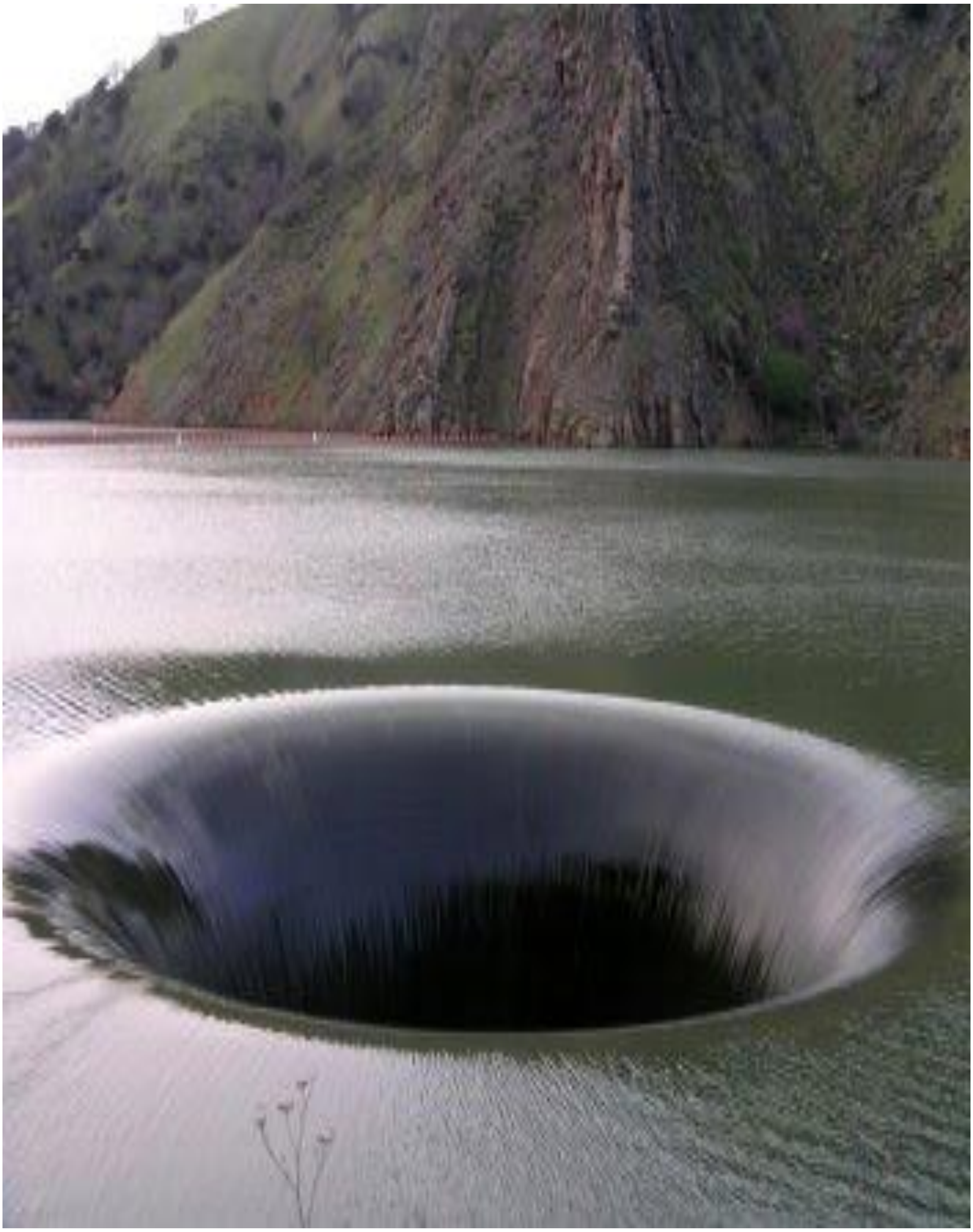
Global Market Strategy - Liquidity Traps and competitive FX devaluation



Let us begin by first posing a question: Do we agree that Japan is in a liquidity trap where further Monetary succour has diminishing marginal utility? Can we expand this question to include the US and the EU? The answer to the above two questions is an affirmative as Central Banks in these three monetary blocks find that further easing of monetary conditions is not giving them the same bang for the buck once they have reached close to the lower end of short term rates.

Let us see how FX rates are affected by the size of the Balance sheets of the above mentioned Central Banks.

Chart 1. US Federal Reserve Balance Sheet - ECB Balance sheet size , vs. EUR/USD

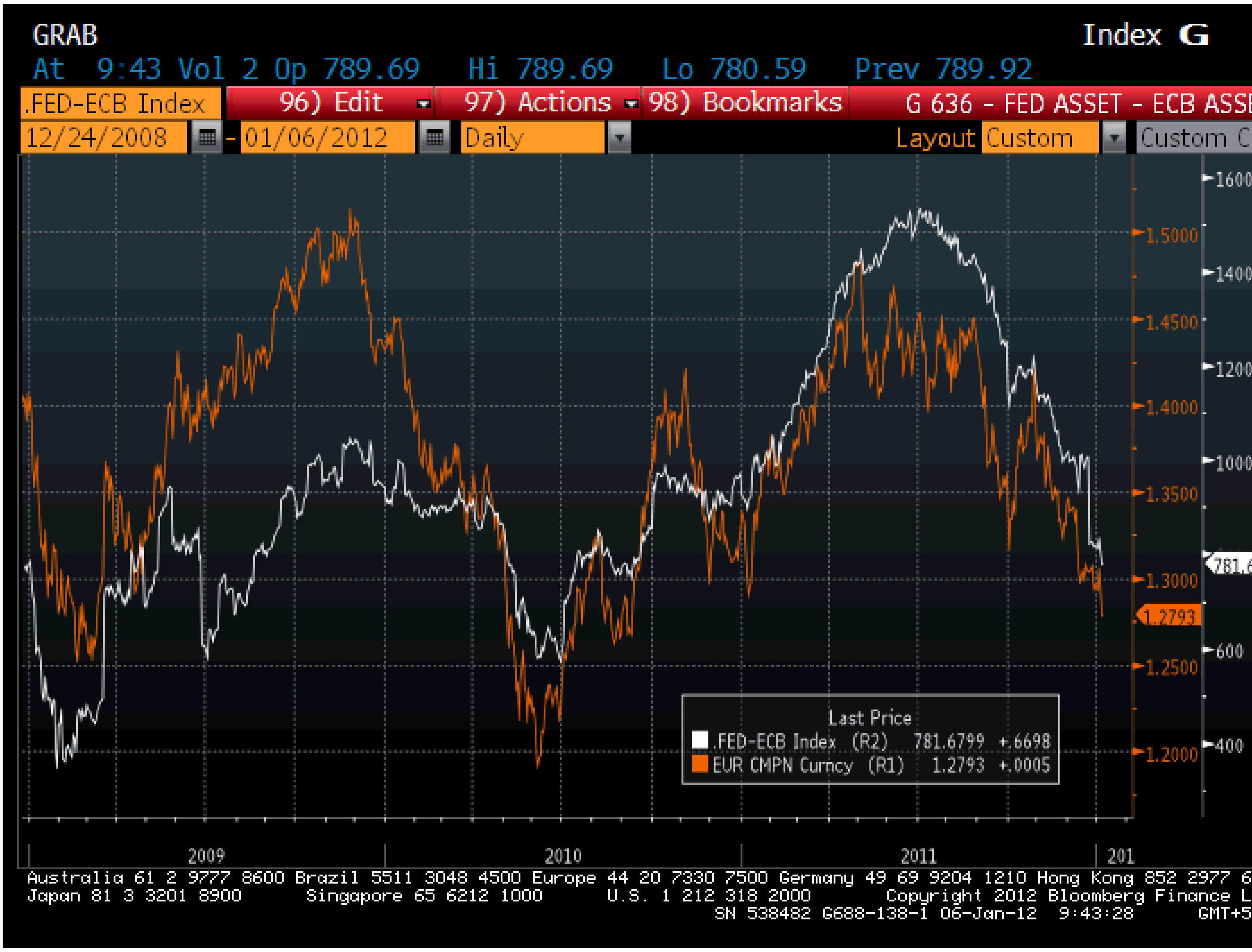


Chart 2. BoJ Balance sheet- US Federal Reserve Balance Sheet size , vs. USD/JPY

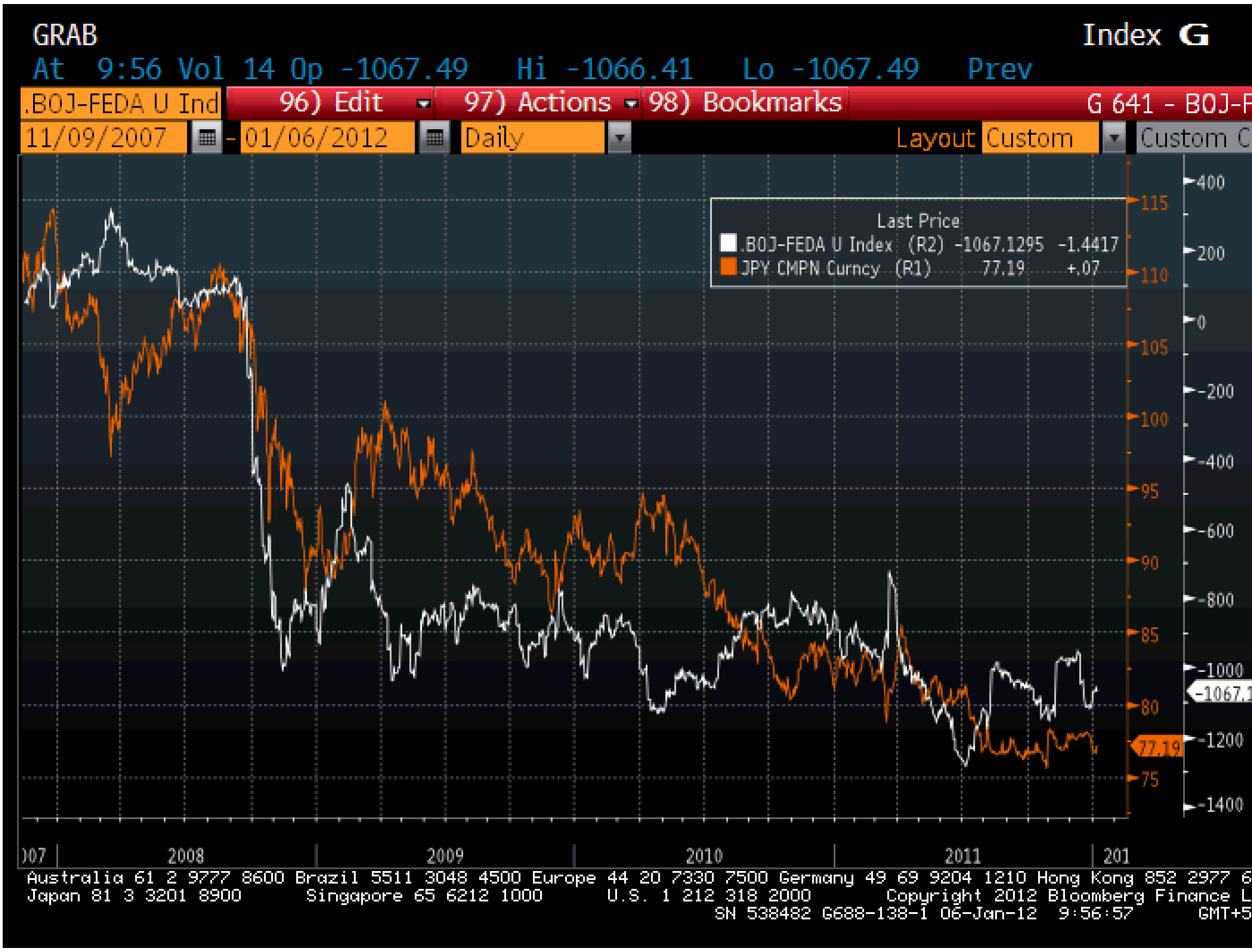
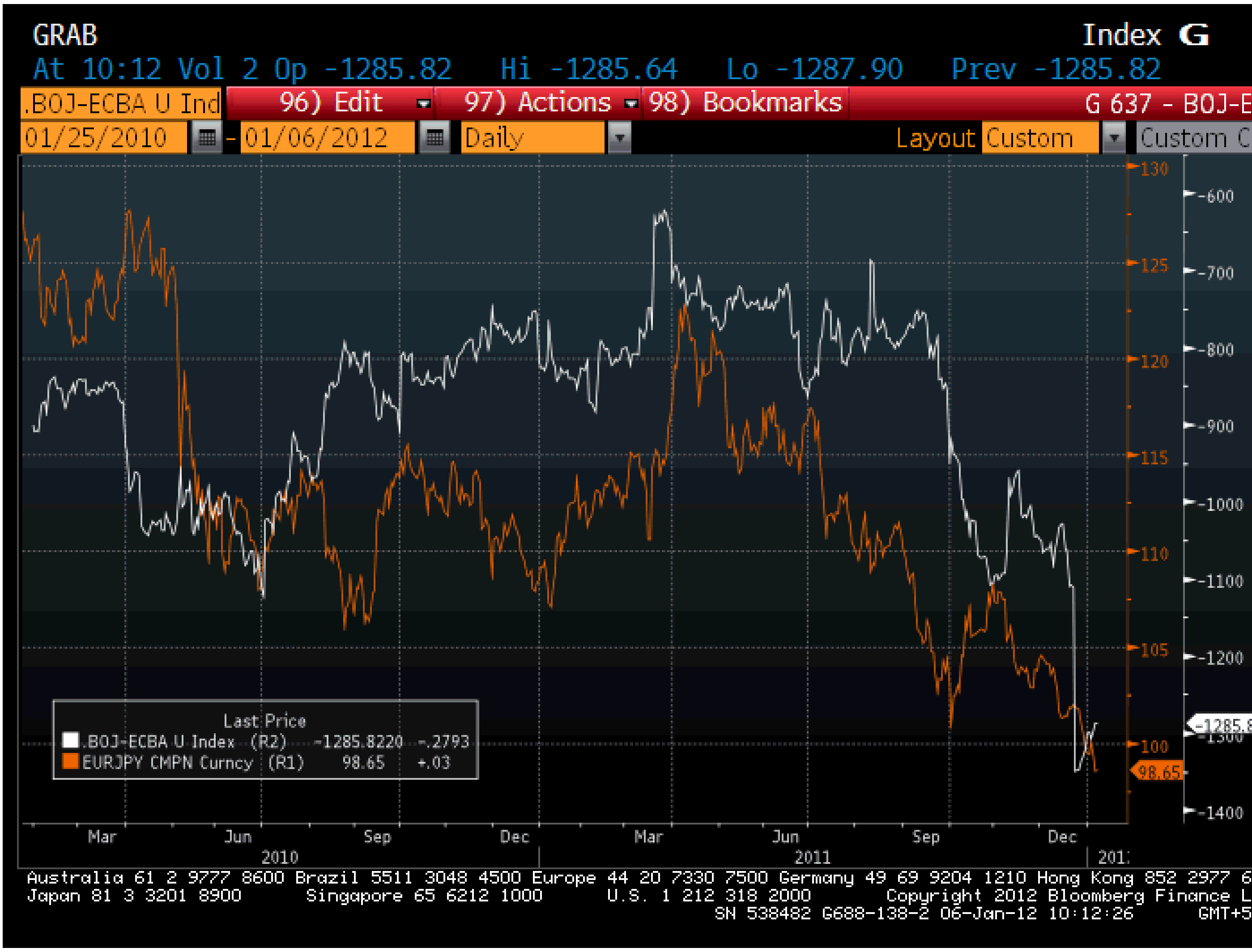


Chart 3. **BoJ Balance sheet - ECB Balance sheet size , vs. EUR/JPY**



The important point to note is that this kind of "bang on" and direct cause and effect is seen to exist between currency pairs that belong to economies in a liquidity trap. For example we would never find such a relationship between AUD/CAD and differential between ACB and Canadian Central Bank balance sheet size because Australia and Canada are not *yet* in a liquidity trap.

It is here that the plot thickens. There's some talk of growing discomfort within the US establishment of the gnawing weakness of the Euro and the discomforting strength of the US$. So what must the US Fed do to try and reverse such outcomes? Expand the Fed Balance sheet off-course!!!! And the news out of Washington/NY is that the Fed may be looking at a USD 600 Bio QE III by March 2012 FOMC Meet which will concentrate on purchasing not just 30 yr MBS but also US AAA(actually AA+) Corporate Commercial Paper and medium tenor bonds. And where will that take the EUR/USD exchange rate? 1.45 +. That will be cause mayhem in the EU already in dire straits. So what should the ECB do in it's April 2012 Meet to get to it's target of 1.20 by June end 2012 *? The answer: Balance sheet expansion of 700 Billion Euros.

*Pl. refer to Note dated 12/06/2011 entitled "The G7 predicament" (Pl. refer to Appendix)

Chart 4. ECB Target 1.20 by Mid 2012 : How does it get there?

And what does the deluge of competing QE's and currency wars bring to emerging market economies? High oil prices, high Gold prices, high inflation, and in some cases -social unrest.

Welcome to the brave new world of perpetual FX wars where no matter who the winner is, emerging market economies stand to lose out.

Date : 12/06/2011

The G7 Predicament

The Global scenario is such that the Eurozone, if it is to be sustainable in its present form, must depreciate it's currency by 30% to boost it's exports and let it's southern members recover competitiveness. As much as the EUR/USD is viewed as a signal for risk assets, an immediate level of 0.95 would be bad for markets. Hence the ECB would like to ease the FX markets to that level over a period of time- let's say 9 months- which translates to 4 big figures per month depreciation on an average - a rate of depreciation that can be digested by markets without panic.

The other reforms that Merkozy-Monti are committing/will commit are very long term projects that will take atleast 3-4 years, even if they say this weekend that it will be done in a jiffy. Remember the EFSF "deal" last October which was supposed to be an immediate starter? The EFSF is yet to be properly operationalized till date.

Offcourse , competitive devaluation as spoken of in the first para will not be taken to kindly by the Obama administration which faces elections next year. And therein lies the greatest challenge for the G7. Will they be able to convince the US to postpone it's 3 year project of debasing the US$ to let the the Euro have a go at a similar exercise at a time when the US Presidential elections are looming? The Republican primaries can provide an answer. Herman Cain is out. Mitt Romney is fighting a close battle with Rick Perry and others. Obama is still the only "TINA" for US Voters thus far even though his administration has a poor score on the economy front. "It's the economy , Stupid" said Clinton.
And anything can happen in 1 year. So a mid point? Not 0.95 , but 1.15 on the EUR/USD over the next 6 months? 3.3 big figures per month. That's a great compromise for the G7.

What about the USD/INR in 6 months if EURO is at 1.15? India Inc. - Lets' cover those USD Liabilities/ECBs/FCCBs- buy on dips.

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Strategy

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