

## Currency Outlook First Quarter, 2007

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### Executive Summary

Prospects for the dollar may be improving. While the dollar has looked undervalued for some time, the market environment has not been conducive to recognizing that value. Relative inflation and real interest rates, which had been moving away from the dollar, are now moving in the dollar's favor. If the U.S. economy accelerates as we expect, relative monetary policy should shift in favor of the dollar. Various trend indicators that we monitor suggest that the market may be seeing this as well.

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The current market environment is generally positive for the dollar. U.S. inflation is trending lower relative to our trading partners, leading bond yield differentials to widen in favor of the greenback. The dollar should also be helped by further signs of U.S. growth and increasing expectations of Fed tightening as the year progresses. In addition, slower Euroland growth and concerns about the impact of a stronger euro on Europe's competitive position may make the European Central Bank bring a halt to rate hikes. Meanwhile, the yen has weakened as the Bank of Japan has been reluctant to raise rates due to stop and go growth and concerns about deflation. Although a softer yen helps Japan's competitive position, political pressure is building to strengthen the currency.

#### Currency Market Trend, Momentum 5 and Breadth Indicators

The trend in the dollar remains down but the momentum has shifted. This could portend a change in the currency's longer term trend. In the short term, investor sentiment has turned more positive but it is not yet excessively so. We are also seeing some improvement in the models provided to us by Ned Davis Research.

# Currency Market Valuation

The trade weighted dollar is currently undervalued based on its Purchasing Power Parity (PPP) and relative to its long-term trend. The yen also appears undervalued on a PPP basis, but less so relative to its long-term trend.

PPP is used to establish the long run fundamental value of a currency and is based on the notion that over time currency values should reflect changes in relative inflation rates. If a country's currency deviates too far from its PPP, that country's goods and assets become cheap or expensive relative to other countries. Eventually, those goods or assets become so attractive that the currency self-adjusts.

While PPP sets a fundamental value, it is only a loose, long-run central tendency and is of little use in explaining day to day currency fluctuations. However, empirical evidence strongly suggests that, in the long run, currency relationships are restored to underlying inflation rates. As a tool, PPP is used to help identify extremes in valuation where opportunities or risks are the greatest. When combined with other indicators, PPP can be used to gauge the risk of a major trend reversal.

Determining PPP is not as easy as it appears, since it will depend in part upon the starting point of the analysis and the measures of inflation used. PPP

also only adjusts for the relative inflation of goods and services, not for changes in asset values. To help mitigate this problem, we evaluate currencies relative to their five-year moving average and assume that over long periods of time the market accurately establishes the correct level of parity.

## CURRENCY MARKET VALUATION MONITOR

Currency	Purchasing Power Parity
U.S. Trade-Weighted Dollar	- 8.0% undervalued
Japanese Yen vs. Dollar	-11.7% undervalued
Euro vs. Dollar	9.2% overvalued
British Pound vs. Dollar	13.8% overvalued
Swiss Franc vs. Dollar	2.4% overvalued
Canadian Dollar vs. Dollar	8.5% overvalued

Currency	Price 2/9/07	Deviation from 5-year Trend
U.S. Trade Weighted Dollar	85.77	-9.5% undervalued
Japanese Yen	120/\$	-4.0% undervalued
Euro	1.30	7.5% overvalued
British Pound	1.97	8.2% overvalued
Swedish Krona	7.02/\$	12.5% overvalued
Australian Dollar	0.78	10.3% overvalued
Canadian Dollar	1.18/\$	9.3% overvalued
Swiss Franc	1.24/\$	4.0% overvalued

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bloomberg

## Currency Market Environment

**The current market environment is generally positive for the dollar. U.S. inflation is trending lower relative to our trading partners and, as a result, bond yield differentials have widened in favor of the dollar.**

Although the Fed has moved to the sidelines, as the year progresses expectations of Fed tightening should increase. Signs of stronger growth reversed the dollar's slide and further signs of growth should push it higher. At the same time, Eurozone growth, which tends to trail U.S. growth by six to twelve months, may surprise to the downside and bring a halt to European Central Bank (ECB) rate hikes. The ECB is also concerned about the strength of the euro and the impact that this currency appreciation is having on Europe's competitive position. As a result, the central bank may be reluctant to raise rates because that could push the euro higher. Faster U.S. growth and softer European growth should be dollar positive. Meanwhile, the Bank of Japan has been reluctant to raise rates due to stop/go growth and concerns about deflation. This has created weakness in the yen. Although a softer yen helps Japan's competitive position, political pressure is building to strengthen the currency.

The value of a currency is affected not only by changes in relative inflation, which affects purchasing power parity, but by changes in relative interest rates among trading partners that impact capital flows. In the past, trade flows dominated foreign currency transactions.

Today, capital flows and foreign exchange trading swamp trade flows as key drivers of currency movements. In general, money tends to flow where it is treated best. Countries with low inflation, attractive real interest rates, growing economies and potential for asset appreciation attract money and have stronger currencies.

Changes in relative inflation and inflation expectations affect capital flows. Rising (falling) relative inflation tends to be bearish (bullish) for a currency. For example, in the 1970's, U.S. inflation was high and rising relative to our trading partners and the dollar trended consistently lower. In the early 1980's, the reverse was true and the dollar rose steadily. In the long-run, inflation stability is good for a currency.

Inflation and inflation expectations also drive interest rates, which affect financial asset flows. Rising interest rates tend to increase capital flows and falling rates tend to discourage capital flows. If interest rates are rising faster than inflation (i.e. real rates are rising), this is bullish for a currency. If inflation rises faster than interest rates (i.e. real rates are falling), this is bearish for a currency. However, rates will have less of an impact on a currency if interest rates and bond yields merely keep pace with inflation. In addition, the influence of inflation and interest rate changes on a currency should be viewed relative to

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### CURRENCY MARKET ENVIRONMENT MONITOR

Indicator	Current Bias
Real T-bills	Dollar
Real T-Bonds	Neutral
Inflation Differential Trend	Dollar
Relative Nominal Short Rates	Dollar
Relative Real Short Rates	Dollar
Relative Nominal Bond Yields	Dollar
Yield Curve Differential	Dollar
Relative Industrial Production	non-U.S.
Relative Business Sentiment	non-U.S.
Relative GDP Bailard Outlook	Dollar
ISM Exports + Imports	Neutral
U.S. Budget Deficit	Dollar
Monetary Policy Bias	
U.S.	Neutral
Japan	Neutral
Europe	Neutral
U.K.	Tighten
Political Pressure	Yen Too Weak
Ned Davis Research Composite	Dollar

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bloomberg.

# Currency Market Environment (Continued)

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inflation and interest rate trends in other countries. We monitor inflation, cash yields and bond rates across countries to help evaluate the attractiveness of currencies. Sustained moves in currencies occur when relative interest rates and monetary policies shift. Without a change in monetary policy, currency fluctuations driven by speculation and/or interventionist tactics tend to be short lived.

Relative economic prospects can also cause capital flows to shift. Currencies of countries with improving prospects tend to do better than currencies of countries with deteriorating prospects. Evaluating relative economic growth trends, leading indicators and business sentiment can give clues as to the attractiveness of underlying asset markets. Relatively optimistic business outlooks (low inflation, sustainable growth) tend to be positive for financial markets, while relatively pessimistic business outlooks tend to be negative. A positive market environment tends to be currency positive and vice versa.

# Currency Market Trend, Momentum and Breadth Indicators

The trend in the dollar remains down but the momentum has shifted. This could portend a shift in the currency's longer term trend. In the short term, investor sentiment has turned more positive but it is not yet excessively so. We are also seeing some improvement in the models provided to us by Ned Davis Research.

While fundamental based currency models are useful in explaining long-term trends, they don't work as well in the short term. This is because currency movements are driven by a number of different fundamental factors that often are hard to discern and often work against each other. While relative inflation rates determine real long-term equilibrium PPP, cyclical factors impact intermediate term currency movements. Cyclical factors that drive capital flows include inflation expectations, relative monetary policy shifts, asset valuations, real interest rate differentials and relative economic conditions.

However, even cyclical macroeconomic factors don't adequately explain currency movements in the short term, where market fundamentals tend to generate a lot of noise. To sort through the noise, most currency traders utilize trend-following techniques. Technical or price oriented measures help in identifying turning points and keeping investors on the right side of the market. We utilize a number of trend indicators, including moving averages, price momentum, support and resistance levels, deviation from trend measures and investor sentiment.

As with fundamental analysis, trend-following techniques have a major flaw. While fundamental techniques can put an investor out of synch with the market for long periods of time, technical tools leave them vulnerable to costly whipsaws. As long as a trend is in place, technical tools work well, but sudden shifts in the market can create whipsaws. Trend-following techniques will, by definition, be late.

Totally abandoning either fundamental or technical tools is not advisable. We prefer to take a composite view of fundamental and technical factors in assessing the currency markets, since the best opportunities usually occur when these tools confirm one another

### CURRENCY MARKET TREND, MOMENTUM AND BREADTH MONITOR

	Trade Wtd. Dollar	Yen	Euro	Pound
Price	\$82.5	121/dollar	\$1.304	\$1.958
52-week Trend	Negative	Negative	Positive	Positive
Deviation from Trend	Neutral	Oversold	Neutral	Neutral
26-week Momentum	Positive	Negative	Negative	Negative
Momentum OB/OS	Positive	Neutral	Neutral	Neutral
Support/Resistance	80-85	119-122	1.28-1.32	1.93-1.98
Ned Davis Research				
Short-Term Model	Positive	Positive	Negative	Neutral
Intermediate-Term Model	Negative	Neutral	Negative	Positive
Long-Term Model	Negative	Positive	Positive	Positive
Trader Crowd Sentiment	Net Long			
Large Speculators	Net Long			
Investor Sentiment	Neutral			
<b>Ned Davis Currency Model</b>				
	<b>Composite Rank</b>	<b>Short-Term</b>	<b>Int.-Term</b>	<b>Long-Term</b>
U.S. Dollar	4	1	4	7
Japanese Yen	3	4	3	2
Euro	5	7	7	1
British Pound	2	3	2	3
Swedish Krona	1	1	1	3
Australian Dollar	6	5	5	6
Canadian Dollar	7	6	6	8
Swiss Franc	8	8	8	5

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bloomberg

# Market Commentary

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