What's next for the Dollar and Currencies?

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In the short to medium term, the U.S. dollar and currencies are heavily influenced by what the Fed may be up to next. While the particularly high policy uncertainty projects elevated volatility on the bond and currency markets, the good news is that this may yield opportunities for the prudent investor.

All Eyes on Fed

Taper vs. Tighten? Yellen vs. Summers? A little more than halfway through the year there is much debate about the course of Fed policy with respect to winding down asset purchases (QE) and the timing of the first rate hike off of the zero lower bound. Adding to the uncertainty is that Bernanke's term is coming to an end on January 31, 2014 and President Obama looks set to nominate a successor this fall.

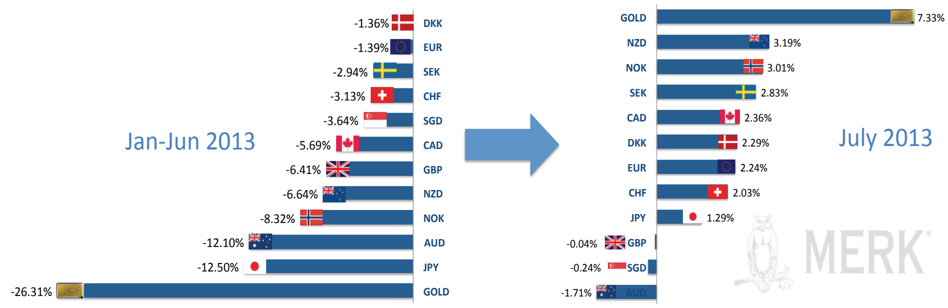
For starters, the word "tapering" for all of its repetition in the press may not be the right way to think about how the QE program will evolve from here. After the tapering talk started, the Fed made clear that it may decrease or increase its monthly asset purchases going forward depending on the outlook for the labor market and inflation.

Furthermore, tapering QE does not mean tightening policy in terms of short-term rates, and the Fed has recently made a concerted effort to make that distinction. The two, QE tapering and Fed funds rate policy, are seen by some as tied because tapering suggests a move towards normalization of policy that would eventually take the Fed funds rate off of the so-called zero lower bound. While there seems to be debate among Fed officials as to the efficacy of QE and the cost/benefit trade off, there seems to be consensus, certainly among the dovish camp which we believe is in control of today's Fed, that rates should remain extraordinarily low well after QE ends and for a very long time in general.

In our view a steady tapering of the QE program is far from a foregone conclusion. To boot, any such decision may be made by the successor of the lame-duck Bernanke.

Hence, ***the most important question is who will succeed Bernanke***. Janet Yellen, Larry Summers, and Donald Kohn appear to be the names on Obama's short list. While Summers does indeed appear to be Obama's preferred choice, our view is that Yellen will more likely carry the day. Most relevant to the market is

From Dollar Strength to Dollar Weekness



Source: Merk Investments, Bloomberg
LEFT Currency returns relative to the U.S. Dollar for period 01/01/2013-06/30/2013
RIGHT Currency returns relative to the U.S. Dollar for period 06/30/2013-07/31/2013
CAD: Canadian Dollar, SEK: Swedish Krona, NOK: Norwegian Krone, GBP: British Pound, EUR: Euro, DKK: Danish Krone, CHF: Swiss Franc, SGD: Singapore Dollar, JPY: Japanese Yen, NZD: New Zealand Dollar, AUD: Australian Dollar

her ideology, where she is regularly scored as more dovish than Bernanke. Any change in leadership would provide an opportunity for modifications to the policy and messaging of the Fed, which could have dramatic ramifications for the currency markets.

We believe this lingering uncertainty fosters volatility in all markets: they have yet another excuse to over-interpret the news of the day rather than price risk in terms of a longer term trajectory of monetary policy.

As far as solid economic recovery is concerned, we believe the glass may be half empty:

- As mortgage rates have risen substantially, odds are high that the housing recovery might stall. Bernanke has specifically pointed to this risk; we believe Bernanke, just as Yellen if she succeeds him, may further taper the taper talk should housing disappoint.
- Unemployment reports continue to paint a mixed picture. Ahead of the implementation of Obamacare, employers have an incentive to shift full-time jobs to part-time jobs.
- Corporate earnings have done okay, but a number of sectors have had disappointing sales. Weak sales suggest this economic recovery is not as strong as rising stock prices suggest.

In this context, ***there may be a lot of work for the markets to taper its taper expectations***. As the dollar has risen on the backdrop of taper talk, we expect the greenback to face headwinds.

Gold – Hardened Money

Gold has been seriously out of favor over the first half of the year. Having had twelve consecutive up years it is not surprising that the precious metal should have a major correction, although it experienced a remarkable capitulation in the second quarter. To put it into context, there were a lot of non-fundamentally driven buyers that came into the market during the run up to the highs of 2011, chasing the trend, using leverage, and only interested in the idea of speculating on further price increases in the shorter term. Those marginal buyers have since then gone and indeed some have come in aggressively on the short side, exacerbating the trend in the opposite direction.

Importantly from our standpoint, the fundamentals are still very positive as many parts of the world, including the U.S., are burdened with too much debt and the path of least resistance remains inflation and a gradual debasement of the purchasing power of the currency. In our assessment, the U.S. and many other governments around the world cannot support their bonds should their cost of borrowing rise significantly. In that sense, the sluggish recovery has been beneficial to governments. Taper talk might be hazardous to the price of gold, but ultimately, we believe, the ***Fed will have to err on the side of inflation, boosting the long-term prospects of the shiny metal***.

Euro – Cursed to Rise

The much-unloved euro has managed to appreciate against the dollar last year as well as so far this year. One under-reported driver: while the Fed continues to print money, the ***ECB's balance sheet is actually shrinking***. The ECB has a demand driven balance sheet, where liquidity has been drained from the system as banks have returned loans. Add to that improving current account balances in peripheral Eurozone countries, as well as an overall current account for the Eurozone that's roughly in balance, and ***the euro may be "cursed" to go higher, even as economic growth remains sluggish*** (albeit improving).

British Pound – Loony Bin

As soon as his first policy meeting, Bank of England's new chief Mark Carney signaled introduction of more forward guidance on the rate path. After one month on the job, one thing Carney has already achieved is the pound's higher volatility: since July the pound has been more volatile than the euro.

We maintain our bearish call on the British pound over the next twelve months. While some interpreted the BoE's recent unanimous decision against more QE as a hawkish signal, we view this as simply a tactical move. Moreover, Carney will have a good chance to reshuffle the board and push forward his preferred policy strategy. Stay tuned.

Japanese Yen – Sayonara

Late last year we published a piece "Is the Yen Doomed?" and in our January currency outlook, we removed the question mark. As of this writing, the yen has weakened more than 11% against the dollar year-to-date. Investors have stopped looking at the yen as a safe haven. Indeed, the yen's implied volatility has been the highest among all G10 currencies.

Our price target for the yen is infinity, meaning that ***we believe the yen will be worthless down the road***. The policymakers of Japan are unaware of the dynamics they are unleashing. Prime Minister Abe's three arrows – money printing, fiscal stimulus and structural reform – have all boosted inflation expectations and weakened the value of the yen. It may be dangerous for the massive government debt as higher inflation gets priced into bond yields.

Aussie – Down Under

As the highest yielding currency in the G10, the Aussie is a favorite for the carry trade strategy. It is also a commodity currency as Australia exports industrial raw materials such as iron ore and coal, among others, to emerging markets, China in particular. Despite these attractions, the Aussie was the worst performer in the G10 in H1 2013 in large part due to two key drivers: changing expectations about short-term interest rates and concerns about growth in China.

We expect headwinds for the Australian dollar to continue, with the caveat that its substantial selloff might allow it to bounce back temporarily. But it may take a while for the Aussie to find a firm footing given, amongst others, also a deteriorating domestic budget outlook and investment cutbacks in the commodity sector that won't be reversed on short-notice.

Kiwi – Got Milk?

Similar to the Aussie, the Kiwi is a high yielding commodity currency. However, based on their latest policy statement RBNZ looks set to start a tightening cycle in contrast to expectations that the RBA will further cut their benchmark rate. Also, New Zealand is a large commodity producer and exporter, but is more heavily geared towards soft commodities such as dairy rather than the heavy industrial commodities of Australia and may therefore have far less exposure to a slowdown in China.

For all intents and purposes the Kiwi is now the highest yielding currency in the G10 and ***may well benefit from carry trade popularity more than the Aussie when the carry trade comes back into fashion***. Going against the New Zealand dollar is that this may all be priced in already, indeed, it has rightfully outperformed the Australian dollar of late. Still, we believe New Zealand's monetary policy will surprise the world by being more hawkish than many expect.

Chinese Strength – Slowly but Surely

China's new leadership is working hard to demonstrate its commitment to real reform. One concrete example is that the administration didn't engage in competitive devaluation this year. Year-to-date, the Renminbi has strengthened by over 1.6% against the dollar, more than 1.03% in the full year of 2012. Meanwhile, it appreciated more than 15% against the Japanese yen.

More broadly speaking, the new leadership has called structural reforms and deleveraging their top policy priority. By targeting a lower GDP growth rate, the Chinese government is now seeking sustainable quality growth. It also lifted the interest rate cap on financial institutions and launched a second round of nationwide auditing on local government debt. ***These initiatives and reforms are positive for the Renminbi in the long term.***

Emerging Markets – Asian Winners

We stay positive on the Korean won, the Malaysian ringgit and the New Taiwan dollar. Despite recent market volatility, all these currencies have been relatively resilient, benefiting from benign inflation and strong external positions, reflected by large foreign reserves and current account surpluses. We also like these currencies' low correlation (and lower correlation compared to other EM currencies) with the U.S. markets.

Let's also keep in mind that Japan's policies to debase its currency are not all-threatening to the region: the expansionary policies may lead to significant investments throughout the region, providing a significant stimulus to regional economies.

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Merk Investments, LLC is a leader in the currency asset class and a pioneer in providing uncorrelated returns and portfolio diversification through actively managed currency funds.

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Axel Merk is the Founder, President and Chief Investment Officer of Merk Investments.

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