►On Target

Martin Spring’s private newsletter on global strategy

April 12, 2014 No.174

Strong Euro, Weak Dollar

One of the more difficult decisions facing investors is what is going to happen to the euro.

Not only for those of us who don’t regard it as our base currency. After all, the euro is the world’s most important currency after the dollar. If you fear the impact of a weakening dollar on the value of your savings, you have to look to alternative currencies, of which the euro is the most important.

Most people think China is now the world’s second largest economy, but the Eurozone is still much bigger. It’s home to some of the world’s most important multinationals, and their shares are open to foreign investors in a way that China’s are not. Its bonds are some of the world’s safest and most tradeable, such as the formidable German government Bunds.

Looking back through my files reminds me how much the financial media have been filled with pessimism about the euro, largely based on assumptions that the European political elite would be unable to deal with the region’s debt crisis without defaults, a break-up of the zone, or crippling public hostility to required austerity.

The pessimists have been wrong. Defaults have been limited to a micro-state, Cyprus. The Eurozone shows no sign of breaking up, but instead has been inching towards more centralized fiscal control. Amazingly, the backlash against the pains of austerity – unemployment, destroyed businesses, cuts in benefits and subsidies – has been contained in the countries worst affected.

In terms of the dollar, the euro has been rising in value for almost two years, from below 1.21 to about 1.38 now. This is bad news for the region’s exporters (a strengthening currency makes it harder to compete on world markets), good news for consumers and businesses geared to imported products such as oil (which have tended to become cheaper in euro terms).

But it creates a worsening problem for policymakers, particularly those at the European Central Bank.

The Eurozone economy is sluggish, weighed down by an abundance of welfare costs and regulations hostile to economic growth, banks choked with toxic assets, and austerity imposed on the “Club Med” countries by their bloated debt burdens.

One consequence is extremely low inflation – now only ½ per cent a year. There is an increasing risk that prices will stop rising at all, and start to fall – deflation.

All central banks are terrified of deflation, because it makes it much harder to prevent economic slowdown sliding into a depression, and to engineer recovery.

Over the past five years, when the world has been slowly recovering from the shock of the financial crisis, Europe's has been the most conservative of the major central banks. While the US, the UK, China and Japan have pursued aggressive easy-money policies, the European Central Bank has done little more than provide unlimited credit to commercial banks. So far, it has avoided quantitative easing ("printing" money to buy government bonds).

This may be about to change.

If economic conditions in Europe worsen, or if the euro's exchange rates continue to rise and so increase the risks of worsening conditions, that could force the central bank to be much more aggressive in deploying monetary weapons.

It does face legal constraints that Germany insisted on when the Eurozone was established as the price of abandoning their much-loved deutschemark because of their fear of eventually being forced to go to the aid of profligate "Club Med" countries.

But Germany has ended up doing that anyway, largely by lending through the Eurozone banking system.

Politicians and government officials of the European Union and its currency-based sub-group the Eurozone have proved adept at circumventing constitutional restrictions and simply ignoring those who violate them:

► The president of the European Central Bank, Mario Draghi (originally a Goldman Sachs banker), has shown himself to be a clever and creative operator, for example by using aid to banks (legal) to buy government bonds (illegal);

► The balance of opinion in Germany's political elite is retreating from its traditional insistence on conservative policies, becoming more willing to pay the price of sustaining the Eurozone without requiring radical centralized fiscal control;

► European courts are shifting under political pressure towards greater tolerance of legally dubious financial policies.

A range of monetary-easing policy options

This slowly-developing environment of greater tolerance towards easy-money policies makes it less likely that the European Central Bank will be prevented from implementing more unconventional measures, if they become necessary.

The bank has publicly mooted a menu of options including negative interest rates, long-term loans to banks and even large-scale asset purchases.

Will a shift towards some form of aggressive monetary policy stop the euro rising and send it into decline?

Possibly. But there is no certainty. The euro's exchange rates will be determined not only by decisions taken in Frankfurt, but also by those taken elsewhere:

► The US Federal Reserve is "tapering" – implementing some very timid trimming of its aggressive easy-money policies – which so far has been too equivocal to have any dollar-strengthening effect. In trade-weighted terms, the greenback has been fluctuating within a comparatively narrow range for more than two years, although it's currently at the bottom of that range.

A major change in Fed policies that would impact on the dollar's global popularity seems very unlikely.

► Japan has been implementing the most aggressive money "printing" policy of any major nation. That could get a further boost if it becomes apparent that "Abenomics" is failing (as I have always feared it would). That would further weaken the yen, to the disadvantage of the euro.

► Although China's financial situation is very different from America's, its current posture is similar – there's cautious trimming-back of policies that have been highly stimulatory. Although its tightly-controlled forex market is being manipulated to create uncertainty and burn speculators, weakening the yuan, a reversal in the long-term trend of strengthening in the Chinese currency is unlikely. That will be helpful to the euro.

► Britain pursued particularly aggressive "printing" in response to the global financial crisis, driving down the pound. But for five years its trade-weighted value has fluctuated within a comparately narrow range. It's currently at the top of that range, largely due to pre-election stimulation of the housing sector. But sterling looks dangerously expensive. Any trend reversal would hurt the euro, especially as Europe is the UK's most important trading partner.

Conservative policies aren't just good intentions

Factors that have kept the euro strengthening this year include attractive valuations of European shares relative to US equities, the safety of Eurozone markets relative to the volatile ones of the emerging economies, declining fears of a debt crisis in European banks, and currency risk in Japan.

Perhaps more importantly, markets like the visible proof of conservative financial policies – the European Central Bank's balance sheet is shrinking as banks repay loans they took out at the high of the Eurozone crisis, while the US Federal Reserve's continues to inflate.

The euro has regained its appeal as a currency of choice for central banks, with its share of foreign exchange reserves rising to 24.5 per cent, according to latest figures, while the dollar's share falling to 61.7 per cent. And that's excluding China, which does not reveal the currency breakdown of its reserves, but is also believed to be accumulating euros.

Longer-term, it seems highly probable that the world's strongest major currency will be the yuan, as China's economic and financial power strengthens relative to its competitors', particularly the US.

I see little to choose between the euro and the dollar, except that structural factors favour the euro – assuming, as I do, that the Eurozone is able to hold together, because for all its member-nations the alternative would be worse.

Europe has no central Treasury able to enforce fiscal policies. Its central bank is restricted in what it can do, and cannot act without the support of a dozen governments. All major decisions require protracted negotiations among many sovereign states with often-conflicting interests or attitudes.

Because political and financial power is more centralized in the US than in Europe, it’s easier for the Americans to resort to extreme, and longer-term potentially more dangerous, money-creation and trade-protection policies.

It’s easier for them to manipulate their currency as a weapon to advance their national interests than it is for the Europeans to do so. Counter-intuitively, that suggests the euro is likely to be the somewhat-stronger currency of the two, over the longer-term.

Currency Management for Expat Portfolios

By Chad and Peggy Creveling

One of the more confusing issues for many expats residing overseas is managing their currency exposure.

If you're an American working in Vietnam and plan to retire in Thailand, should you be investing in the US dollar, Vietnamese dong or the Thai baht? Does it matter?

Compounding the problem, many expats don't know what their actual currency exposure really is. Is it the currency stated on your brokerage statement, the currency your investments are reported in, or something else?

Back in your home country, it's all pretty straightforward. You're paid in your home currency, you pay your bills in your home currency, and most of your investments are likely in your home currency. In this case, you generally have very little currency risk.

The problem for expats is that they have too many choices. They have their home currencies, the currency where they live and work, and the currency of their future expenses, whether those include retirement, a vacation home, or their kid's college education. Throw in a yen mortgage to fund a British property and a dual-currency product in Australia and you have some real confusion.

Without a suitable framework to think about and implement a practical currency exposure, expat investors can unwittingly expose themselves to significant currency risk, which can wreak havoc with their finances and their financial goals.

What currency risk is and why it matters: For expats, currency risk is primarily the impact of large exchange-rate swings on their family assets and liabilities that are denominated in different currencies.

For example, if you plan to retire in Thailand, but the underlying currency exposure of the portfolio intended to fund your retirement is primarily in US dollars, any significant strengthening of the Thai baht against the dollar is going to cause problems.

Likewise, if you intend to buy property in Spain, fund it with a Japanese yen loan and you're paying off the loan using US dollars, you have significant currency exposure. If the yen strengthens against the dollar, you may have a hard time paying off the mortgage. If the yen strengthens against the euro as well, you may find that the value of your property is worth a lot less after paying off the now more expensive mortgage.

When investing, it's important to understand that in most cases you are not only investing in an asset, but also a currency. If you invest in a property in Spain, you are investing in the physical asset, but also the euro. If you are a euro-based investor, then the currency exposure doesn't matter. But if you're a US dollar-based investor, it does.

When investing in European stocks, you are not only investing in the future earnings of European companies, but also the currencies in which those earnings are derived. If those earnings are primarily in euro and you are a US dollar investor, exchange rate movements of the euro against the dollar will add to or detract from your investment returns.

In general, any mismatch between the underlining currency of your investments or assets and your base currency, or the currency you will need those assets to fund, carries the potential for adverse outcomes. This is currency risk.

What is your base currency? For an expat, it can sometimes be difficult to determine your base currency. Is it your home country currency? Or the currency of your country of residence?

Well, it depends. If you're a Canadian temporarily working overseas with the intention to retire in Canada, buy a home in Canada, and send your kids to school in Canada, then the Canadian dollar is clearly your base currency. If you're an American who intends to permanently retire in Thailand, then your base currency may be the Thai baht.

The currency denomination of the future liability you intend to fund, whether it is retirement, a home purchase, or college funding, should largely determine your base currency and the primary currency exposure of your assets.

Your true currency exposure: To avoid significant currency risk, it's important to understand your true currency exposure.

If you invest in a house in Spain, it's pretty clear your currency exposure is the euro, but it's not as easy to determine for your investment portfolio. It's not necessarily the currency on your brokerage statements or the currency your investment is traded in.

If you are investing in Eurozone companies that are listed on the Swiss exchange in Swiss francs, and your bank statement lists the value of the investment in US dollars, it gets a little confusing.

Currency risk is in the assets, not the accounting

Your true currency exposure is the currency in which the Eurozone companies' earnings are derived. In this case, it's probably the euro. It doesn't matter that the stock is listed and traded in Swiss francs. The same stock could be listed in dollars on the New York Stock Exchange or the pound on the London Stock Exchange.

The currency of listing is merely a convention of convenience. Regardless of where the stock is listed or traded, in this example the underlying economic exposure is to the euro. The value of the company's stock would be the same in every case, just expressed in different currencies at current exchange rates.

The currency of the brokerage statement is equally misleading.

If you invest with a US custodian, the statement will use the dollar. If you invest with a Thai broker, the statement will most likely be in baht.

Some custodians will segregate investments by the currency of listing, but as discussed above, this is not necessarily your true currency exposure. Again, the reporting currency is merely a convenience determined primarily by where your account is held.

In constructing your investment portfolio, as well as in managing your overall financial situation as an expat, it is important to understand the currency that your future goals are denominated in, and build an appropriate underlying currency exposure into your investment and financial plan.

A practical framework for managing currency risk: Fortunately, managing your currency risk doesn't require exotic hedging tools such currency forwards, futures, options or currency swaps, or the even the services of a Swiss bank!

By following a few simple principles, you can eliminate much of the currency risk from your finances and avoid jeopardizing your financial goals.

► Determine your base currency or reference currency for each of your major financial goals. For example, if you plan to purchase a house in Canada, your base currency for this goal is the Canadian dollar.

► Match the currency exposure of the assets intended to fund each of your goals with the goal's base currency. If you intend to send your kids to college in the US, ensure the investments intended to fund those college expenses are largely dollar investments.

► Make sure you understand your true currency exposure. Don't assume it's the currency on your brokerage statement or the currency the investment is traded in. You may need to do a bit of research, particularly if you invest in multinational companies, mutual funds, or ETFs.

Matching currencies to your different needs

► Consider using different portfolios to fund goals with different currencies. If you intend to retire in Asia, buy a home in Europe, and send your kids to school in the US, you may want to fund these goals with three distinct investment pools that would allow you to match the currency exposure of the investment assets with currency of the expenses they intend to fund.

► Fixed Income Investing: For each portfolio, it's most important to hedge the cash and fixed income portion, as currency movements can have a big impact on the long-run returns of these types of investments. A bit of currency diversification here is OK, but most of the exposure should be matched to the future expense.

► Equity Investing: Currency volatility does not have as great an impact on the long-run returns of the equity (stock) portion of the portfolio. Generally, it's best to maintain diversification across most equity asset classes, industries, and geographical regions, with perhaps a slight bias to the future currency liability.

► Where possible, use ETFs and mutual funds that are internally hedged to your desired currency exposure. For example, for a US dollar goal you probably want to use dollar- rather than euro-denominated bonds. Or you could use an emerging market bond fund hedged back to the dollar, rather than an unhedged emerging market bond fund. With the rapid proliferation of ETFs, this is getting easier to do for many currencies.

► What if you don't know what currency your future liabilities will be denominated in? For example, you're not sure where you will retire or where your child will attend university.

In this case, you should try to narrow down the possible choices, and then build a portfolio that is diversified across those choices. This preserves your flexibility without making a large bet on one particular currency region. Once you've made a final decision, you can rework the portfolio.

A word on currency speculation: it's a zero-sum game: Most expat investors should regard currency management more as way to reduce risk than a way to increase returns. Unlike stock, bonds, and other investments, currencies are a zero-sum game. If one currency appreciates, the other must depreciate.

There is no long-run return potential like stocks, bonds, and other investments. After all, one country's currency cannot appreciate against another's indefinitely.

Furthermore, currencies are affected by a complex interplay of economics, politics, and other random variables, which makes them notoriously difficult to predict even for professional currency traders.

Taking bets on currency is little more than gambling, where you can be expected to lose more than half the time after accounting for expenses. Sometimes, you can get lucky in the short-run, but over the long-run, the risk and cost of getting it wrong greatly outweigh the potential benefits for most expats.

To avoid jeopardizing your future financial goals, take the time to understand your currency exposure and take the steps to eliminate unnecessary currency risk from your finances.

The Crevelings operate a private advisory firm specializing in helping expatriates living in Thailand and throughout Southeast Asia build and preserve their wealth. For more information visit their website www.crevelingandcreveling.com.

Energy Policy Madness

Almost 7 million households in Germany now have to spend more than a tenth of their income on energy, largely because of the surcharge for subsidizing renewables under the nation's extraordinary *energiewende* policy.

"Low-income tenants in the Ruhr area or Berlin are paying high energy prices to subsidize wealthy home-owners in Bavaria who put solar panels on their roofs," says the well-known and highly-controversial critic of global warming policies, Bjorn Lomborg.

"More and more money is going from the poor to the rich."

This year power consumers will pay almost €24 billion on top of their normal electricity bills for the "renewable energies reallocation charge."

Yet "German energy policy is an expensive way to achieve almost nothing:

► "For solar alone, Germany has committed to pay subsidies of more than €100 billion over the next 20 years, even though it contributes only 0.7 per cent of primary energy consumption.

"These solar panels' net effect for the climate will be to delay global warming by a mere 37 hours by the end of the century, according to a report cited by *Der Spiegel*.

► "Green energy cannot meet Germany's need for reliable electricity." The nation's carbon dioxide emissions have risen since 2011 "despite the incredible subsidies for renewables."

► Industrial power costs, have risen six times faster in Germany than in the US and China since 2007, are now 19 per cent higher than the European Union average, and making the country ever less attractive as a place for energy-heavy manufacturing. The German chemical giant BASF has already said it will make most of its future investments outside Europe.

► It's argued that the German policy is an investment in developing "the energy of the future" – but most of the money is being spent, not on research and development of new technology, but on buying existing inefficient green technologies. It does not enhance protection against climate change, in fact it makes such protection much more expensive.

"For every euro spent, 97 cents are wasted," according to a new study by experts. If the budget for subsidizing renewables were to be spent on "green innovation," Lomborg argues, every euro "could avoid €11 in long-term damages from global warming.

"If we can reduce the price of future green technology below the cost of fossil fuels, everyone will switch." Such cheap green energy would rid Germany of its dependence on imports of fossil fuels from Russia, would help rather than hurt the poor, and would "actually fix global warming."

The world as a whole is now spending $60 billion a year on subsidies for solar and wind power, yet "total climate benefit" is less than $1½ billion a year. An additional $19 billion a year goes on subsidies for biofuels that produce no climate benefit at all.

The huge amounts being wasted on current policies for renewables – which amount to prodigious handouts to climate-change vested interests in business, academia and non-governmental organizations – Lomborg argues would be far better spent on improving healthcare, hiring more teachers, building better roads… or possibly reducing taxes.

Shale Gas: a High-Cost Resource

Despite much talk about how it's going to revolutionize global supplies, investors in the shares have seen them perform poorly for years, major companies in the sector such as Shell and BHP Billiton have been taking some big write-downs and the much-predicted improvement in natural gas prices fails to arrive.

What's been happening?

"It is going to take much longer, and require much more money, to get that unconventional gas produced than global strategists presume," says the *FT*'s erudite commentator John Dizard.

"The shale gas boom of the past decade turned a set of engineering advances into a property bubble. Investors were selling development rights to each other." Promoters of exploration and development companies "were spending multiples of their operating cash flow on buying properties and drilling them to show more production, then selling more stock and more debt." But "eventually the promoters could not pedal fast enough… "The investment world backed away from shale even as the political world embraced it."

Dizard emphasizes: "Unconventional gas is not a miracle; it is a high-cost source of fuel that requires a lot of technical skill, time and capital." It's probably going to require gas prices in the US a couple of dollars a unit higher than current levels (around $4.50) to make it pay in invest in the drilling rigs and crews, processing plants and pipelines to bring large volumes of shale gas to the domestic and export markets.

Easy Credit in an Age of Oversupply

American investment banker Daniel Alpert argues in his new book* that there are only four solutions to an unsustainable debt problem:

► Strong economic growth can make debt sustainable; but growth in advanced economies will remain anaemic as long as there is a need to deleverage.

► Net debt can be reduced by increasing savings; but Keynes' paradox of thrift suggests that if consumers and governments simultaneously spend less and save more, the resulting recession and contraction of GDP will simply render the original debt unsustainable again. A macro-economy cannot "save its way out of recession."

► Unexpected inflation can wipe out the real value of private and public debts and avoid debt deflation. But inflation can also result in substantial collateral damage and, in any case, is nearly impossible to engineer when an economy is in a deflationary liquidity trap, as is the case today.

► If an economy cannot grow, save or inflate itself out of an excessive debt problem, then the only solution remaining is debt restructuring: reduction and/or conversion into equity. This is widely recognized to be true for businesses, but it is just as true for governments, households, and banks and other financial institutions.

**The Age of Oversupply, by Daniel Alpert. Pub. by Portfolio/Penguin.*

Tailpieces

Biotech: It's been one of the hottest stock-market sectors over the past three years because of the wave of new medicines coming out of companies.

Gilead Sciences' new hepatitis C drug, Sovaldi, which costs for $84,000 per 12-week course of treatment, is claimed to be highly-effective, curing 90 per cent of its targeted patients. It's reported to be "on track to notch among the biggest sales ever for the first year of a newly-approved drug"… anything from $5 billion to $9 billion, according to analysts.

The biggest seller last year was AbbVie's new rheumatoid arthritis treatment Humira, earning nearly $11 billion.

However, reports, the *FT*: "Bears point to the sector's stretched valuations, with stocks trading at an average 400 times reported earnings and almost 94 times estimated forward earnings, as evidence of a bubble."

IPOs: Why has there been a flood of them?

David Fuller of Fuller Treacy Money says there may be some truth in the view that CEOs know a public offering is a way of getting more for their companies than they're really worth. It's certainly a fact "that IPOs usually peak around the same time as the stock-market – managements respond to the opportunities created by frothy, generously-valued markets." In other words, a big increase in IPOs is "a contrary indicator."

However, "investors need to be careful about reducing their portfolios too quickly, because in a strong bull market fuelled by easy money, IPOs can go on rising for several years."

The Ozzie dollar: "Australia is plagued by a currency that is so overvalued it makes oil-rich Norway's currency looks cheap," argues *FT* commentator Henny Sender. "But the price of oil is high, while the prices of Australian commodities are under downward pressure, leading to deteriorating fundamentals."

One reason the Ozdollar "continues to defy predictions," says CLSA strategist Christopher Wood, is that interest rates in Australia remain relatively attractive, with the short-term rate still 2.5 per cent and the ten-year government bond yield at 4.2 per cent.

Australia continues to attract foreign capital, including investment by China's property developers.

Themes: US sectors likely to experience highest revenue growth this year, says investment bank Morgan Stanley, are biotechnology (forecast to expand 20 per cent), internet and software services (18 per cent) and internet and catalogue retail (17 per cent). The bank says: "Investors who want to have exposure to growth should consider investing around some themes such as the rerating of the research and development pipeline (either through biotechnology or select pharma), internet and software, and airlines."

Weaker greenback boost profits: A dollar that is weaker in terms of the euro, its principal rival as an international trade currency, is "quite helpful to US corporate earnings," says investment bank Morgan Stanley. "Each 10 per cent the dollar weakens against the euro over a full year helps S&P 500 earnings by about 6 per cent. So, compared with say the stronger dollar in the middle of 2012, today's earnings have been helped by about 1.5 per cent per quarter due to the weak dollar/euro alone."

US companies have stockpiled nearly a trillion dollars in cash offshore to avoid paying higher tax bills at home, the *FT* reports. Tech companies account for nearly half the money.

Wise words: *Rule No. 1: Never lose money. Rule No. 2: Never forget rule No.1.* Warren Buffett.

Martin

Know someone you'd like to receive ►On Target ? Click on Reply and send me his/her email address. Or email your request to me at: afrodyn@gmail.com.

In this issue: Technical analysis □ Banks' high-risk offers □ Fed fears deflation □ Investment ideas □ Germany □ Worthless advice □ Women outperform men