

My Thoughts on Currencies

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Bottom line: The currency and other markets remain confusing, and seem out-of-sync with the global economic fundamentals, relative equity and bond market performances. So far this year, to me, the dollar has been surprisingly weak. To some of the central bankers, it has been worryingly weak, or their currencies have been unjustifiably strong. The RBA, RBNZ, ECB, and more recently the PBOC as well as some of the EM central banks - which not too long ago were raising interest rates to defend their currencies - are now showing a preference for a stronger dollar. I confess I don't quite understand why the dollar is so weak. Market positioning and central bank rebalancing could have been important factors. But another thought is that the Fed's abusive policies toward the dollar in the past years may have dealt it some permanent reputational damage. Further, the US' single-minded fixation since 2009 on money printing instead of structural reforms may have also been behind the remarkably weak Treasury TIC capital flow data. (1) The latest economic data are consistent with a US economy in a recovery, Europe flat-lining, and EM decelerating. This configuration of economic growth is inconsistent with a weak dollar. (2) As the policy path that is consistent with the Taylor Rule deviates further from that consistent with Optimal Control, the Fed will face more intellectual challenges to its policy stance. The recent debate on the role of the long-term unemployed workers is one example, and the mounting worries about QE3's impact on the financial markets are another example. I came across a couple of really well-written speeches last week on these issues, which I comment on below. (3) I just came back from a really useful fact-finding trip to China. The issues China faces now are complex and the solutions are difficult and uncertain. I will write a more detailed note later this week on my findings, but the main thesis I have is that a cyclically-bearish-but-structurally-bullish investment view on China seems to make most sense.

A divergent global economy. Recent data (retail sales, weekly claims) are consistent with a recovering US economy, suggesting that US growth has accelerated thus far in Q2, compared to the weather-influenced Q1. The EMU as a whole is showing a very modest recovery, exaggerated by the out-performance in Germany. EM, however, continues to decelerate. These three groups of countries also have different inflation trajectories. The US has high growth, but relatively low inflation; Europe has low growth and low inflation; but EM has low growth and higher inflation. In theory, this should suggest that the dollar is forming a bottom, while the EUR is forming a top. EM currencies, on the other hand, should reflect the relative emphasis the EM policy makers place on growth or inflation. Neither low growth nor high inflation is popular to the voters. Whether the ‘Southern’ EM currencies peak here and head back down will be determined in part by the policy makers’ emphasis, and I have detected a subtle shift recently, from inflation to growth.

Long-term unemployment and the Fed. The SF Fed just published an Economic Letter making the point about Okun’s Law – a rule-of-thumb linking a 2% decline in GDP growth relative to trend to a 1% increase in the unemployment rate. While there might be short-term deviations from this 2:1 ratio, the Okun’s Law, the paper argues, has held up reasonably well through the GFC. At the same time, what has worked less well is the Phillips Curve. At the depth of the GFC, inflation fell but was *higher* than what was consistent with the large output gap (or the unemployment rate). While the absolute level of inflation is low in the US, some have argued that it is still higher than the output gap suggests. The latest argument has an interesting twist, as it makes the point that wage inflation is more sensitive to short-term unemployment and long-term unemployment is a structural issue that has little bearing on wage inflation. (1) This is an interesting and potentially important argument because it is in stark contrast to Fed Chair Yellen’s argument that the Fed will need to keep its policies extraordinarily loose precisely because of the stubbornly high long-term unemployment, while people like Mr Alan Krueger – himself a former Chair of the White House Council of Economic Advisors, like Mr Bernanke and Ms Yellen – argue that the long-term unemployed are on the fringes of the labour market and their presence has no bearing on the formation of wages on the margin. (‘Are the Long-Term Unemployed on the Margins of the Labor Force?’) If the Fed targets its policies at long-term unemployment, it may run the risk of stoking wage inflation at some point. (2) For the US, while the overall unemployment rate is 6.7%, which is still higher than the widely-

assumed full-employment level of 5.5%, the short-term UR, some argue, is already down to 4.3%. (3) Because of the intellectual capital Fed Chair Yellen has spent on long-term unemployment being the main motivation for an easy Fed, I doubt that she will be easily persuaded by the counter-argument, until there is ample evidence (e.g., wage inflation) against her. (4) A recent IMF Working Paper (WP 14/66, 'Official Demand for US Debt: Implications for US Real Interest Rates') showed their estimate that the Fed's QE from 2008-12 had artificially depressed real 10-year yields by 140 bps, compared to the 80 bp worth of distortions coming from the 'Global Savings Glut.' This figure of 140 bps is rather huge, and may help explain why the dollar is struggling.

Fed communications. The Fed can be confusing. The minutes from the March 18-19 FOMC meeting showed that some of the Fed policy makers were concerned that the rate forecasts in the SEP '*could be misconstrued as indicating a move by the committee to a less accommodative reaction function.*' So the FOMC first shows the medians of the 'dots' rising meaningfully for 2015 and 2016, compared to the last round of forecasts, mainly reflecting the doves having become less dovish, rather than the hawks turning more hawkish. Why would they show a material shift in the SEP forecasts only to dismiss these changes? The only logical explanation I could come up with, and I think I am being generous to the Fed, is that the SEP reflects the view of all of the FOMC members while the Fed Statement reflects the views of the voters, and this particular reference quoted in the minutes could be from a couple of voters, complaining that the group-wide forecast could be mis-leading. The minutes also said, '*a number of participants observed that an upward shift was arguably warranted by the improvement in participants' outlooks for the labor market since December and therefore need not be viewed as signifying a less accommodative reaction function.*' If this sentence means what I think it means, it is meaningless and confusing.

An excellent speech by Mr Caruana of the BIS. Mr Caruana – the General Manager of the Bank for International Settlements – gave a fantastic speech ('Global Economic and Financial Challenges: a Tale of Two Views'). This is definitely one of the very best speeches I've come across this year. Here is the abstract from the speech. '*This speech contrasts two explanatory views of the sluggish and uneven recovery from the global financial crisis of 2008-09. One view points to a persistent shortfall of demand and the other to the specificities of a financial cycle-induced recession - the "shortfall of demand" vs the*

"balance sheet" view. The speech summarises each diagnosis in seven stylized propositions covering: the origin of the recession, the implications of deleveraging, the causes of weak credit growth, the role of asymmetries in the international monetary system, the nature of hysteresis, the interpretation of negative equilibrium real interest rates, and the risk of deflation. It then reviews evidence bearing on the two views and contrasts the policy prescriptions to be inferred from each view. The speech concludes that the balance sheet view provides a better overarching explanation of events. In terms of policy, the implication is that there has been too much emphasis since the crisis on stimulating demand and not enough on balance sheet repair and structural reforms to boost productivity. Looking forward, policy frameworks need to ensure that policies are more symmetrical over the financial cycle, so as to avoid the risks of entrenching instability and eventually running out of policy ammunition.' But his arguments are so clear and convincing, I reproduce some quotes from it. (1) (T)he crisis is not an exogenous shock; rather, it represents the inevitable collapse of a previous unsustainable boom – the bust phase of a financial cycle. This naturally ushers in a balance sheet recession, featuring large sectoral and aggregate debt and capital stock overhangs and an impaired financial sector... (2) (G)iven initial conditions, deleveraging is a necessary precondition for a self-sustained recovery: debt overhangs relative to income need to be reabsorbed for the economy to rebound sustainably. (3) (A) key factor restricting aggregate demand is anaemic credit demand: agents realise that they have borrowed too much given their lower income expectations and seek to pay down debt. This numbs the effectiveness of monetary and fiscal stimulus. (4) (T)he major asymmetry in the global monetary and financial system that worsens the picture is that easy monetary conditions in major economies spread to the rest of the world. As a result, the system has produced inappropriately low interest rates for the world as a whole. Non-crisis-hit countries find it hard to operate with interest rates that are significantly higher than those in the large crisis-hit jurisdictions because of the fear of exchange rate overshooting, even when the economy has been growing strongly. In several cases, this has been fuelling unsustainable financial booms ("financial imbalances"). The result is expansionary in the short run but contractionary over the longer term. (5) (N)egative real interest rates, especially when associated with zero policy rates, are not equilibrium phenomena. As a result, they risk causing collateral damage, not only in the crisis-hit countries themselves, where they may further delay balance sheet adjustment or

encourage unhealthy forms of risk-taking, but also, and more visibly, elsewhere in the world, by causing a build-up of financial imbalances. This, in turn, could end up validating those low interest rates, as the unwinding of the imbalances could make normalisation extraordinarily difficult globally. (6)

(D)is-inflationary, and possibly deflationary, pressures may in part reflect benign underlying forces, notably heightened global competition, that the boom had obscured. To that extent, the concern is not so much declines in the prices of goods and services per se as the harmful interaction between debt and asset prices. Reading through this 12-page speech, I was stunned by the similarities in his thinking and mine. Even his arguments on deflation are remarkably similar to mine, which I have long thought were unorthodox and regularly dismissed by policy makers I talk to. I have long argued that deflation can be benign, and the fear mongering about any deflation being a precursor to a 'Japan' has been used by doves to confuse rather than clarify the true dynamics of inflation formation. I have, frankly, been disappointed by so many well-learned macroeconomists who know these counterarguments well but chose not to stand up to challenge the Washington Consensus... 'The historical evidence indicates that deflations have often been associated with sustained growth in output. Surprisingly perhaps, the Great Depression was more the exception than the rule. Similar spells have also been evident since the 2000s, including in China, Nordic countries and, as I speak, Switzerland. In these cases, sustained output growth has proceeded alongside strong increases in credit and asset prices. At the same time, there is growing evidence that global factors have been playing a bigger role in domestic inflation just as domestic measures of slack have lost significance. Indeed, macroeconomists and policymakers know that, for many years now, the link between domestic slack and inflation has proved elusive. To be sure, one common explanation is that better-anchored expectations, underpinned by greater central bank credibility, have reduced the sensitivity of inflation. Even so, it would be implausible to rule out the role of the globalisation of the real economy, notably the entry of China and former communist countries into the world trading system. Surely, in addition to relative prices changes, this produced welcome disinflationary tailwinds, which were at play well before the crisis and may well still be at play.' Further, his diagnosis of the fundamental illness of the economy is important, as the 'insufficient demand' thesis has justified heavy doses of caffeine pills for close to six years, with ambiguous results. I have also long argued that the policy response in the US has been highly unbalanced and too short-term in nature.

‘(T)he post-crisis policy response has been unbalanced. There has been a lot of emphasis on fiscal pump-priming and monetary accommodation and not enough on balance sheet repair and structural reforms. This suggests that we have not yet fully come to grips with the financial cycle. In economies still recovering from balance sheet recessions, reacting ever more aggressively with monetary and fiscal policy will not resolve the problem. After a certain point, it may even be counterproductive (eg depletion of policy ammunition, development of new imbalances).’ Mis-diagnosing the root problem of the US and administering the wrong medicines will have consequences in the long-run – a point I whole-heartedly endorse. Mr Caruana is most articulate about the negative side-effects of policy short-termism. *‘(T)here should be more emphasis on structural policies (eg labour, competition, taxation) to address structural problems. There are no short cuts: the path from here to there will not be easy. But the longer we wait, the bigger the costs will be... Failing to carry out these policies raises several risks, as standard aggregate demand measures fail to gain lasting traction. Fiscal policy expansion risks undermining further the sustainability of public sector finances. A persistently aggressive monetary policy risks exacerbating collateral damage, both domestically and internationally, as unwelcome spillovers foster the build-up of disruptive financial imbalances in other countries whenever financial cycles are out of sync. And as results disappoint, such a policy can ultimately sap the central banks’ credibility, effectiveness and public support... More generally, there is a serious risk of exhausting the policy room for manoeuvre over time. As policymakers respond asymmetrically over successive business and financial cycles, hardly tightening or even easing during booms and easing aggressively and persistently during busts, they run out of ammunition and entrench instability. Failure to consider the sources of disinflationary pressures can add to this risk. As a result, lasting normalisation remains elusive. In particular, the accumulation of debt and the distortions in production and investment patterns associated with unusually low interest rates hinder their return to more normal levels. Low rates, paradoxically, validate themselves.’*

Raghuram Rajan: Competitive Monetary Easing. This is another good speech (not as great as that above, but pretty good nevertheless). Mr Rajan equates QE with competitive devaluation, that they are in an ‘economic equivalent’ class, though the channels they work through may be different. He questions extending QE beyond fighting dysfunctional markets. *‘(T)here is a role for unconventional policies – when markets are broken or grossly*

dysfunctional, central bankers do have to think innovatively. Fortunately for the world, much of what they did immediately after the fall of Lehman was exactly right, though they were making it up as they went in the face of extreme uncertainty. The key question is what happens when these policies are prolonged long beyond repairing markets – and there the benefits are much less clear. Let me list 4 concerns: (1) Is unconventional monetary policy the right tool once the immediate crisis is over? Does it distort behavior and activity so as to stand in the way of recovery? Is accommodative monetary policy the way to fix a crisis that was partly caused by excessively lax policy? (2) Do such policies buy time or does the belief that the central bank is taking responsibility prevent other, more appropriate, policies from being implemented? Put differently, when central bankers say, however reluctantly, that they are the only game in town, do they become the only game in town? (3) Will exit from unconventional policies be easy? (4) What are the spillovers from such policies to other countries?’ Mr Rajan then argues that aggressive QE could lead to competitive monetary easing, which in turn could lead to a Pareto inferior outcome for everyone. ‘A good way to describe the current environment is one of extreme monetary easing through unconventional policies. In a world where debt overhangs and the need for structural change constrain domestic demand, a sizeable portion of the effects of such policies spillover across borders, sometimes through a weaker exchange rate. More worryingly, it prompts a reaction. Such competitive easing occurs both simultaneously and sequentially, as I will argue, and both advanced economies and emerging economies engage in it. Aggregate world demand may be weaker and more distorted than it should be, and financial risks higher.’

The EUR is too strong. The over-valued EUR is becoming a problem for the ECB. This is related to the point made by Mr Rajan, that the Fed’s aggressive policies have artificially depressed the US yield curve and the dollar. Mr Yves Mersch (Luxemburg central bank governor and ECB member) said that ‘*continuation of currency developments would trigger action... Euro area facing exchange rate risks... Currencies increasingly have impact on inflation outlook...*’ He also said that ‘*the role of the ECB in fostering recovery is limited.*’ These comments suggest that some at the ECB believe the exchange rate channel could be more powerful than the interest rate channel. If so, the particular mechanism of QE they ultimately choose will likely be one that will lead to a weaker EUR. FWIW, I continue to believe that the ECB will continue to resist adopting QE, for as long as possible. Most of the fall in inflation came

from lower energy prices, as I mentioned last week, and the strong EUR contributed to the rest of the fall. Adjusting for these two factors, inflation in the EMU would have been around 1.8 or 1.9%.

Trip to China. I had a most-productive fact-finding trip to China last week. There is a lot to write about and I plan to do a full briefing note on this later this week. The main point is that I found more reasons to be cyclically-bearish but structurally-bullish. My sense is that a slowly decelerating Chinese economy is by now the consensus view – a view I share. But the opinions on whether the Xi-Li Administration is committed to reforms range widely. FWIW, I believe President Xi means what he says, and reforms will progress meaningfully. In the past years, investors tried to understand China, not to trade Chinese equities or bonds but to trade the assets of other countries that are affected by China. But if the reforms are done right, five years from now, the world will be trading Chinese equities and bonds and expressing their bullish or bearish views on these assets as they see fit. Reforms in China will likely not look like a ‘Big Bang’ a priori, but will, looking back years from now, likely look like a ‘Big Bang.’ In other words, the manner in which the reforms will be carried out will be deceivingly subtle, but powerful, I suspect. This, to me, is very exciting, that China could focus on reforms and ignore short-term market pressures. (In contrast, the talk of a collapse in Japan’s GDP to perversely force the BOJ to print – a scenario some myopic ‘investors’ hope to see – does not excite me.)

Duties and responsibility. I have often waited in long lines to go through immigration at airports. On more than one occasion, I witnessed British Airways pilots waiting for all of their crew to go through immigration first before they themselves did. Pilots of Asian airlines, on the other hand, tend to ‘lead’ the crew through immigration control. Captain Schettino of Costa Concordia’s behaviour was reprehensible but not totally surprising. But the captain of the South Korean ferry did surprise me. Part of why we are surprised or not surprised by people’s actions reflects our prejudices. But I cannot help but think that some of this is due to the world having become intrigued by celebrities rather than heroes. Self-sacrifice, patience, courage, and honour are no longer virtues that are valued, it seems. We prefer the easy way out (e.g., money printing, doping...).

Nobel prize. Technology and innovations will be increasingly important for countries’ development and growth. Looking through the tally of the past Nobel laureates, one sees some patterns. (1) The US has had the most laureates

(350). (2) The UK has an impressive 115. I've always thought that the UK's technological know-how and scientific achievements are under-rated, partly because of the self-deprecating nature of the media here. (3) Germany has 101, and France has 66. Impressive. (4) The combined total for the BRIC countries is only 43. This number is of course artificially low, because many scientists born in these countries won the Nobel prize as citizens of other countries. The US, incidentally, has the most foreign-born Nobel laureates. This says something about the inclusive nature of the US as a society, I think.

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