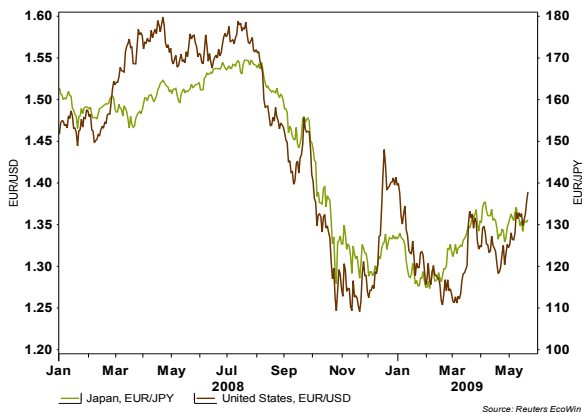


Safe havens less attractive ahead

- Investors turn to CHF, JPY and USD in times of turbulence...
- ...but once the outlook clearly improves, they should weaken
- Certain small currencies look set to be among long-term winners

When complete financial market frenzy broke out last autumn after the bankruptcy of the Lehman Brothers investment bank, there were gains for those currencies that attract investors when market risks escalate, as expected. These currencies are often described as “safe havens” and their main representatives are the Swiss franc (CHF), the Japanese yen (JPY) and the US dollar (USD).

Up in hard times, down in good times



The US dollar and the Japanese yen are among the currencies that usually appreciate in turbulent times – such as last autumn – but weaken when economic conditions improve.

There are several characteristics that give a currency the status of safe haven. Firstly, such currencies tend to show resilience when many other currencies are shaky. Secondly, the home countries of these currencies usually display good economic fundamentals, such as current account surpluses.

Thirdly, these countries often have positive long-term characteristics in the form of political stability, a good economic policy track record and support for free capital movements. Especially in the case of Switzerland, low geopolitical risk and – at least earlier – bank secrecy can be added. In the case of the US, additional factors are the role of USD as a global reserve currency, the depth and liquidity of American capital markets and relatively high long-term productivity and economic growth.

Another example of the above-mentioned currencies attracting investors was in late April 2009, when the emergence of a swine flu epidemic seemed to pose a new threat to an already reeling world economy. The influenza danger has faded, however, while the outlook for a continued cautious increase in risk appetite and lower market volatility appears good. In addition, there has been mounting evidence that the global economic downturn is decelerating. What happens in the foreign exchange market in such an environment?

The currencies that play the role of safe havens should weaken. The current strength of their currencies is hurting growth prospects in Switzerland, Japan and the US, countries that have now all witnessed sizeable GDP declines. In addition, their monetary policies are very loose – with key interest rates at or below 0.25 per cent and their central banks are launching aggressive quantitative stimulus measures (purchases of both private and government bonds) – which usually have a negative impact on currencies. Such an environ-

ment will probably also lead to a “carry trade”: borrowing in low interest rate currencies and investments in countries with higher interest rates. One consequence will be the creation of capital outflows from low interest rate countries, which will weaken their currencies.

CHF is being pushed down by the Swiss National Bank’s interventions in the foreign exchange market, which are aimed at steering the franc to levels that sustain Switzerland’s economic growth via better exports. The country’s economic performance is also worse than that of its neighbours, and the danger of deflation – a general decline in prices over a long period – is greater. In addition, the Swiss franc is being weighed down by sizeable lending to Central and Eastern Europe denominated in CHF (equivalent to about 60 per cent of GDP). On top of this, bank secrecy laws have begun to be interpreted more flexibly, and the CHF is sharply overvalued according to such indicators as purchasing power parities (PPP).

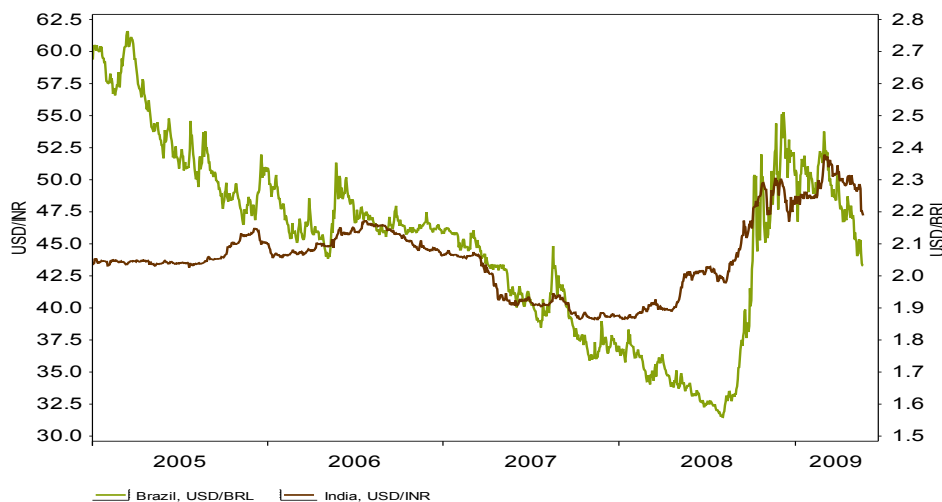
The yen is being undermined by Japan’s very weak economic situation, and the lowest key interest rate (0.1 per cent) in the safe haven currency category is likely to make the yen the foremost target for carry trading. The country is also plagued by a runaway government budget deficit, and the current account balance – which has shown large surpluses for years – may occasionally show deficits this year. In the longer term, Japan’s savings surplus is challenged by demography = a rapidly ageing population.

The USD is being subjected to conflicting forces. On the one hand, the ultra-loose monetary policies of the Federal Reserve, a burdensome short-term cyclical situation, long-term inflation worries, a large foreign debt and the outlook for more active carry trading. On the other hand, the US together with the emerging markets sphere will most likely lead the imminent (mild) global cyclical recovery, and the American current account deficit is now shrinking at a rapid pace because the private sector is boosting its savings faster than the federal budget deficit increases.

Our basic forecast is that the USD will strengthen somewhat against CHF and JPY during the remainder of 2009. USD is also likely to increase in value against the euro (EUR) this year. We predict that the European Central Bank will cut its refi rate again this summer, from 1 to 0.75 per cent, while the cyclical slump in the euro zone will be deeper and the recovery will occur later than in the US. The euro zone’s economic exposure to Central and Eastern Europe is another factor pulling down EUR.

Looking further ahead, as the economic and financial climate clearly improves, by all indications a number of smaller currencies will be among the winners. These will include commodity-dominated currencies – for example the Australian dollar – and emerging market currencies such as the Indian rupee and the Brazilian real, as well as the Norwegian krone and Swedish krona.

Strength during economic upturns



In a good economic climate, currencies in the emerging market sphere tend to climb in value as global investor interest in these regions increases. In recent months, both the Indian rupee and the Brazilian real have appreciated against the US dollar.