Currency Wars

Mario Singh explores the global forex outlook and what the seven trading milestones of 2010 mean for currency traders in 2011.

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The year 2010 was eventful for the currency market. Some currency pairs broke new highs while others found new lows. Understanding some major milestones from 2010 will help us to be better prepared for the currency market in 2011.

Milestone #1: Greece receives a bailout package

On 15 May 2010 Greece received the first tranche of a 110 billion euro bailout package jointly provided by the European Union and the International Monetary Fund.

In return for the loan, the Greek cabinet vowed austerity measures aimed at achieving budget cuts of 30 billion euros in the next three years and reducing Greece's deficit from the current 13.6 per cent of Gross Domestic Product (GDP) to less than three per cent of GDP by 2014.

In the aftermath of the bailout, the European single currency fell to its lowest level against the dollar since 2006, reaching 1.1876 on 6 June 2010.

Milestone #2: China de-pegs from the US dollar

On 21 June 2010 China announced that it would de-peg its currency from the dollar; a first after 23 months of pegging.

It was a step in the right direction because it was largely a vote of confidence in global economic recovery. The initial impact caused a slight appreciation in the yuan, which would have hurt Chinese exporters.

However, on the international front, the Chinese government felt that global consumers were back to their spending ways and there wasn't a need to protect their exporters. On the domestic front, the strong yuan made foreign goods cheaper for domestic consumers and would help to curb inflation within the country; a signal that the Chinese government was looking to stimulate domestic demand.

Milestone #3: Bank of Japan intervenes for the first time in six years

On 15 September 2010 the Bank of Japan (BoJ) sold about $20 billion worth of yen. This was the first time in six years that the BoJ had intervened in the currency markets in an attempt to weaken the yen.

Like the intervention that took place in March 2004, the effect was short-lived, with the 300-pip blast-off in the USD/JPY pair negated after about two weeks.

The intervention would have delivered more firepower had it been a coordinated effort between the BoJ, the Federal Reserve and the European Central Bank (ECB). However, for the Fed and the ECB to 'help' Japan and sell the yen, they would effectively have had to buy their own currencies in the process. The Fed and the ECB were opposed to doing that because buying their own currencies would inherently cause the dollar and the euro to appreciate. That would run counter to their plans to maintain a weak currency to pull their economies out of the slowdown.

This led to the solo effort by Japan, which didn't meet its objective of weakening the yen.

Milestone #4: USD and EUR hit historic lows against CHF

On 8 September 2010, EUR/CHF hit an all-time low of 1.2764. In similar fashion, just one month later, on 14 October 2010, the USD/CHF hit an all-time low of 0.9462.

The massive demand for the Swiss franc was caused by the general wave of fear and panic among traders and investors. Unconvinced of global economic recovery, they fled to safe havens.

Two main themes dominated the move:

1) Europe's woes with sovereign debt issues. As well as Greece, Ireland seemed to be teetering on the brink of spiraling debt. In November 2010, interest rates soared on Irish government bonds. The gap between Irish and German borrowing costs also shot up to record highs. To make matters worse, borrowing costs in Spain and Portugal also spiked.
2) The Fed's impending decision on a further round of quantitative easing. Talk was rife in the financial markets that the recovery of the American economy remained sluggish. Unemployment was at stubbornly high levels, just shy of 10 per cent. Many economists were predicting a fresh round of asset purchases by the Fed, valued at between USD500 billion and USD800 billion.

Milestone #5: Aussie reaches parity for the first time

The star of the currency show in 2010, the Aussie hit parity against the US dollar for the first time in history on 15 October 2010. The strength of the Aussie hinges on two factors:

1) Continued weakness and low interest rate for the US dollar. Australia has the highest interest rates (4.75%) among the G20 countries, which makes the carry trade very attractive for traders and investors
2) China's insatiable appetite for raw materials. Australia has been lapping up China's demand for raw materials, namely gold, iron and coal. This has caused the currency pair AUD/USD to peak. In fact, for the second half of 2010, we saw how the AUD/USD moved in tandem with China's trade figures.

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Milestone #6: Fed launches second round of QE

On 3 November 2010, the Fed announced a second round of monetary stimulus, dubbed QE2, in a bid to jump-start the sluggish recovery of the US economy.

It will buy long-term Treasuries worth $600 billion until June 2011, and reinvest $250 billion to $300 billion more in Treasuries with the proceeds of its earlier investments.

The bond purchases will total up to $900 billion and will be completed by September 2011. This is the second time the Fed has had to step in and revive the economy through a round of asset purchases. From November 2008 to March 2010, the Fed launched its first Quantitative Easing Program, buying $1.7 trillion in Treasuries and securities.

Milestone #7: Gold and silver at historic highs

On 9 November 2010, silver hit a record high of $29 per ounce. On the same day, gold was seen at a price of $1424 per ounce.

These prices were the highest ever reached by both precious metals. This occurred just one week after the Fed announced its second round of asset purchases, causing the dollar to plunge. Widely seen as a natural hedge against the falling value of the dollar, gold and silver prices took off after both traders and investors hedged their bets and found solace in commodities.

G20 Meeting

The G20 meeting, held in Seoul in November 2010, was a bit of a letdown. The term 'Currency War' was used frequently by many nations leading up to the meeting, but concrete details of how countries would prevent currency devaluations and cope with trading imbalances were sorely lacking.

The highlight of the meeting was probably when US President Obama called the Chinese currency "undervalued", though it was something traders knew all along.

Looking forward to 2011

'Currency Wars' was the major theme for 2010, and I expect the sequel to be played out in 2011. With the Fed's second round of QE announced in November 2010, the possibility of higher interest rates for the United States in 2011 has all but vanished.

With low yields in the United States and sovereign debt problems plaguing peripheral countries in Europe, it is not difficult to see that the biggest beneficiaries of money flows in 2011 will be in the Asia-Pacific region.

China, in particular, will do very well. With its incessant demand for raw materials and its focus on building domestic growth, China will be the star of the growth story in 2011. Additionally, its strategic downsizing of US debt in the later part of 2010 sheds light on its emergence as a true global superpower.

2011 forecasts

Here are my thoughts for the majors in 2011.

- **EUR/USD**

  With the PIGS (Portugal, Ireland, Greece, Spain) coming into the currency spotlight for all the wrong reasons, I expect the euro to remain depressed for much of 2011. Its 'web of debt' will always be in the way of organic growth. Additionally, it is no secret that a low euro would help the region to increase its exports.

  Year-end call: EUR/USD at 1.31

- **USD/JPY**

  With a failed intervention on 15 September 2010, Japan knows that its economy is heavily reliant on the progress of the American economy. However, with high unemployment and low spending, the US economy is badly wounded. Hence, the Japanese government and Japanese exporters have started to get used to a stronger yen. Many exporters have readjusted their hedging positions to factor in a stronger yen for 2011.

  Year-end call: USD/JPY at 85

- **GBP/USD**

  Called the 'whipping boy' in 2010, Sterling remained fairly resilient towards the end of last year. However, dogged by conflicting signs of economic recovery and inflation, the Bank of England reported that higher costs of living were certain and inflation will remain above its two-per-cent target until the end of 2011.

  Year-end call: GBP/USD at 1.45

- **USD/CHF**

  Influenced by its label as a safe haven, many traders and investors fled to the Swiss franc during bouts of fear and panic in 2010. Although Switzerland is an export-oriented country, the Swiss National Bank has forsaken currency intervention and become used to its strong currency.

  Year-end call: USD/CHF at 0.95

- **USD/CAD**

  On the domestic front, Canada is expected to do well in 2011. With oil as its biggest export and the possibility of more rate hikes, the Canadian dollar should strengthen over the next 12 months. However, bearing in mind that close to 80 per cent of Canada's exports land in the United States, its gains will be somewhat muted, with weak US demand.

  Year-end call: USD/CAD at 0.98

- **AUD/USD**

  Winning the title for favorite carry trade, the Aussie racked up an impressive 15 per cent gain over the dollar in the latter half of 2010. Piercing parity for the first time in history in October 2010, the Aussie is poised to extend its gains in 2011.

  Reserve Bank of Australia Governor Glenn Stevens has dropped clues that rate hikes will continue well into 2011; and with China's huge appetite for raw materials, the Australian economy will be red-hot.

  Year-end call: AUD/USD at 1.06

In summary, some currencies are in for a bumpy ride, while others will continue to extend their gains.

One thing is certain: the Asia-Pacific region is poised to be the recipient of hot money flows in 2011, which will see its currencies rising.

Let's trade forex!

***Mario** is the Director of Training and Education at FXPRIMUS.com, Asia's fastest growing forex broker. As an internationally renowned expert on forex, his views are widely sought in the industry. Mario is a frequent guest on international media CNBC where he shares his thoughts and analysis on the forex market. For more information, please visit www.mariosingh.com*

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