

Currency “wars” and the potential impacts of developed market QE

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Investors should expect greater volatility in foreign exchange markets as the 'beggar thy neighbour' approach of quantitative easing across the developed world triggers economic, political and social consequences for developing economies.

Back in the dark days of post-Lehman 2008, the Federal Reserve adopted a new framework for monetary policy with the introduction of quantitative easing, or QE, and an era of central bank balance sheet expansion was born. (In truth this approach pre-dates Ben Bernanke with its origins in post-bubble Japan; however the magnitude and impact of Federal Reserve QE far out-weighs Japan's half-hearted attempt). Fast forward to the present day and it seems everyone in developed markets is now playing the QE game to one extent or another. Whilst the approach taken has varied in its format across the developed world, we have seen non-traditional policy adjustments from the ECB, the Fed (in three different shapes and sizes) the Bank of England, Bank of Japan, and Swiss National Bank. In just four years the balance sheets of the G3 central banks have expanded by US\$5 trillion.

One of the direct consequences of this monetary printing machine has been currency debasement – or so-called “currency wars”. The basic law of supply and demand suggests that if you increase the supply of something then, all else being equal, the price should decline. It is true to say that the initial effect of QE1 was to turn a strong dollar weaker. However history shows that since 2008 the dollar has moved broadly sideways, although it has weakened from its post-Lehman stress highs. Global co-ordination and monetary easing across the developed market landscape suggest to us that the true effect of QE on the home currency is difficult to ascertain as so many players are up to the same tricks. “War” feels like an excessive term when market volatility levels seem to be on a continuous declining trajectory.

The effects are more noticeable, however, against currencies or real assets where no supply adjustments are taking place. Gold for example, has rallied 160% since its 2008 lows, illustrating the true magnitude of debasement. Certain emerging market currencies have also felt the pain of QE. The direct consequence has forced some countries to become more interventionist in an attempt to mitigate the currency effects of global QE. Brazil is a telling example, with interventionist rhetoric and action virtually omnipresent as USDBRL approaches 2.00.

Whilst a more co-ordinated QE has tended to suppress volatility amongst developed market currencies, less benign effects are perhaps occurring elsewhere. Real asset prices across the globe have been rising, and in the case of essentials such as food, the geo-political consequences can be significant. What seems likely is that whilst QE may successfully deliver us from the threat of deflation, the risks associated with expanding and broadening



this aggressive global monetary action mutate, from economic to social and political. The beggar thy neighbour consequences of incredibly easy monetary policy can quickly lurch from discomfort to market fracture. An interesting case in point is the current situation in South Africa. Higher commodity and food prices, perhaps as a direct result of global QE, are causing social unrest and mass strikes in South Africa's mining industry. Cost push pressures are reaching flash point and causing the market to reassess some of the "benign outcomes" priced by financial markets. QE is perhaps the most regressive of economic policies, supporting the rich developed market stock portfolios whilst taxing the cost of living of the poorest workers in countries whose currency and commodity prices are inexorably rising.

As investors in global currency markets we are constantly alert to these tensions coming to a head and broadening into wider geo-political concerns. History tells us that the unintended consequences of austerity policies have at times proved dramatic and life changing. We view the benign nature of today's foreign exchange markets, where volatility seems to fall daily, with a healthy dose of concern and scepticism that the status quo can be maintained in the medium to longer term.

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