JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of Sovereign Debt Trading

When Italian Film director Sergio Leone brought 'A Fist Full of Dollars' to the movie screens in the late sixties, a fist full of anything else would have been ridiculous. Although the picture was set in a town in Mexico it is doubtful the players would have been so motivated by a fist full of Pesos. A fist full of British Pounds or even German Deutschemarks at the time would have rang equally absurd. The Dollar was mighty both fictionally in art and really in life. With Hollywood devoid of any creativity it is possible that classics like this will be remade and if it were to be made in Italy (as was the previous one) would the antagonists be more prepared for a noon showdown for 'A Fist Full of Euros'? Surely some European director would be tempted, even as an attempt at parody. The Dollar has again become the world's whipping mate and seems to have been deserted roundly and without remorse. Gangs of bears have descended upon the greenback and the American unit seems out of bullets. Or is it?

The British pound has appreciated over ten percent versus the Dollar since the beginning of May but this isn't reflective of a sudden reversal in the fortunes of the UK economy. The data continues to remain very weak although the bad news, as in the US, is experiencing its own type of diminishing returns. Participants are betting that the UK economy has bottomed. It may have, but the recent upward plough of Sterling seems hardly justified based on an economy that will likely move laterally well into next year. Sterling's dose of helium is a product of renewed Dollar unpopularity and the global search for higher yielding assets. The outlook for the UK economy remains extremely uncertain and we don't expect a V-shaped recovery despite what the FTSE and Sterling might be suggesting. The unemployment rate is currently over seven percent and despite the current optimism GDP is likely to continue to contract and will probably end the year with a negative five percent on its resume for 2009. Whilst residential and commercial real estate continues to fall, unemployment continues to rise and the financial sector remains vulnerable and largely dependent upon state aid, it's hard to remain bullish on sterling. The British currency looks overbought and its direction will remain determined by global risk appetites rather than UK macro fundamentals. This will generate volatility, and we think, eventually a retrenchment of GBP/USD to more realistic levels.

The last meeting held by the European Central Bank resulted in the key rate being left unchanged at one percent and the ECB's head honcho stating that rates were at an appropriate level. We feel however that there is a credible chance that the ECB could cut again. Trichet believes that the recession in Europe may have bottomed in the first two quarters of this year. It is possible that future data out of the zone may experience a bottoming out but again we remain skeptical as to the emergence of a robust and rapid recovery within the Euro-zone. Germany's industrial production dropped nearly twenty two percent year over year in April and exports plunged nearly thirty percent the same month. It is plausible that this may represent a floor for Europe's largest economy but with unemployment soaring across the continent, it is more likely that we will see a continuation of the economic malaise across borders. With Spain having an unemployment rate of over eighteen percent and rates in France, Portugal and Ireland heading for ten percent it is possible that the ECB will have to cut rates further. As with the British pound, the Euro's advance against the greenback cannot be accredited to the re-emergence of any European macro-economic muscle. It is simply down to investors' appetites and the re-emergence of demand for higher yielding assets. The fact that the European financial sector will probably write down a further three hundred billion Dollars of bad loans within the next two years demonstrates the fragility of the Euro-zone recovery. Global sentiment can shift back as suddenly as it has shifted forward and renewed concerns and doubts can resurface almost overnight. If we see equity markets begin to soften on renewed economic concerns then we should see some reciprocity for the Dollar and see some Euro bulls run for cover.

The same picture can be painted across most of the foreign exchange canvas. Higher yielding units like the Aussie Dollar, Kiwi Dollar, South African Rand and even the Canadian Dollar are all vulnerable to exogenous perceptions. Their own macro-economic data seems to have been misplaced and the market has focused on an impending global recovery and flight to higher beta assets. We think this flight is premature and until evidence of a real and sustainable economic recovery is palpable then forex markets are likely to continue to experience marked volatility.

The Japanese Yen has also seen its share of short sellers in recent weeks as the so called carry-trade remerged but we think that the unit's status as a safe haven currency is a little precarious. As the bands of nervous sentiment stretch the Yen is a likely beneficiary but again the economic fundamentals make this status a by-product of fear rather than feature. The Japanese economy will probably contract somewhere around seven percent this year exacerbated significantly by the near implosion of global trade. Even though the Japanese financial sector has avoided the collapse that smothered the US, the UK and Europe, the Japanese economy will probably be the worst hit of all the G8 countries due to the economy's huge reliance on exports. To compound problems, the recession has re-introduced the dreaded 'D' word back to Japanese

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shores. As oil prices (and commodity prices in general) capitulated at the end of last year and early this year, consumer price inflation in Japan began to tumble which has resulted in the shadow of deflation being cast across the Asian giant. As with her European counterparts, the Japanese macro-economic drama seems to have hit its acme but again a rapid recovery seems very unlikely. Since the bank of Japan cannot control a possible deflationary spiral the Japanese economy seems more vulnerable to a global slowdown. Consequently this may result in Japanese assets being particularly exposed. Whilst the YEN will likely continue to benefit from risk aversion once the foreign exchange markets return to a fundamental model of valuation, we may see the YEN display marked weakness, not only versus the Dollar but also against the Euro.

Global commentators and leaders have become more vociferous in calling for a monetary system that would reduce the dependency upon the world's main reserve currency. We have seen how the creation of a single currency in the Middle East has been proposed and how many countries have diversified portions of their foreign exchange reserves away from Dollars. Much of the Dollar criticism comes from emerging market countries as these developing nations want to exert more influence on the financial stage as their foreign exchange reserve coffers bulge. The emerging market crowd wants to dilute the Dollar's muscle. However, if we look at bonds sold by the BRIC countries in US Dollars in the past year, the returns outperformed those of the bonds denominated in the nations' local currencies. Chinese USD denominated debt returned over ten percent last year which is over twice the four percent notched up by debt denominated in Chinese Yuan. Even Brazilian global debt in USD returned nearly five percent whilst the local currency debt lost nearly two percent in the same period. The bonds denominated in USD are more liquid, trade and settle more easily and therefore garner more demand. There is limited foreign investment in local currency bond markets because of currency restrictions and the jaggedness of the local markets. So, although the wagons may be circling the Dollar camp, it's too early and probably too misplaced to be calling for a greenback requiem. Its status as the principal reserve currency will not be penetrated anytime soon and notions of denominating commodities, such as oil, in Euros for example seems a little farfetched even now. The US unit will remain under a volatile flame as risk sentiments swing back and fro across all market spaces but if economic wobbles resurface expect to see the Greenback reclaim the sheriff's star. •

The US Dollar has been the victim of the "GreenShoots Paradigm" but if economic data, and consequently sentiment, begins to wither again, expect a USD bloom.

Source: Bloomberg, June 22, 2009.

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