

# What can we expect from currency markets in 2011?

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**D**ale Thomas, Head of Currency at Insight Investment, explains why he is excited by the future prospects for his asset class and outlines some of the key trends investors should look for over the coming twelve months.

## Great opportunities for macroeconomic investing

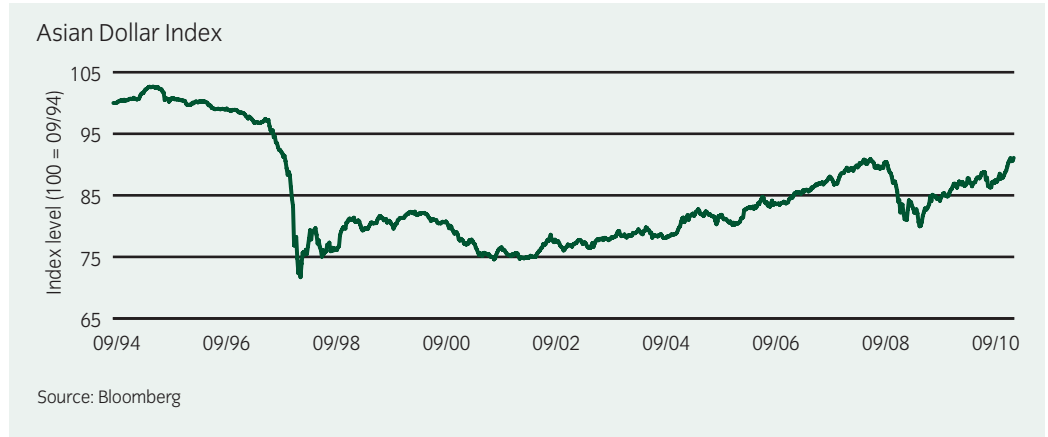
Foreign exchange markets have been making the national news on an increasingly regular basis in recent months, with numerous countries attempting to devalue their currency to boost their economic recovery. Clearly not all countries can possibly be successful in this simultaneously, and in our view foreign exchange investing remains one of the purest ways to play macroeconomic themes. Currencies tend to move together with changes in economic conditions in the long run, regardless of attempts by governments at intervention. This year, large currency moves have been commonplace and the changes going on at both a regional and a global level should continue to provide excellent opportunities for macroeconomic investing throughout 2011.

## The large structural shift to developing economies

One of the key changes taking place is a big structural shift in purchasing power from the western consumer to the emerging world consumer. Investors will become convinced by the strong underlying fundamentals of emerging economies in 2011, which should lead to strong inflows into emerging market assets. While several emerging market countries have expressed concern at the impact of appreciation in their local currencies, their economic strength is likely to continue to drive local currencies higher in the medium term irrespective of any attempts by governments at intervention. The rise of the purchasing power of emerging currencies relative to that of the West is all part of the rebalancing of demand, as emerging consumers run down their high savings levels and demand higher standards of living, while western consumers look to pay down their debts. Currencies will do much of the work, with higher real exchange rates in emerging economies increasing their purchasing power in global terms, and weaker western currencies reducing developed countries' debts in a relative sense. A move to stronger currencies in emerging economies is necessary to contain inflation given their high growth levels, and similarly weaker currencies in the West should help boost faltering long-term growth prospects and bring about the inflation necessary to erode our debt burden.

## Time for Asia to take its turn

The chart below shows the Asian currency index, which collapsed in the Asian currency crisis of 1997. Asian currencies have recovered a lot of ground over the past decade, but this shows that there is still some way to go. In line with our view that emerging currencies should appreciate as the global economy rebalances, we expect the Asian currency index to move higher in 2011.



## Considering cyclical factors

In addition to the underlying structural movements, there are two main cyclical factors which we believe are likely to influence the direction of currency markets.

### An upswing in the global cycle

In our view, it looks as though the economic downturn in the middle of this year has troughed, and we believe that global economic activity will continue to increase from here. Market expectations for the global economy are now too pessimistic, which means if activity does pick up, risk assets should perform strongly. This is likely to create a positive environment for growth-sensitive currencies. An example of a currency in this vein is the Korean won, which performs well when global growth is accelerating. Its economy is export-centric, meaning inflows into Korea tend to increase when aggregate demand is rising. By contrast, the dollar tends to lose ground as risk appetite strengthens. With their economies heavily weighted towards commodities, both the Canadian dollar and the Australian dollar would also be beneficiaries of a more constructive economic environment as demand for basic resources grows. Although historically sterling has often benefited from an improvement in risk appetite, we believe this is less likely to be the case this time around. The UK consumer is under severe pressure from the government's continued fiscal tightening and the domestic economy is likely to underperform as a result. Weakness in the UK housing market is also a matter of concern and is likely to weigh on consumers' desire to spend.

### Quantitative easing

With the US and Japan having announced new programmes of quantitative easing, there are considerable implications for the currencies in those countries. Furthermore, with the yen having risen to all-time highs against the US dollar, the Japanese central bank recently took the decision to intervene in the currency markets in an attempt to reduce potential adverse effects on its export-driven economy. The impact of Chairman Bernanke's printing presses should also be taken seriously, as should the knowledge that the Federal Reserve and the Bank of Japan are both keen to devalue their currency in favour of economic stability. In particular, a weaker US dollar is now on the Fed's agenda, which is likely to weigh on appetite for the US dollar and encourage developing

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central banks to build up reserves in other major currencies. In the eurozone there is a much reduced probability of fracture, as mechanisms are now in place to deal with insolvent nations. However, the Euro should still lag somewhat, with intra-European politics likely to destabilise the currency, as seemingly reasonable measures that are popular with the German electorate are likely to push Ireland and Portugal into much-needed formal EU and IMF assistance programmes.

As we move into 2011, we expect that the rebalancing of the global economy from the developed world to the developing world will gather pace, and that much of the heavy lifting will be done by the currency markets, with western currencies broadly depreciating against emerging currencies. In addition, we expect an upswing in the global economy will be beneficial for commodity producers and growth-sensitive currencies, but lead to outflows from the US dollar, especially given the very loose monetary policy in the US. The combination of large structural and cyclical forces is likely to lead to large moves in the foreign exchange markets, and correspondingly, a wealth of exciting opportunities for currency investors.

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