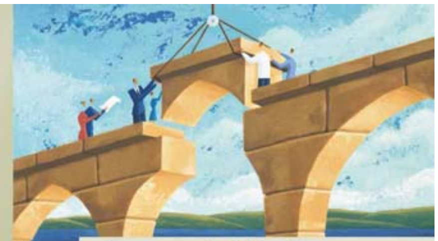
TAL Global Asset Management Inc.

Market Insight



Invested Minds

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Paving the way for a currency showdown

As the G7 central bankers met in Boca Raton, Florida over the weekend, two messages emerged. First, European finance ministers stepped up their intervention rhetoric, and second, China was challenged to revalue its currency. Considerable hype going into this meeting was based on the results of the last such meeting in September in Dubai, where the G7 broke tradition by specifically addressing exchange rate misalignment in their statement.

“At first glance, their new statement should not come as a surprise and has few major market implications,” says **Maxime Tessier,** Vice President of Currency Management at TAL Global Asset Management Inc. “However, reading between the lines you can see some kind of currency showdown coming sometime in the spring of this year, as there were two changes of note in the statement.”

-1- A sentence was added: **"Excess volatility and disorderly movements in exchange rates are undesirable for economic growth."**

This addition came at the request of the Europeans. Should exchange rate movements become disorderly or cause noticeable spillover into bond markets, this sentence could justify central bank intervention.

“It can be construed as a warning by the G7 that the consequence of currency markets’ misbehavior could be coordinated intervention,” says Tessier.

While this action is certainly not imminent, the fact that new wording got in the statement at all is a victory for euro-area policy makers. Canada, the UK, Japan and the U.S. are looking at their own current currency levels relative to the rest of the world with some degree of benign neglect *(see right)*.

Canada already lowered growth and inflation forecasts and cut interest rates once, otherwise intervention is not on the table.

A weak **U.S.** dollar is positive: helps stabilize inflation, spurs growth (in an election year) and helps the ailing and politically significant manufacturing sector. It is good for bonds: Japan and China's intervention translates into foreign purchases of U.S. treasuries.

UK - a strong pound is a positive development for the Bank of England, who has been raising interest rates seeking to cool down the red-hot economy.

Japan has been massively intervening partially because it cannot cut rates that are already at zero.

-2- A small insert was made in the sentence arguing for greater flexibility, targeting “…economic areas **that lack such flexibility** to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

“This is a direct challenge to China to start liberalizing its own foreign exchange market, a long-standing point of policy for the U.S. and for Japan,” explains Tessier. “The fact that China was not represented at Boca Raton takes a lot of the bite out of this statement,” he says.

Conclusions and Market Implications

- No policy coordination or joint intervention appear imminent given the lack of G7 agreement on what to do about exchange rates.
- Euro-area policy makers are reaching the end of their tether with regards to how much stronger they will allow the euro to become.
- Japanese direct intervention will not be frowned upon by the G7 for as long as China holds the renminbi peg.

Positive for stocks and moderately positive for bonds -- because it means that no one will dare to raise rates again (except maybe the UK) before the U.S. Federal Reserve does. If that is to take a while - as the market is discounting - then stocks will benefit.

U.S. dollar will keep weakening -- and speculators may be inclined to push even harder to find out where Europe's pain threshold lies.

Watch for a policy reaction from Europe -- maybe in the form of foreign exchange intervention by April or May. By that time, we will have a better idea of the euro's impact on growth and inflation and also a better idea of when the Fed might start to act. A complacent Fed and economic disappointment in the euro area will speed up the response.