

# FX

## TRADER MAGAZINE

CYPRUS AND  
THE EURO

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FIBONACCI  
RATIOS

JAPAN CHINA  
RISING TENSION

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PROBABILITIES  
THROUGH THE  
TRADING DAY

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MINDFUL  
AWARENESS  
FOR TRADERS

currency war  
or  
dangerous game?

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# CURRENCY WAR OR DANGEROUS GAME?



*Mirror, mirror on the wall, who's the weakest of them all?*

It was, two years ago, Brazilian Finance Minister Guido Mantega who delighted headline writers around the world by warning that quantitative easing and other stimulative monetary policy measures risked unleashing “currency wars” upon the world.

Such a warning has now become almost boring, especially following Shinzo Abe’s election in Japan. Even François Hollande, during the recent (and kind of short lived) euro rally towards high 1.30s levels, joined the chorus worrying about the risks of an overvalued

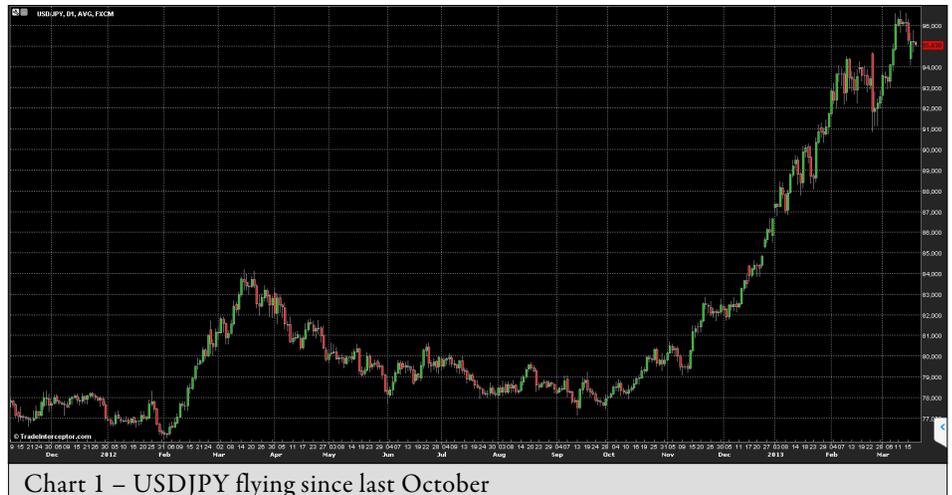
euro to the French economy. Yes, the drumbeats of the currency war are back with doubled hype. From the Weekly Standard columns, US economist Irwin Stelzer warns that “Lenin would be cheering the currency wars” as a step on the road to destroying capitalism.

So “currency wars” are all the rage, at least judging by media headlines. But I think it is worth to give a more careful look at facts in order to better understand if a real war is in place. And especially if it could be a real threat to the global economy.

It's difficult to even explain what a currency war is, since proponents of the term seem confused themselves, but the basic idea is that central banks and governments are manipulating monetary and fiscal policies to weaken or strengthen the value of their currencies.

### Large FX moves are only one part of a broader asset market story

There is no doubt that there have been significant moves in key FX crosses over the past few months. Since the start of October, the JPY has depreciated by more than 20% (Chart 1) and, since the start of the year, the GBP has lost almost 10% both versus USD and EUR. The CHF itself, at a certain stage, has depreciated few percentage points, which is notable compared with recent negligible volatility, moving away from the SNB imposed floor at 1.20, which is itself often singled out as a by-product of the currency war. The fact that stock markets in Japan, the UK and Switzerland are also some of the best performing markets year-to-date gives credence to the notion that weaker currencies are boosting potential economic performance and equity markets in these countries at the expense of trading partners.



There is certainly a grain of truth in this notion since the correlation between FX moves and equity index performance over the past few months is one of the highest on record. It could also be noted that Korean equities are among the worst performers year-to-date which could easily relate to the fact that companies in this country are some of the closest competitors to Japanese firms.

But the moves in the currencies and headline stock market indices are not the entire story. If we look across markets to rates, inflation and equity sectors it could be argued that what is actually being priced is a broader monetary easing, which is also causing currency weakness and equity strength.

### Declining Real Rates

Real interest rates have declined significantly in Japan and in the UK recently. In Japan real rates – measured as the difference between nominal 10-year yields and 10-year inflation swaps – have fallen from about +0.5%

at the start of October 2012 to well in negative territory currently. It is the first time since Japan entered its 20 years long liquidity trap that some kind of serious repricing of future price level is happening.

In the UK, while real rates were already negative, they have declined further. Real mortgage fixed rates have also been declining in the UK over this period as the ‘Funding for Lending’ policy appears to have gained traction, at least in the residential secured lending market. The absence of a liquid inflation market in Switzerland makes it harder to gain a sense of shifts in real rates directly, but here too there has been a modest steepening in nominal curves, consistent with a bout of monetary easing.

### Equity Sectors

A recent research from Goldman Sachs is also quite insightful in better understanding which way the cause-effect link of weaker currency/easier monetary stance/rallying equity markets should be interpreted. If