FFTW Weekly Commentary
FOR PROFESSIONAL INVESTORS

Currencies are acutely, if not fatally, cyclical

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Key takeaways

- Currency markets are very cyclical and we believe the factors are shifting towards strength in emerging markets (EM) currencies
- Currency markets offer value following a 5-6 year trend: the US dollar has increased its trade-weighted valuation by 30% over the last six years, whereas EM currencies have devalued nominally by more than 40%
- The relative growth differential also favors EM market currencies, while conditions for US dollar appreciation are abating

Full commentary

John Maynard Keyes made and lost a small fortune investing in European currencies in the inter-war years. Several emerging markets, most recently Argentina, have committed the "original sin" of borrowing in foreign currencies when they were weak and then defaulting when they strengthened. Recently, investors became enamored with hedging strategies as both Europe and Japan proactively devalued and the US dollar soared. So what's next?

Several ingredients combine to form the cyclical nature of currencies. In our view, growth is first among these. Historical data show that when a country's growth rate increases relative to the rest of the world, this attracts long term capital in search of productive investment opportunities, which strengthens a country's external position and, all else equal, contributes to its foreign currency reserves. In this scenario, a country's interest rates are likely to rise, as growth stokes inflation or the central bank adopts a more hawkish stance. Higher interest rates reinforce the relative attractiveness of the country for foreigners and bond investors may enter the market in search of carry.

Secondary factors affecting currencies include technical considerations such as terms of trade; volatility; and investor positioning. Although these factors in our experience are contemporaneous rather than leading indicators, there can be autocorrelation or a tendency for momentum in the data, except when at extremes.

We believe currency markets now stand at just such an extreme. The US dollar rally that began in 2011 has increased its trade-weighted valuation by as much as 30% according to some estimates. Emerging market currencies, in turn, have devalued nominally by more than 40% from their 2011 peak and real effective exchange rates for a basket of EM now stand approximately 10% cheap to the long term average.

Growth also favors EM. Green shoots appeared in EM data late last summer and have now sprouted into full grown expansion for many countries. Industrial output is now positive in all EM regions and "hard data" covering exports and consumption mark robust recovery across EM. The conditions that led to US dollar appreciation from 2011-2016 have now abated: the US is no longer accelerating relative to EM; volatility in currencies has subsided; and terms of trade, which for most EMs means commodities prices, have pulled out of their slump.

Having called the bottom on EM currencies, we have been decidedly long in our FX exposures for most of the last six months. We recently pared this back due to the strong moves in currency markets following the last Federal Open Market Committee (FOMC) meeting but plan to re-enter positions on the next correction in valuations. We recommend investors similarly enter dedicated exposures as opportunities present themselves over coming months.

Currencies will always be a bumpy ride, but we can now say with conviction the cycle is on EM's side.

This week's market developments

Monday, March 27
- German IFO Business Climate Index increased to 112.3 for March

Tuesday, March 28
- US Wholesale Inventories growth (prelim estimate) increased to 0.4% m.o.m. (s.a.) for February

Wednesday, March 29
- UK Mortgage Approvals decreased to 68,300 for February

Thursday, March 30
- German CPI growth (prelim estimate) decreased to 0.2% m.o.m. (s.a.) for March
- US 4th Quarter Annualized GDP growth (third estimate) increased to 2.1% q.o.q.
- Japan National CPI growth decreased to 0.3% y.o.y. for February
- Japan Industrial Production growth (prelim estimate) increased to 2.0% m.o.m. (s.a.) for February

Friday, March 31
- UK 4th Quarter GDP growth (final estimate) remained at 0.7% q.o.q.
- US Personal Income growth remained at 0.4% m.o.m. (s.a.) for February
- US Personal Spending growth decreased to 0.1% m.o.m. (s.a.) for February

Source: Bloomberg, as of April 3, 2017

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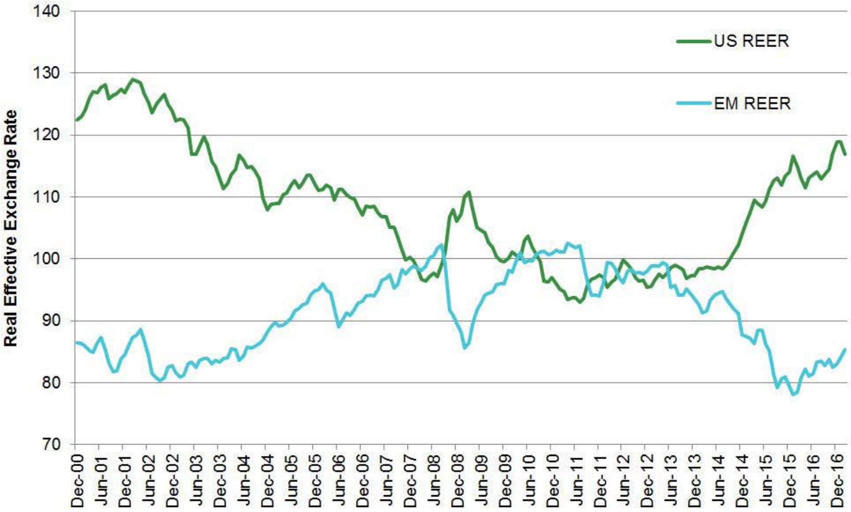
Chart of the Week

US & Emerging Markets Real Effective Exchange Rates



Sources: Bloomberg, as of February 28, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on June 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	March 15, 2017	0.75% - 1.00%	0.98%	May 3, 2017
ECB	-5 basis points	March 10, 2016	0.00%	-0.17%	April 27, 2017
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	April 27, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.36%	May 11, 2017

Sources: Bloomberg, as of April 3, 2017

Next week's market developments

Monday, April 3

- UK Markit PMI Manufacturing is expected to increase to 55.0 (s.a.) for March
- Eurozone Unemployment Rate is expected to decrease to 9.5% for February
- US ISM Manufacturing is expected to decrease to 57.2 for March
- US Construction Spending growth is expected to increase to 1.0% m.o.m. (s.a.) for February

Tuesday, April 4

- US Factory Orders growth is expected to decrease to 1.0% m.o.m. (s.a.) for February

Wednesday, April 5

- US ADP Employment Change is expected to decrease to 195,000 for March

Thursday, April 6

- Germany Factory Orders growth is expected to increase to 4.0% m.o.m. for February

Friday, March 31

- Germany Industrial Production growth is expected to decrease to 0.2% m.o.m. (s.a.) for February
- UK Industrial Production growth is expected to increase to 0.2% m.o.m. (s.a.) for February
- UK Manufacturing Production growth is expected to increase to 0.3% m.o.m. (s.a.) for February
- US Change in Nonfarm Payrolls is expected to decrease to 175,000 for March
- US Unemployment Rate is expected to remain at 4.7% for March

Source: Bloomberg, as of April 3, 2017

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