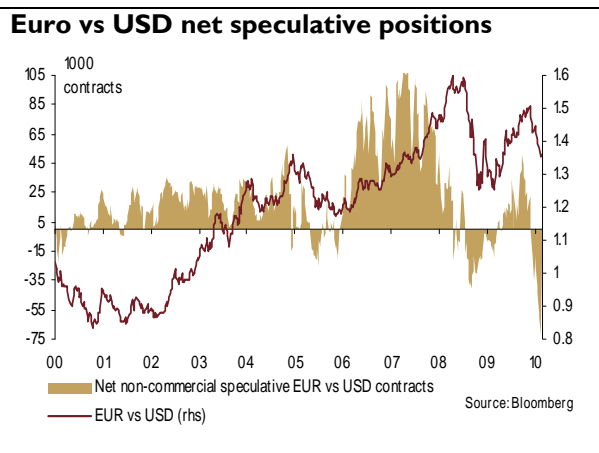


Speculating about currency

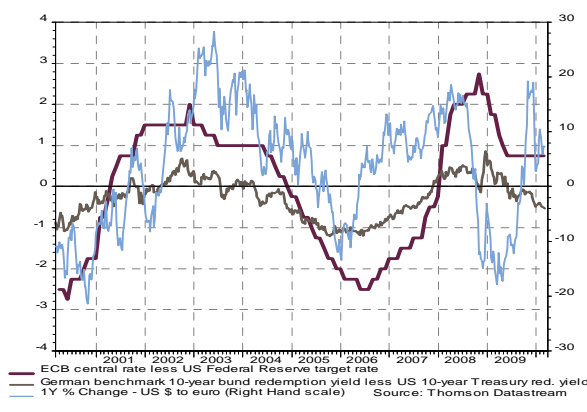
In search of a scapegoat for the euro's rapid decline, the spotlight is on currency speculation. Following accusations by European politicians and media, the US Department of Justice is investigating whether selling of the euro by a number of hedge funds represents illegal collusion. It's an emotive topic. Currencies are a very obvious symbol of economic status and affect the purchasing power of the voting public. However, we don't believe there is any merit in trying to trace the cause of the euro's woes to 'speculators,' who follow market trends rather than create them.

The very large and liquid currency markets – daily volumes are around \$3 trillion - are driven by a host of economic and market factors. Exchange rates influence and are influenced by the global economy, in a complex interplay that makes it extremely difficult to clearly discern the individual impact of each potential factor.

At first glance, there also appears to be a correlation between the exchange rate and net short or long speculative positions, as measured by the number of 'non-commercial' (investors rather than financial institutions) positions on the International Money Market (IMM) of the Chicago Mercantile Exchange.



The influence of interest-rate differentials



Interest-rate differentials, which can attract investment into higher-yielding currencies, are one of the more important factors. The chart above shows a clear correlation between euro-dollar exchange rates and eurozone and US yield differentials.

However, a closer look at week-on-week changes shows that exchange rate moves are more likely to produce a change in speculative positions than the reverse. Simply put, speculators look to profit by buying currencies that are already going up and selling those that are going down. The current speculative short position on the euro, around €10 bn, is large in absolute terms, but dwarfed by the roughly €500 bn daily volume of euro-dollar trades.

We believe that currency markets are largely driven by fundamental factors, while currency speculation has a limited role and tends to reinforce existing trends. We therefore look at the current scale of speculative short euro positions as a contrary indicator, suggesting that the market is becoming increasingly vulnerable to a reversal of investor sentiment. Still, we remain negative on the longer-term outlook for the euro, which we expect to lose its current yield advantage as US rates rise in response to a stronger economic recovery.

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