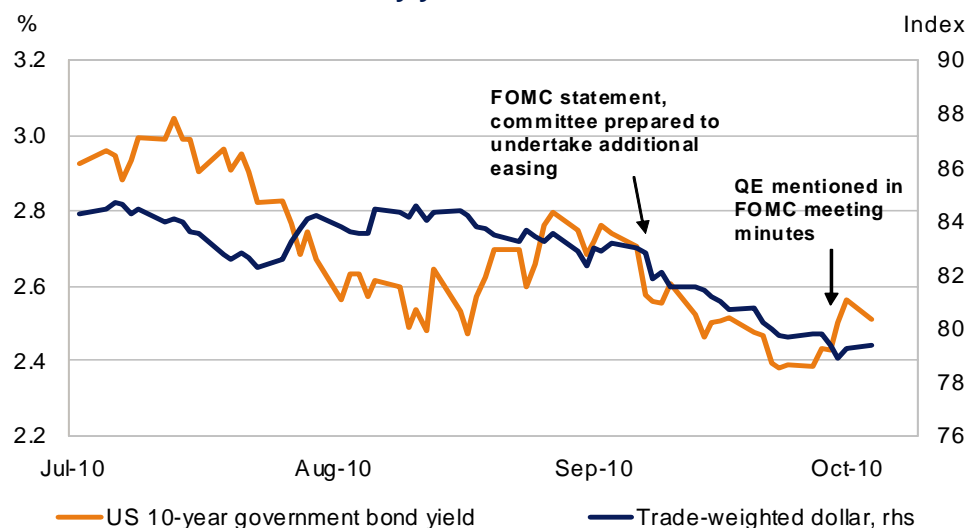
The head of the IMF, Dominique Strauss-Kahn lamented that the co-operation seen during the financial crisis was now absent amongst the G-20. Everyone wants a weaker currency to stimulate their economy, but as a zero sum game this is something the foreign exchange market cannot deliver.

¹ Source EPFR Global

Emerging economies are responding with increased intervention and taxes

The move toward Quantitative Easing (QE) in the US has only exacerbated the problem by driving down the US dollar and Treasury yields, sending investors into higher yielding assets (see chart 2). Increased capital flows to the emerging economies have been one consequence. In turn, central banks in the emerging world are resisting the upward pressure on their currencies by intervening heavily in the foreign exchange market, or trying to slow the flow by raising taxes on foreign purchases of assets. Brazil, whose finance minister coined the term ‘currency wars’, has increased the tax on purchases on bonds and Thailand has just announced similar action.

Chart 2: US dollar and Treasury yields



Source: DataStream, Federal Open Market Committee (FOMC). Updated 19 October 2010.

The problem for those countries trying to resist currency appreciation through intervention in the foreign exchange markets is that they have to neutralise the boost to their money supply in order to prevent a pick up in inflation. This is achieved through conventional bond sales to mop up the liquidity (sterilisation operations). However, the scale of capital flows makes this task increasingly difficult. For example, China reported a \$200 billion increase in reserves during the third quarter implying massive sterilisation operations.

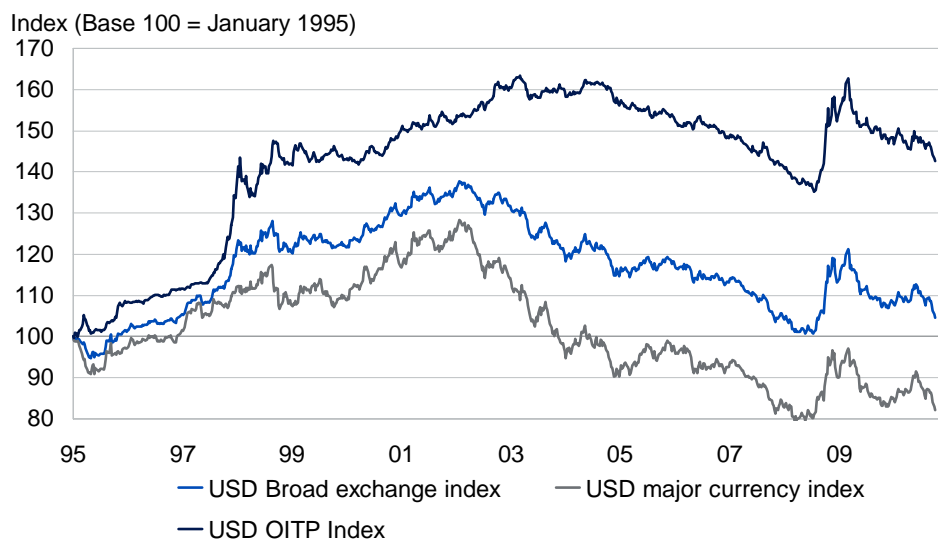
Strong evidence that emerging currencies are undervalued

At the centre of the G-20 row is China, the largest of the emerging economies, which has been criticised for continuing to peg the Yuan to the US dollar at what is seen as an undervalued rate. Evidence of which can be found in the huge trade surplus and the subsequent accusation that China is stealing growth from its trading partners. China’s current account surplus is the largest part of the overall emerging surplus, and is the counterpart to much of the US current account deficit (see chart on front page).

We have consistently argued for an appreciation in emerging currencies, noting that large surpluses and strong export driven growth point to an undervalued currency. The divergence between the US dollar trade weighted exchange rate for the major currencies and the emerging markets (described here as other important trading partners), highlights the uneven distribution of dollar weakness with the developed economies taking the bulk of the adjustment (see chart 3 on next page).

Looking back, chart 3 shows that the emerging economies effectively locked in the fall in their currencies following the crisis of 1997-98. This was achieved through a mixture of pegging or linking their currencies to the dollar.

Chart 3: Dollar weakness is against the majors, not emerging currencies (USD trade-weighted indices)



Source: Thomson DataStream. Updated 13 October 2010.

USD OITP index: US dollar against a subset of currencies in the broad index that do not circulate widely outside the country of issue. Currencies against Mexican peso, Chinese yuan, New Taiwanese dollar, Korean won, Singapore dollar, Hong Kong dollar, Malaysian ringgit, Brazilian real, Thai baht, Philippine peso, Indonesian rupiah, Indian rupee, Israeli new shekel, Saudi riyal, Russian ruble, Argentine austral, Venezuelan bolivar, Chilean peso and Colombian peso.

Policy Clash

The financial crisis has reduced the west's tolerance of the east's currency policies

So the issue is not new, yet nor was it a problem during the boom years of the last decade as growth in the west was led by the credit driven spending of US and European consumers. The emerging economies provided the supply and in the process helped prevent inflationary pressure from building, thus prolonging the cycle.

Today, post the financial crisis, it is a different story. Western consumers are deleveraging, spending is weak and with fiscal and monetary policy reaching its limits, developed country governments are looking overseas for demand to support their economies. Hence the desire for a weaker currency to boost overseas market share and export growth. However, despite accusations of currency protectionism by the advanced countries, the emerging economies continue to follow the same economic path of export led growth underpinned by a competitive currency, otherwise known as mercantilism.

The policies of west and east are now at odds with one another: the willingness of the West to tolerate the undervaluation of Eastern currencies has been considerably reduced by the financial crisis.

The IMF meetings highlighted this divergence with little sign that either side would give way. Since China has seemingly ruled out any significant move in the Yuan, little progress can be expected in coming months and certainly not before next month's G-20 meeting in South Korea.

Little sign of a policy shift implies more of the same for financial markets

Double bubble?

Recognising that currency wars are likely to continue suggests that we could be in for a turbulent time. The US is already preparing protectionist measures which will be wending their way through Congress. Countries that are seen to deliberately run a policy of keeping their exchange rate undervalued are to be targeted. Rhetoric could turn ugly and tensions are likely to mount as countries pursue beggar-thy-neighbour policies².

Meanwhile, we are likely to see continued capital flows to the emerging markets as interest rates in the west remain close to zero and the US restarts QE. In the absence of a shift in policy, the outcome will be more intervention and a recycling of the capital flows back into the US Treasury market. This in turn depresses long rates and forces more capital outflows as investors seek yield. The result could be a simultaneous bubble in both Treasury bonds and emerging market equities.

² Beggar-thy-neighbour policy: policy which seeks to improve a countries' situation at the expense of its neighbours'.

Eurozone

Rigidities of the Eurozone are holding back policy action that could help growth.

Losing the currency war

Once again, the rigidities of the Eurozone are holding back policy action that will hurt growth. As quantitative easing seems set to resume in the US, and possibly in the UK (as discussed in the global section of this note), northern European Hawks on the European Central Bank's (ECB) monetary policy committee are refusing to support any new form of monetary stimulus. Emergency liquidity is slowly being phased out causing short-term interest rates to rise, while some leaders are already calling for policy normalisation soon, despite the tragic state of peripheral economies.

As the only major currency with a central bank refusing to take part in the race to the bottom, the Euro is making an astounding recovery from the falls seen earlier this year. Though the rebound in the Euro partly reflects some success in policy making, continued strength could jeopardise the strength of the recovery, especially for export-orientated economies like German, Austria and the Netherlands.

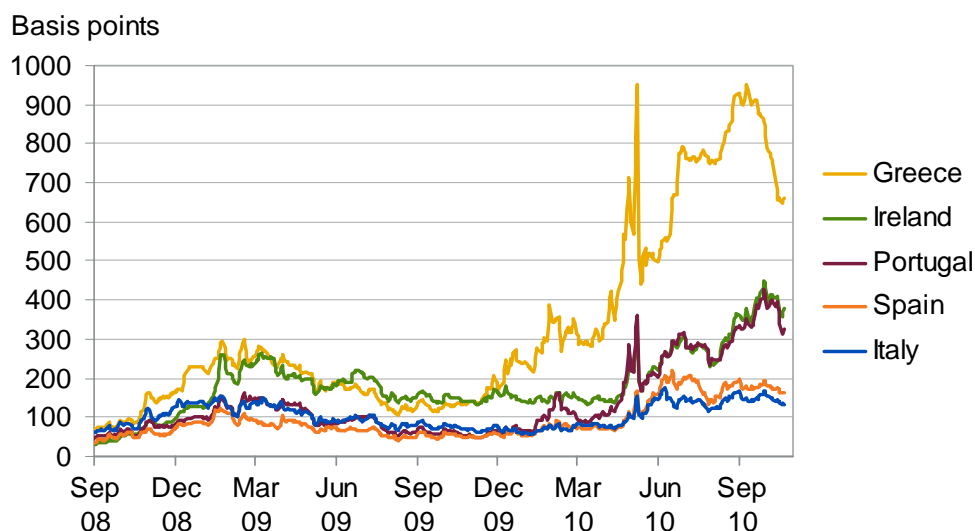
The cost of success

Apart from a couple of short-lived flashes of panic over the past few months (in particular Ireland being downgraded by rating agencies and more banking write downs), the crisis in peripheral European bond markets appears to have abated. Favourable comments from Norway and China towards peripheral debt have helped provide the market with some confidence that sovereigns are unlikely to default – at least in the short-term.

Relative calm has returned to European sovereign debt markets...

The premium the market demands for holding 10-year Greek government bonds over 10-year German Bunds has fallen by a third since its recent peak in September. Several successful small Greek T-bill auctions and a European road show by Greek Finance Minister Giorgos Papakonstantinou, IMF, European Commission and European Central Bank (ECB) officials seem to have helped boost confidence for now (chart 4).

Chart 4: 10yr Government bond yield spreads over Bunds



Source: DataStream. Updated 21 October 2010

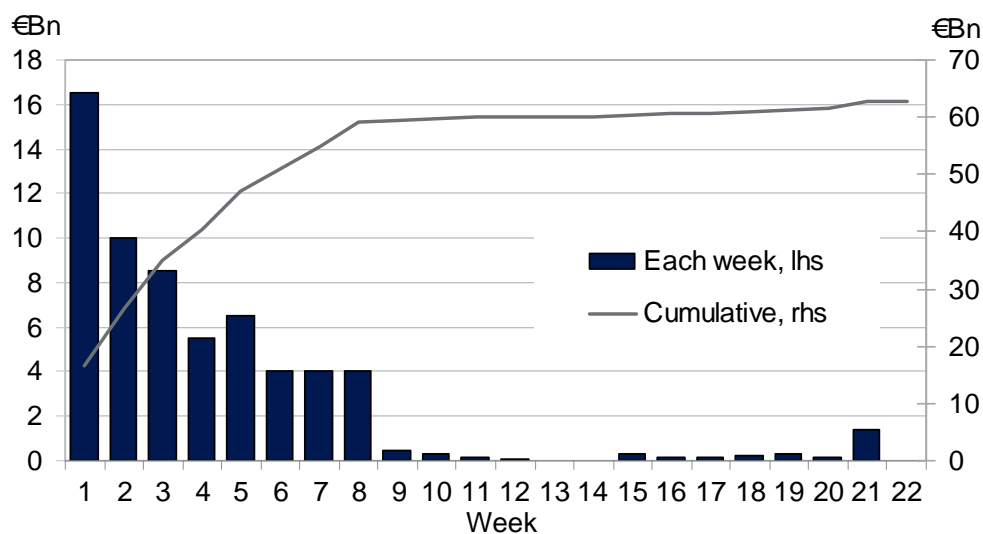
Elsewhere, Portuguese, Irish, Spanish and Italian bonds all saw yields falling relative to Bunds, though spreads remain wide compared to the start of the year. However, it is encouraging to see spreads falling without much intervention from the ECB.

The ECB had been purchasing government bonds to provide additional liquidity to markets shortly after the announcement of the €750 billion European backstop facility. However, unlike the Federal Reserve (Fed) and the Bank of England (BoE), the ECB sterilised its purchases by issuing short dated debt to keep the quantity of money in the system unchanged.

...helping the ECB to slow its asset purchase programme...

ECB purchases which began with a cantor have since slowed markedly. Purchases have recently averaged in the hundreds of millions rather than the billions that were seen in May and June, with the cumulative total hovering just over €61 billion to date (see chart 5).

Chart 5: Weekly ECB purchases of government bonds



Source: ECB. Purchases began on the 10th of May 2010. Updated 21 October 2010

ECB Hawks circling

...but also awakening the Hawks at the ECB.

The calm in sovereign debt markets appears to have helped boost the Euro, but also awaken the Hawks at the ECB. Earlier this month, European Central Bank Governing Council member and President of the Bundesbank Axel Weber said the ECB should stop its bond purchasing program.³ *“The securities purchases should now be phased out permanently”*. Weber stated that in his view, *“exiting too late”* from emergency measures presented a greater danger than *“exiting too early”*.

Weber who is widely seen as favourite to take over from President Jean-Claude Trichet as ECB President next year, represents the fear of inflation that is still present in Germany, which resides from post-war hyper-inflation during the last century. Germany, which grew at an astounding 2.2% in the second quarter, is close to reversing the sharp rise in excess spare capacity caused by the recession. As Germany continues to grow strongly while southern Europe struggles, the ECB will have a difficult time keeping everyone happy over the coming years.

³ Axel Weber speaking in New York on 12 October 2010.
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The ECB is unwinding emergency liquidity, raising short-term interest rates...

Nevertheless, policy was technically tightened at the end of September when the last of the one-year and 6-month emergency liquidity auctions for banks matured.⁴ Though the ECB provided unlimited 3-month and 6-day refinancing operations to allow debt to be rolled over, markets were expecting the total amount refinanced to fall from the €225 billion that was set to mature, to around €180 billion. In the end, European banks borrowed far less than expected from the ECB, a total of €133.5 billion, or just under 60% of the amount repaid. The removal of over €90 billion of liquidity from money markets helped lift short-term inter-bank interest rates back to the ECB's main refinancing rate (see chart 5).

Meanwhile across the Atlantic, Chairman of the Federal Reserve 'Helicopter' Ben Bernanke has been leading a charge to restart quantitative easing as the US economy slows.⁵ The threat of additional purchases of US Treasuries has not only driven down Treasury yields, but also pushed down market expectations of future interest rates. As measured by 90-day Euro-Dollar futures, US interest rates are now expected to only reach just over 1% by March 2013, down over half a percentage point compared to a month ago (see chart 7). By comparison, as measured by 3-month EURIBOR futures, ECB interest rates are expected to rise to 2% over the same time period, with little change in expectations over the past 3 months (chart 6).

...while the Fed and BoE are threatening to restart QE, pushing down future interest rate expectations.

Chart 6: 3-month EURIBOR futures

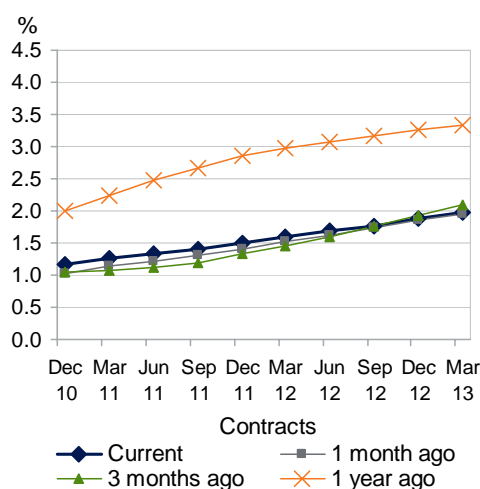
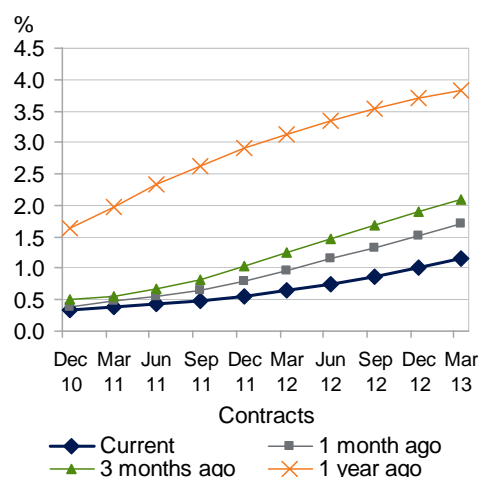


Chart 7: 90-day Euro-Dollar futures



Source: Bloomberg. Updated: 21 October 2010

Losing the race to the bottom

The relative calm in peripheral bond markets, coupled with the reduction in European money market liquidity, plus the obvious reluctance of the ECB to undertake quantitative easing has lead to renewed confidence in the Euro.

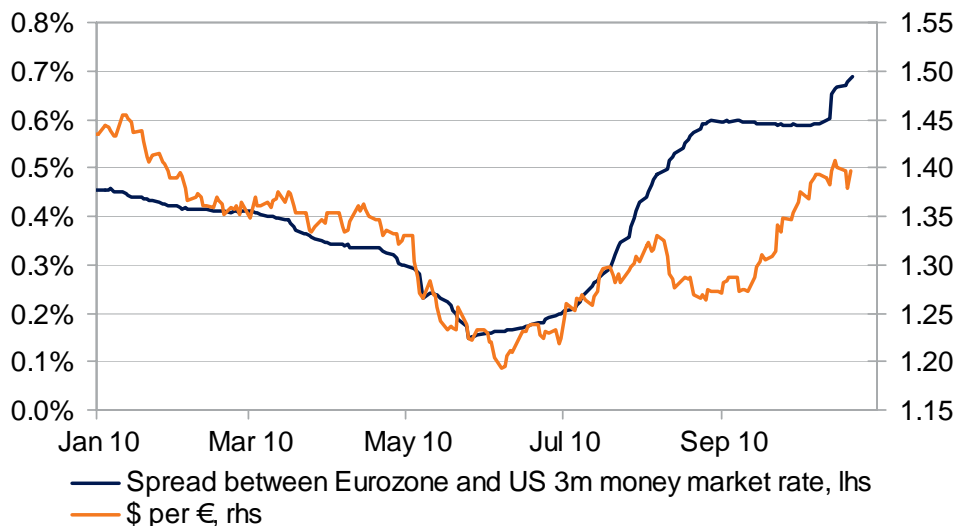
⁴ Referred to as Long-Term Refinancing Operations (LTRO).

⁵ Ben Bernanke is often referred to as "Helicopter Ben" after he referred to a statement made by Milton Friedman about using a "helicopter drop" of money to fight deflation in a speech he gave in 2002.

Indeed, when we compare the difference between Eurozone and US 3-month interbank interest rates and the USD/EUR exchange rate, we can see how the pick up in short-term interest rates in the Eurozone relative to the US came about at around the same time the Euro bottomed out against the US dollar (see chart 8). Temporary fears over Ireland broke the relationship in August but it quickly resumed once comments emerged from the Federal Reserve about the possibility of resuming quantitative easing.

As Eurozone short-term interest rates increased relative to US short-term rates, so did the Euro against the USD.

Chart 8: Changes in relative short interest rates vs. USD/EUR

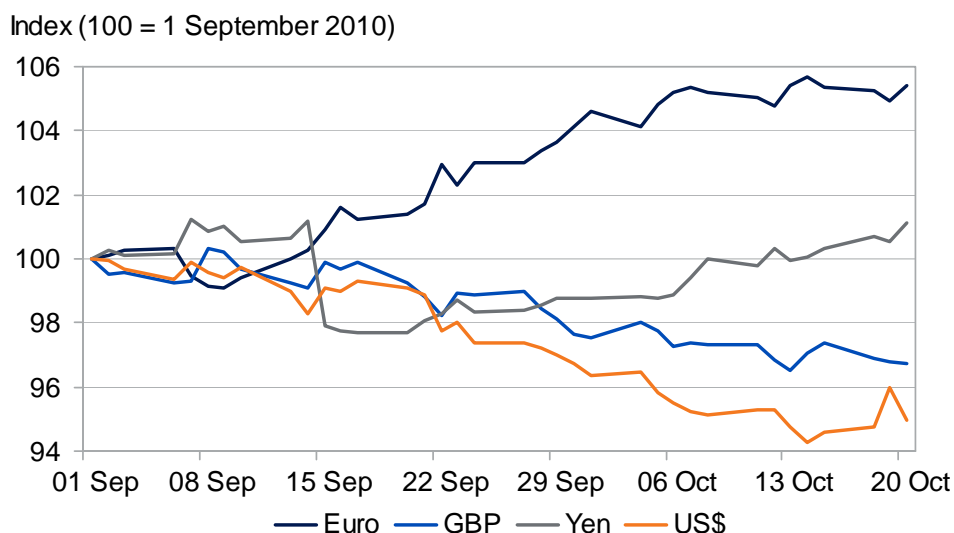


Source: Bloomberg. Updated 21 October 2010

As discussed in the global section of this note, the US dollar has been weak against other major currencies and not just the Euro. However, when we consider that the Euro has appreciated by 5.4% in trade weighted terms since the start of September versus a 1.1% appreciation in the Yen, 3.3% depreciation in Sterling and 5% depreciation in the US dollar, it is clear that Europe is losing the currency war (see chart 9).

On a trade weighted basis, the Euro has appreciated faster than any of the other G4 currencies.,,

Chart 9: Trade weighted exchange rates



Source: Bank of England. Updated 21 October 2010

...which will have a negative impact on growth, particularly for export orientated economies.

The trouble is, unlike emerging economies, the Eurozone as a region is not growing like an emerging economy, nor is it running a large current account surplus. Though northern European members are running moderate external surpluses, these are offset by current account deficits in southern Europe. This puts the region as a whole in a difficult situation. In the June issue of the Economic and Strategy Viewpoint, we discussed the potential benefits of depreciation in the Euro that had been experienced during the sovereign debt crisis. Using the OECD's 'New Global Model', we showed that a 10% depreciation in the trade weighted nominal exchange rate could add 1.6% to GDP growth three years after the depreciation. This can of course be reversed to give an estimate of the impact on growth of a currency appreciation.

Before we begin to panic over the recent pick up in the trade weighted Euro, it is important to remember that the 5.5% appreciation since the start of September still means that the Euro has depreciated by 8.3% since its peak in October 2009 (see chart 10). While the recent appreciation will mean some loss in demand for exports to foreign competitors, European exporters are still better positioned than they were a year ago, especially as there has been a recovery in global demand.

Though the trade weighted Euro has risen lately, it remains 8.3% lower than this time a year ago...

Chart 10: Euro trade weighted exchange rates

Index (100 = 23 October 2009)



Source: Bank of England. Updated 21 October 2010

...however, should the Euro keeps appreciating, it poses a risk to our growth, inflation and interest rate forecasts.

What if the Euro keeps appreciating? Short of another flare up in sovereign debt markets, there seems to be little to stand in the way of the Euro over the next 6 months. This is becoming an important risk to our forecast. If the Euro continues to appreciate, then we believe that the negative impact it will have particularly on northern Europe will mean that the ECB would then be unlikely to raise interest rates at all in 2011. Our growth forecast would be lowered, and the risk of deflation would come screaming back to the forefront.

Can Europe fight back?

Given the reluctance of certain parts of the ECB to undertake quantitative easing, can the central bank do anything to slow down the appreciation of the Euro? The answer is yes and no. Like the Bank of Japan (BoJ), the ECB has in the past intervened directly in currency markets. However, also like the BoJ recently, it has learnt that unilateral action tends to only have a short-term impact on currency levels (again, like the BoJ has just seen).

Trade tariffs have also been used by the European Union in the past, though we doubt the EU will be keen to enter into a tit for tat trade tariff conflict after working for many years to increase its trade openness.

Ironically, a resumption of the sovereign debt crisis may be the only saving grace for Eurozone exporters.

So what could Europe do? Well ironically, it may be that as Ireland decides to return to the bond market in late 2011, and Greece approaches the point when it too needs to return (early 2012), the existence of the Euro may once again be questioned, which could violently reverse any gains we have seen and will see in the Euro over the coming months. In such a situation, perhaps we may see a little schadenfreude from German exporters.

Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

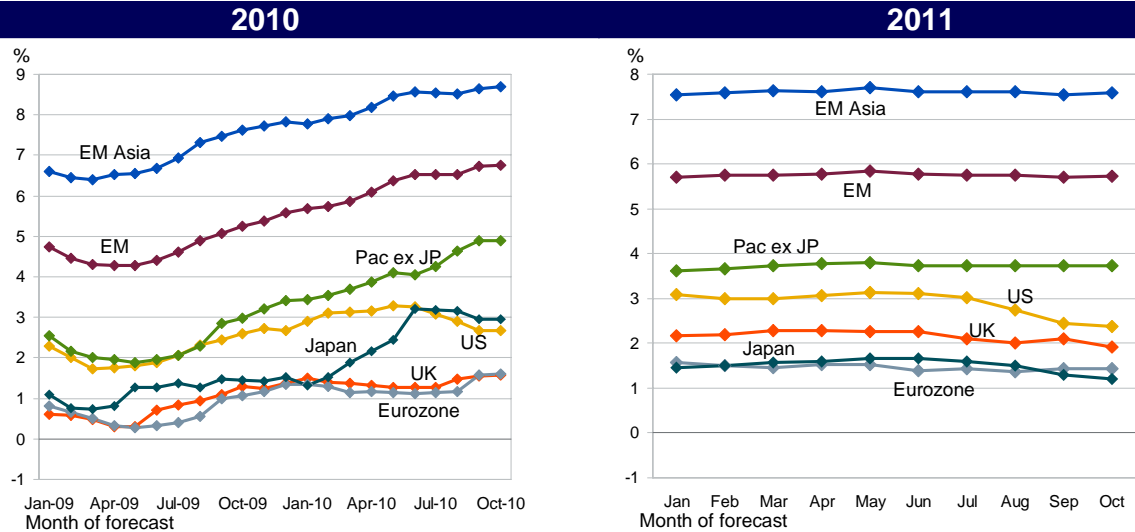
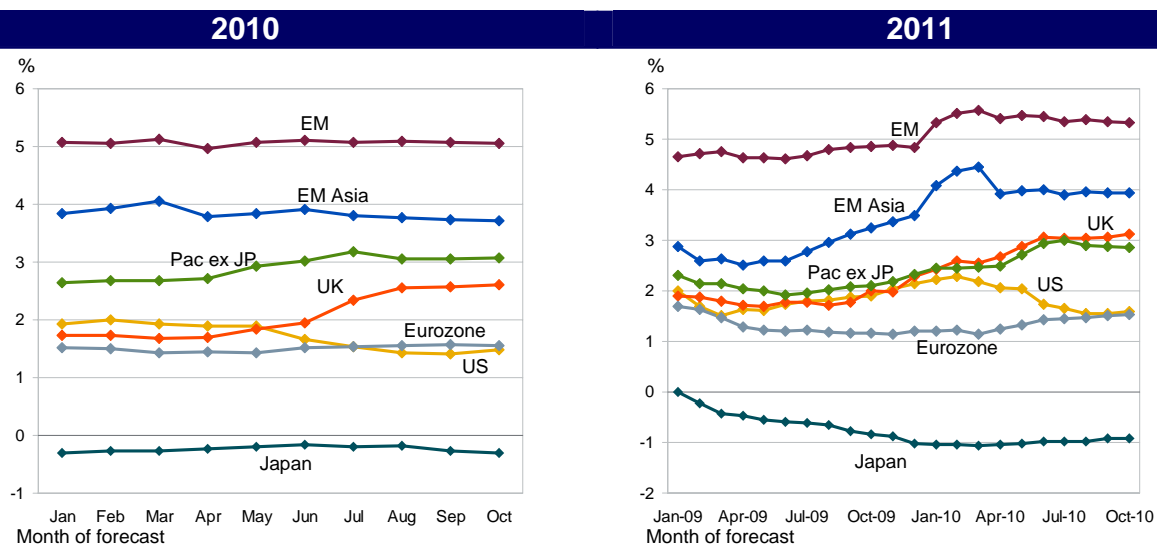


Chart B: Inflation consensus forecasts



Source: Consensus Economics (October 2010), Schroders

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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