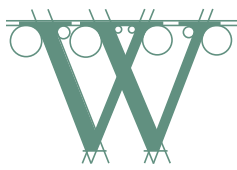


# Current economic cycles and their implications for currencies

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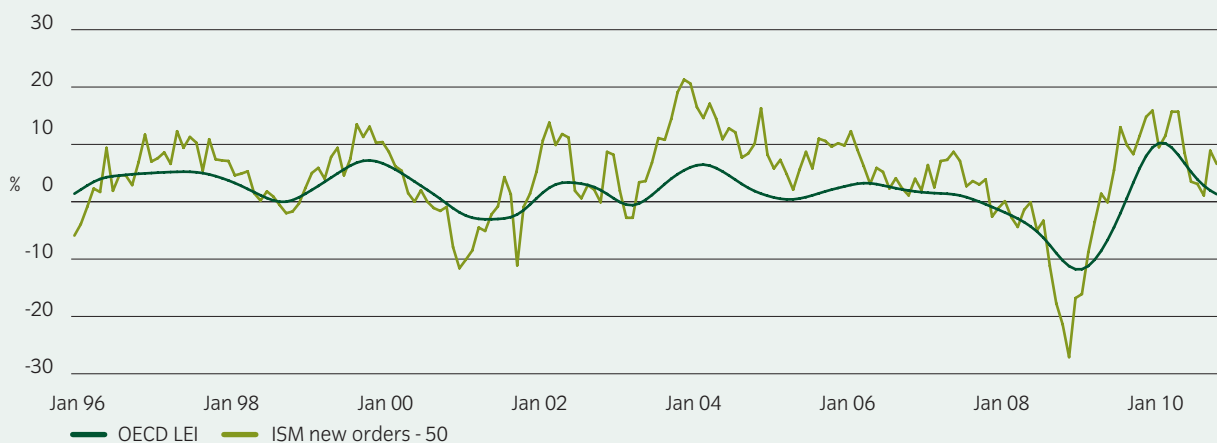


When forming a view on where a currency might head next, it is crucial to consider all of the possible economic and market forces which may have an impact on market direction. Dale Thomas, Head of Currency Management at Insight Investment and Manager of the Absolute Insight Currency Fund, describes four major economic cycles he currently sees in financial markets and how they are likely to influence future currency moves.

## Global inventory cycle

The global inventory cycle can be defined as the fluctuation of global GDP growth caused by either the accumulation or selling of company inventories. As stocks tend to be accumulated in good times and production reduced in bad times, the inventory cycle tends to amplify the existing economic cycle. As chart 1 shows, the inventory cycle is currently in an upswing, which tends to boost commodity prices and create inflationary pressures in economies where supply is constrained. The currencies of commodity producers are the likely beneficiaries of this scenario, hence we currently are positive on currencies such as the Australian and Canadian dollar, the Brazilian real and the Russian rouble. Furthermore, an upswing in economic activity points to strong growth in global trade, which is beneficial for the currencies of relatively small open economies such as the UK and export-centric countries in Asia. The likely losers of a more constructive economic environment are the Japanese yen, the Swiss franc and the US dollar, given their safe haven status and reliance on the major commodity producers for natural resources.

Chart 1: Global Inventory Cycle turning up



Source: Datastream

## US interest rate cycle

Monetary policy in the US is currently very easy, with a second round of quantitative easing underway and interest rates at historic lows. Although this clearly implies that the US rate cycle is near its trough, we believe policy will remain loose as there is a large amount of spare capacity in the economy and growth in the US is likely to remain slow. This should keep a lid on core inflation levels and reduce political pressure for monetary tightening. US interest rates, therefore, are likely to remain at low levels for some time to come and investors will find it increasingly hard to justify giving the US a premium rating, meaning the greenback will struggle to rally. The US economy is suffering from large fiscal and current account deficits, as well as capital outflows. The combination of this and the Federal Reserve's monetary policy is, in our view, likely to keep the US dollar weak for the foreseeable future.

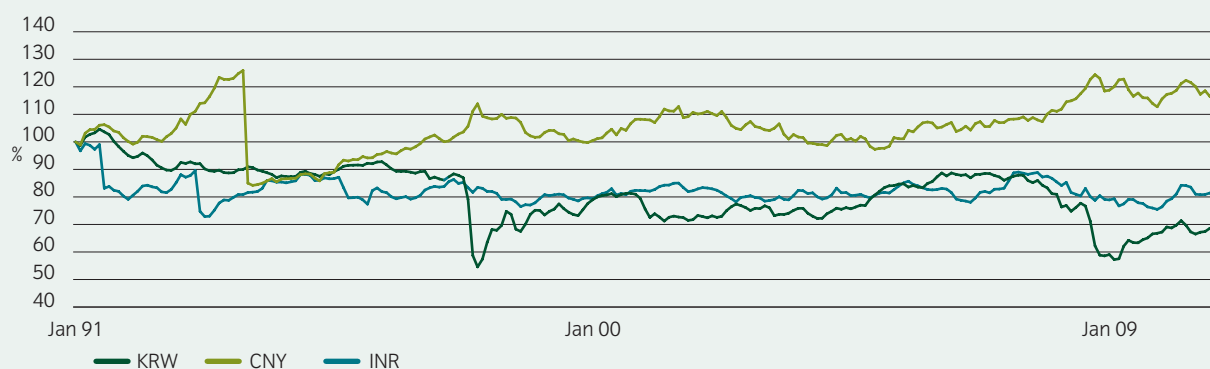
## European tension cycle

In the first half of 2010 the euro was weak following a crisis of confidence with bond spreads rising to extremely high levels in peripheral European countries, as investors worried about their ability to fund rising debt levels against a backdrop of weak growth. A look back at the past shows that similar tension cycles have occurred in Europe before where economies in the region have diverged, with core countries becoming strong and the periphery becoming uncompetitive. In the past, a build up of imbalances would have been solved by currency devaluation in the weaker countries. With strong political will to keep the eurozone together, however, this is not possible now as monetary policy in the peripheral countries is tied to the core. Some sort of peripheral default, therefore, is more likely this time around. This is likely to lead to periodic weakness in the euro, notwithstanding the fact that the core of Germany is strong and should provide structural support for the single currency.

## The rise of the East

While Asian currencies have appreciated since the trough of the global financial crisis in the first quarter of 2009, chart 2 shows there is still plenty of scope for further appreciation. The Korean won (KRW) is still near its post-crisis lows of 1997 and 2008 and the Indian rupee (INR) is near the lower end of its long-term historical range. China, arguably the most robust Asian economy with its large currency reserves and rising domestic demand, has seen its currency kept artificially low by the authorities. We feel this situation is unsustainable in the long run given political pressure from the US for yuan appreciation and a desire by China to rebalance their economy away from exports and towards domestic consumption. The rise of the East is a multi-decade structural shift, and as such represents a long-term theme in our currency Fund. Real exchange rate appreciation can come about through both higher nominal exchange rates and higher domestic inflation. With export-centric countries likely to opt for structurally higher inflation rather than risk stifling growth by raising rates too aggressively, the likely outcome for Asian economies is a combination of the two.

Chart 2: Scope for Asian currency appreciation



Source: JP Morgan

## Buy growth not safe havens

With a positive inventory cycle underway, we expect commodity-backed and Asian currencies to appreciate relative to the safe havens of the yen, the Swiss franc and the US dollar. Interest rates in the US are likely to stay lower for longer and encourage outflows. These could go into the euro where the core remains strong, despite peripheral European sovereign debt concerns being likely to cause periodic euro weakness. Lastly, the rise of the East and the domestic consumer in particular is likely to lead to a combination of higher inflation and nominal exchange rates in Asia.

The value of investments and any income will fluctuate (this may be partly due to exchange rate changes) and investors may not get back the amount invested.

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