

A wealth of opportunity in currency markets

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“**F**oreign exchange markets have continued to make the news in 2011, with the first coordinated intervention of a major currency for 35 years following the earthquake in Japan and an announcement by China that they intend to increase the renminbi’s exchange rate flexibility further in response to rising inflationary pressures. Given these and other ongoing changes in the political and macroeconomic backdrop, large currency moves have been commonplace over the past few years.

Profiting from structural and tactical positions

Insight believes that a number of structural changes at both a regional and global level should provide excellent long-term opportunities for foreign exchange investing. In addition, changing news flow and market volatility should continue to provide scope to profit from more tactical trades. Investors looking to allocate capital to an asset class with a wealth of profitable opportunities, low volatility and the potential for uncorrelated returns may be well advised to consider an absolute return currency fund.

Structural shift to emerging markets

One of the key changes taking place at present is a large structural shift in purchasing power from the western consumer to the emerging world consumer. While several emerging market countries have expressed concern at the impact of appreciation in their currencies, their economic strength is likely to continue to drive local currencies higher in the medium term irrespective of any attempted government intervention. The rise of the purchasing power of emerging currencies relative to that of the West is all part of the rebalancing of demand. Emerging consumers are running down their high savings levels and demanding higher standards of living, while western consumers look to pay down their debts. Currencies are likely to be the mechanism through which much of the change occurs, 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.

Chart 1: Chinese yuan has significant scope for appreciation



Source: Datastream.

A move to stronger currencies in emerging economies is necessary to contain inflation given their high growth levels. Similarly, weaker currencies in the West should help boost faltering long-term growth prospects and bring about the inflation necessary to erode its debt burden. However, at any given time there are likely to be a number of emerging countries which are unattractive in a relative sense and investors should look to build up short positions in these countries at that time. From a long perspective, the Chinese yuan represents a particularly attractive opportunity as it has arguably the most robust emerging economy with large currency reserves and rising domestic demand, yet 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 and a desire by China to rebalance their economy away from exports and towards domestic consumption, which should lead to a significant long-term appreciation in the Chinese currency. To profit from such an outcome, a structural long position in the Chinese yuan and other Asia currencies such as the Singapore dollar would appear to be appropriate.

US dollar to weaken in the long term

Monetary policy in the US is currently very loose, with a second round of quantitative easing still in progress and interest rates anchored at historic lows. We believe policy will stay 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. Although the US dollar is very out of favour at the moment, which can sometimes be a good contrarian indicator, we believe it is unlikely to strengthen significantly in the immediate future as US growth is actually likely to weaken in the near term. In addition, the US is running large long-term current and fiscal deficits, suffering capital outflows and has only been supported by buying from the Chinese government and OPEC. As a result the Federal Reserve's monetary policy is, in our view, likely to remain loose for longer than the market expects which is likely to keep the US dollar weak on a long-term basis. This should be reflected in currency funds by a structural underweight US dollar position.

Chart 2: US dollar has seen a decade of depreciation



Source: Datastream.

Significant short-term volatility in Japanese yen

The volatility in the Japanese yen has been particularly noteworthy recently. In the immediate aftermath of the Sendai earthquake the yen strengthened sharply as traders anticipated that some of Japan's foreign reserves would be repatriated to help fund the country's rebuilding effort. At the time it was our view that this currency move was entirely unjustified by fundamentals and likely to lead to an intervention to stop the Japanese export industry being adversely affected, in a similar way to what happened in the summer of 2010. Shortly afterwards, G7 countries approved the first coordinated intervention in a major currency for 35 years and the yen weakened sharply. Afterwards, worries that rolling power cuts would hurt the Japanese economy have continued to weaken the yen. However, we would now look to have a long bias in the currency in the medium term, as the Swiss franc, another major safe haven, has remained strong and the two are likely to move more in line with each other. This year's movements in the yen are a prime example one of the many shorter term profitable opportunities which arise in currency markets and can be captured by investing in absolute return currency funds.

Portugal bailout positive for euro

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. Essentially investors were worried that these countries would be unable to fund rising debt levels against a backdrop of weak growth. Similar tension cycles have occurred before in Europe where economies in the region have diverged, with core countries becoming strong and the periphery becoming uncompetitive. Historically, 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 now possible, which has led to the bailout of the weaker peripheral countries. Portugal is the third eurozone country to receive a bailout package, following on from Greece and Ireland. With the uncertainty surrounding these countries dealt with for the time being, investors should turn their attentions to the fact the core European countries are in relatively good shape versus the other major developed countries. On balance, therefore, we believe the bailout of Portugal is a positive development for the euro in the medium term. That said, there are a number of hurdles ahead, including a likely restructuring of Greek debt.

As we move through 2011, we expect that the rebalancing of the global economy from the developed world to the developing world will gather pace. We expect much of the heavy lifting to be done by the currency markets, with western currencies broadly depreciating against emerging currencies. This favours a structural long position in the Chinese yuan versus the US dollar. In terms of shorter term opportunities, Portugal's bailout should focus attention on the more positive story in Europe's core, while recent yen weakness provides an opportunity for a tactical long position.

The value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

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