

3 March 2009

Economic News

FX MARKETS

Prospects for the dollar, sterling, yen and Swiss franc

The global economic and financial crisis now has a currency dimension too. The turbulence is currently having less of an impact on dollar/euro. What is more striking is particularly the strength of the yen, as well as the weakness of sterling and many emerging market currencies. The following analysis takes a look at current trends, and provides an outlook for the major currencies. We shall shortly be publishing a separate "Economic News" that covers our views on some Central and Eastern European currencies.

At a time when many financial market segments have encountered turbulence, it would be a major surprise if currency markets especially were to remain unaffected. In its most recent monthly report, the ECB explained that the continued high volatility of exchange rates was due to, among other things, uncertainty and changing assessments as to which economies would recover first from the downturn. This certainly forms part of the explanation. A further factor is that currency markets reflect a lack of political leadership. Market movements reinforce and justify themselves in an environment of uncertainty where there is a lack of "guidance". This can be witnessed, for example, in Central and Eastern Europe where both vulnerable and more solid economies are currently being treated on an undifferentiated basis. The intensive summit diplomacy of the coming months, for example at the G7, the G20, or the IMF, offers policymakers an opportunity to counter excessive exchange rate volatility with clear pronouncements.

Exchange rate forecasts currently carry a particularly high degree of uncertainty since forecasts for individual countries are currently subject to very many incalculable factors, and each currency pair reflects the (expected) economic trend of two countries or currency areas. To this extent, the following forecasts should be understood mainly as an indication of the expected directions of currency movements, and not as point forecasts.

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Exchange Rates	current	Forecast			
	02/03/2009	last week	3 Months	6 Months	12 Months
USD/EUR	1.26	1.28	1.30	1.30	1.40
JPY/EUR	122.52	121.09	130.00	137.00	161.00
JPY/USD	97.84	94.18	100.00	105.00	115.00
GBP/EUR	0.89	0.88	0.90	0.86	0.82
USD/GBP	1.43	1.43	1.44	1.51	1.71
CHF/EUR	1.48	1.49	1.50	1.53	1.56
CHF/USD	1.17	1.16	1.15	1.18	1.11

Source Ecowin, WestLB Research forecasts

Dollar – only temporary strength

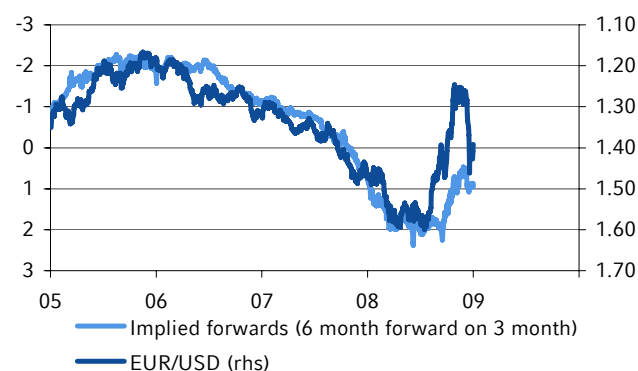
Apart from a temporary rebound in the first half of September, the dollar has appreciated sharply against the euro since mid-2008. The main factors that have recently placed the joint euro currency under pressure have been concerns about the economy and state finances in Southern and Eastern Europe, particularly given the recent rating downgrades, as well as a theoretically conceivable breakup of the European Monetary Union, which we nevertheless regard as quite unlikely. The expectation of a deeper economic collapse in the Eurozone has also proved to be an additional negative factor. During such uncertain times, investors clearly prefer the dollar, which is still regarded as a safe haven for monetary investment given its global liquidity – whether justified or not. A further supporting factor is the expectation that extensive measures taken in the US to stabilise the economy and financial markets will take quicker effect than in Europe. In this connection, market participants are also already airing the topic of a rise in the Fed funds rate, even if this might still lie in the distant future (2010). The ECB, by contrast, is still seen as having scope for interest rate cuts.

USD/EUR



Source EcoWin, WestLB Research

Dollar and interest expectations



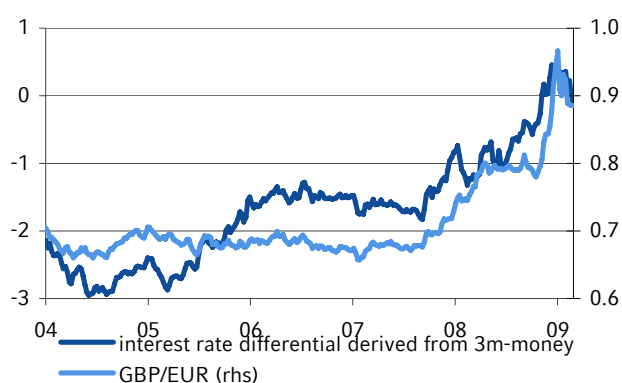
Source EcoWin, WestLB forecast

We regard the dollar's current strength as temporary. The dollar fails to reflect the fundamental weakness of a US economy where private consumption will relinquish its role as a growth motor for the time being due to the high level of private household indebtedness. Although the combination of extremely expansive monetary and fiscal policy will practically force an economic recovery in the second half of this year, we believe it will be weaker than many market participants currently expect. If the US economy does in fact adopt a flatter growth path, many investors will (be forced to) rethink earnings prospects for dollar investments. Beyond that, we also believe the continued existence of major structural imbalances in the US (high indebtedness of private households and government, no further reduction of the current account deficit) will have a negative effect. Consequently, we anticipate USD/EUR rates around 1.40 on a 12-month view. The dollar may well tend to strengthen again in the short term, however, as long as concerns about the Eurozone remain in focus. Finally, we expect that shifts between these two major currencies will remain within bounds because they are both regarded as relatively safe havens in periods of crisis.

Sterling – weakness induced by interest rates

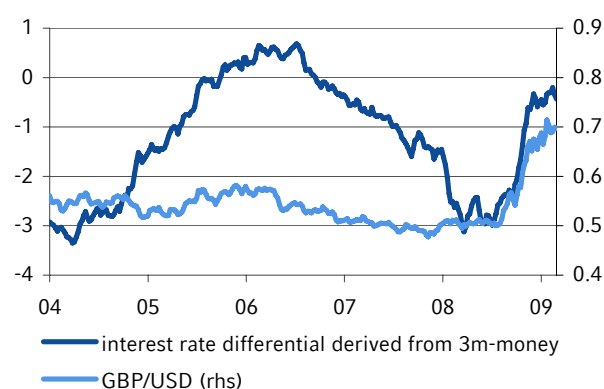
Sterling has depreciated by over 30% against the euro since autumn 2007. Although its depreciation against the dollar started later, in November 2008, sterling has nevertheless depreciated to an even greater extent against the greenback, by around 45%. It is currently close to its historic low of 1976 in real trade-weighted terms too. Most commentators cite two reasons for the sharp depreciation of sterling. Firstly, the United Kingdom, similarly to the US, is suffering from the bursting of a real estate bubble. The property market crash is also having a negative impact on private consumption through negative wealth effects. The UK economy finds itself in a deep recession as a consequence. Secondly, the UK is particularly affected by the financial market crisis. The financial sector's share of total value creation of around 8% is almost double the level in Germany. UK banks' asset write-downs have summoned the state to action in the form of nationalisations and capital injections. Although the state's debt position still amounted to only a moderate 43% of GDP in the last budget year, the sheer size of the banking sector nevertheless gives rise to concerns about default. The Royal Bank of Scotland's assets alone significantly exceed UK gross domestic product, and the assets of all UK banks in 2007 were four times as high as total UK output.

Sterling/euro and interest expectations



Source EcoWin, WestLB Research

Sterling/dollar and interest expectations



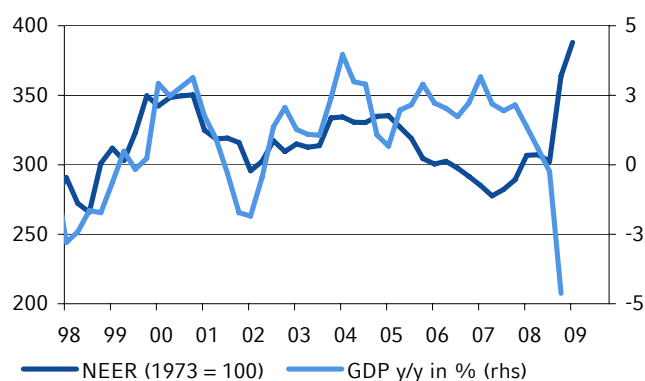
Source EcoWin, WestLB Research

Changes in interest rate expectations already provide an excellent clarification for the current fall in the exchange rate. By contrast with the ECB, the Bank of England has turned on the interest rate taps both rapidly and massively. Despite its higher starting level in the autumn, the current base rate of 1.00% is even below the ECB's key interest rate. The Bank of England is also attempting to lower market interest rates through an expansion of the monetary base. This has resulted in a turnaround in the interest rate differential. An interest rate advantage for the UK has now become a disadvantage. The UK's interest-rate advantage relative to the US has also narrowed considerably. A narrowing of the interest-rate disadvantage relative to the Eurozone can be anticipated in the future if the ECB cuts its key rate to 1%, as we expect. This should result in a slight appreciation of sterling relative to the euro in the future.

Yen – weakness has started

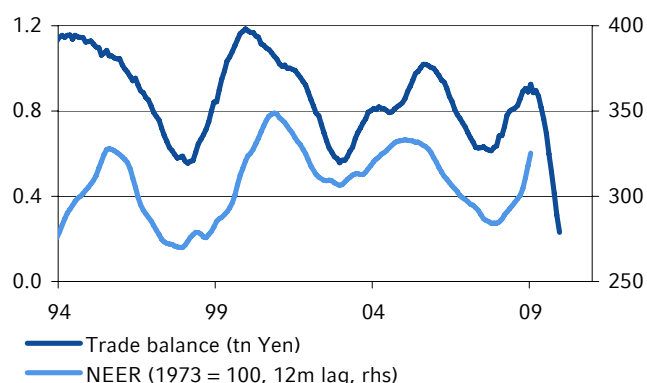
Although the yen has weakened in recent days, it has nevertheless appreciated by around 30% since August 2008 in trade-weighted terms. This stands in stark contradiction to the many negative headlines published in Japan. Japanese GDP fell by almost 13% in annualised terms in the fourth quarter, January exports were down by almost 50% y/y, and the trade balance is sliding into deficit. Fundamental demand weakness in all export markets is dragging the highly export-dependent economy into recession. Corporate investments are falling, and consumers who are concerned about rising unemployment are reining back consumption. The Japanese economy faces darker days before rays of hope will be detectable. The political situation, too, provides little ground for hope. The opposition and governing parties are at loggerheads, and are blocking each other's moves. Prime Minister Taro Aso's ratings in opinion polls are falling rapidly, and parliamentary elections are due in autumn. There is currently no sign of a coordinated attempt to battle the recession. Instead, the lack of leadership in approaching the ever-rising mountain of problems is coming to the fore. A calming of the political waves is currently not in sight.

Effective exchange rate and GDP



Source EcoWin, WestLB Research

Effective exchange rate and trade balance



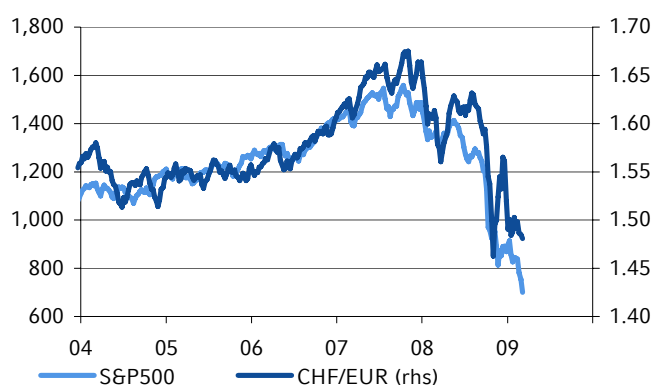
Source EcoWin, WestLB Research

We regard the recent strength of the yen as a consequence of the unwinding of carry trades rather than a flight to a safe haven. Investors unwind their yen loans, which were reinvested in higher yielding currencies, and they are obligated to buy the yen. The phenomenon of yen carry trades gathered momentum from 2004. Until then, the yen was highly correlated to GDP. If economic output weakened, the yen fell, and vice versa. This relationship went into a continuous decline from 2004, before swinging round into a highly negative correlation in 2008. In other words, the yen rose while the Japanese economy crumbled. We do not regard this trend as sustainable. This is why we see the yen's weakness since early February as the start of a return to the yen trading somewhat more in line with the trend in the real economy. We believe the recession will come into greater focus on a 6-12 month view, and, in combination with a wider trade account deficit, precipitate a further weakening of the yen to significantly above 100 JPY/USD. As a result of the global convergence of interest rates (at a low level), we do not expect an environment to soon re-emerge that allows for a massive renaissance of carry trades, quite apart from the currently prevailing lack of risk appetite.

Swiss franc – safe haven status damaged

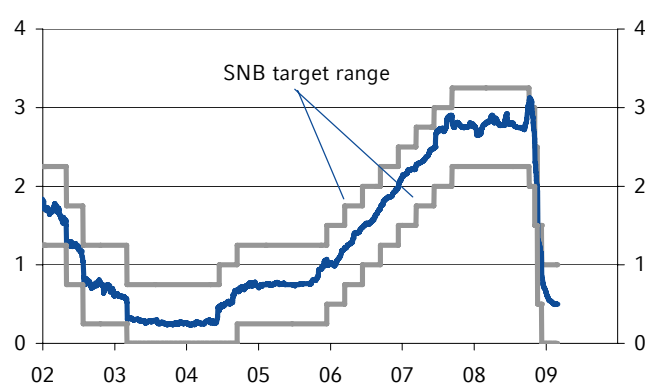
It is striking how little the Swiss franc has benefited from the recent rise in risk aversion. Although its negative correlation with equity markets is still intact in terms of trend (weak equity prices are accompanied by a strong franc), the franc's status as a "safe haven" has not come fully to the fore recently. We see two main reasons for this. Firstly, Switzerland is a small economy with a large financial sector which contributes 10% to gross value-added, and which finds itself in a deep crisis. The fact that the government and the Swiss National Bank are required to support the two big Swiss banks is not contributing to confidence in the currency. Secondly, the economic downturn is hitting Switzerland with its full impact. To the financial sector's weakness is added the export trade dependency of Switzerland, which is surrounded by countries in recession.

Swiss franc exchange rate and equity market



Source EcoWin, WestLB Research

3-month money and SNB target band

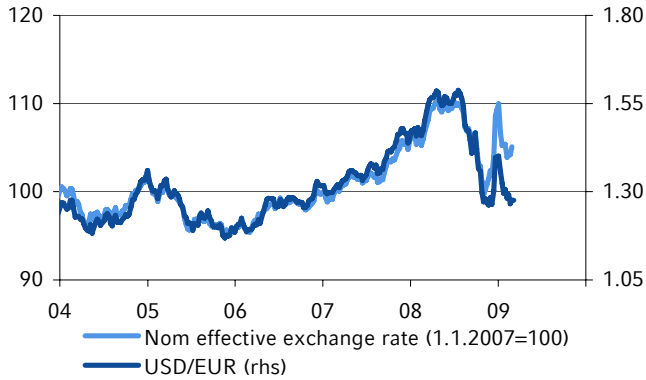


Source EcoWin, WestLB Research

We think investors' risk perception will continue to play a strong role in the franc's short-term volatility. We anticipate the currency will fluctuate around CHF/EUR 1.50 over the next three months. We believe the Swiss National Bank might counter a potential firmer trend in the currency with interventions against the franc if required. We anticipate a somewhat weaker Swiss franc in the medium term if, as we assume, the situation in financial markets stabilises by the end of the year, and investors' risk appetite grows again. We regard it as fairly valued at around CHF/EUR 1.56 on a one-year view.

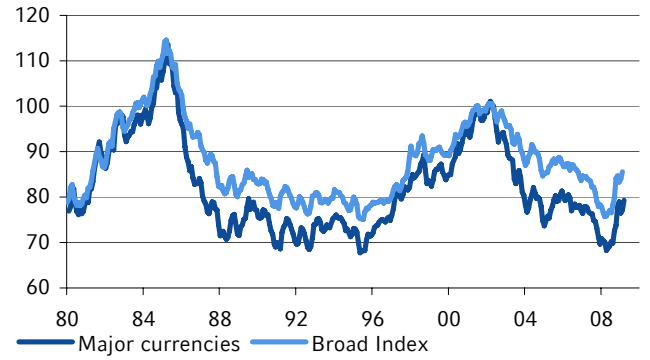
Currency markets in overview

External value of the euro and exchange rate to the dollar



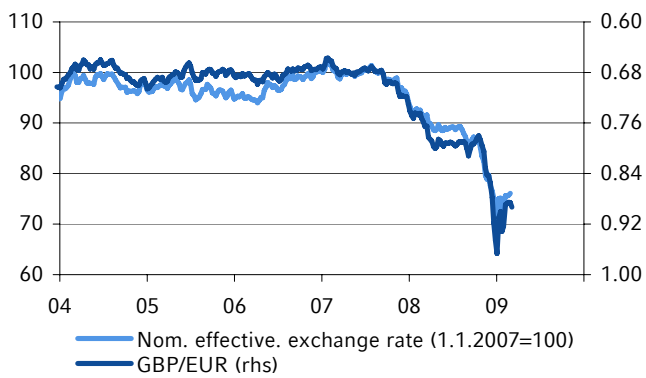
Source EcoWin, WestLB Research

Real external value of the dollar
Jan 2002 = 100



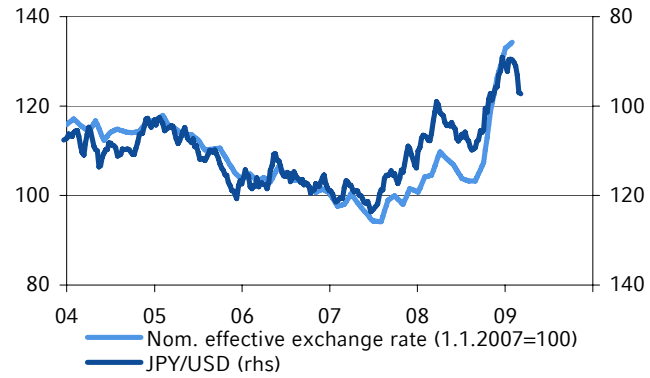
Source EcoWin, WestLB Research

External value of sterling and exchange rate to the euro



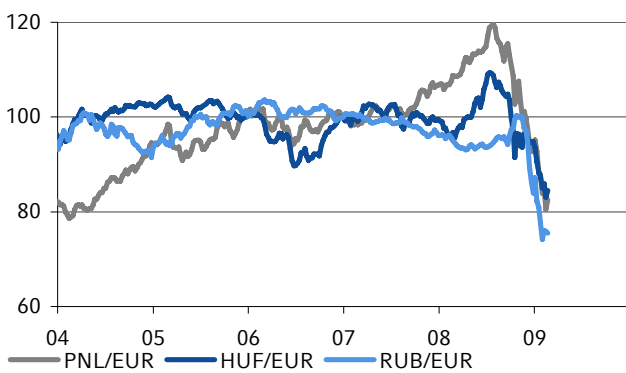
Source EcoWin, WestLB Research

External value of the yen and exchange rate to the dollar



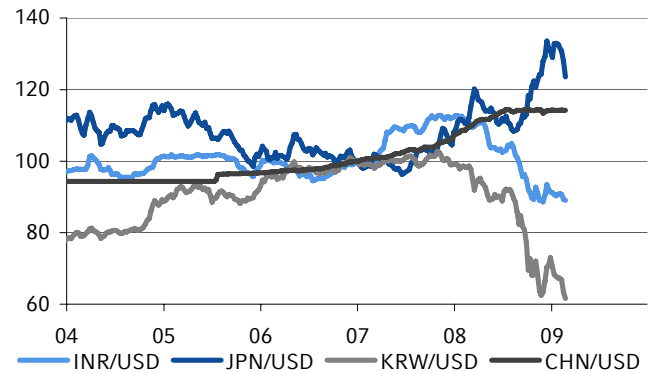
Source EcoWin, WestLB Research

Eastern European currencies relative to the euro
1/1/2007 = 100



Source EcoWin, WestLB Research

Asian currencies relative to the dollar
1/1/2007 = 100



Source EcoWin, WestLB Research

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