

Currencies – Different Asset Class

The volatility of the dollar against the yen or the euro takes many investors by surprise, but there is always a fundamental reason behind the currency trends and a potential benefit for an investor's portfolio. Chuck Butler, the President of EverBank World Markets, provides invaluable insight on the drivers and trends of the currency market and the current weak dollar trend.

Q: What is the general philosophy behind currency investing? Why should investors consider currencies?

A: We view currencies as a different asset class, not as an alternative investment. Since currencies have low correlation with other investments and different pricing mechanisms, they provide adequate diversification. In essence, as a separate asset class, currencies provide diversification and a hedge to a portfolio, regardless whether we are in a period of a strong dollar or a weak dollar.

Currencies should also be considered for tactical reasons. When you understand well the economy of a particular country and the valuation of its currency, you can buy or sell that currency to take advantage of its moves. Nevertheless, we believe that people should not invest more than 10% to 15% of their portfolio in a currency. Only in periods when currency investing provides a great advantage, investors should go up to 20%, so we still treat currencies as an asset class.

Q: What are the major drivers behind the currency fluctuations?

A: We have been investing in currencies since 1985, so we have tracked and researched many of the currency



CHUCK BUTLER is the President of EverBank World Markets. He oversees the trading desk and operations for over 12,000 individual and corporate clients, both in the United States and abroad, who look to EverBank for FDIC-insured World Currency Deposit Accounts, and Single Currency and Index CDs. Butler is also a frequently quoted and respected analyst of the currency market.

Two decades ago, Butler embarked on his career in foreign investments as the Director of Operations for the Fixed Income Division of the Mark Twain Bank. He oversaw the clearing and custody of all bond department trades and Mark Twain portfolio transactions.

In 1992, he became the Chief International Bond Trader and Director of Risk Management for the Mark Twain Bank, and was responsible for trading global bonds and currencies, as well as overall risk management. In that same year, Butler began composing his now decade-old daily currency market commentary, A Pfennig for Your Thoughts—a play on the American aphorism “a penny for your thoughts” (the pfennig is the Germany equivalent of a penny). Butler’s “Daily Pfennig,” as it is more commonly called today, has become a popular resource for currency investors and traders alike.



trends. There have been only four completed currency trends since the collapse of the Bretton Woods system in 1971, when the U.S. suspended the convertibility of the dollars to gold. Since then we have seen alternating trends of strong dollar and weak dollar, which last anywhere from 7 to 10 years and represent long sweeping moves.

There is always a fundamental reason for a trend to start or end. The dollar remains in that trend until the fundamental reason is corrected, or at least is down the road to correction. More importantly, a trend is not a one-way street. Of course, there is volatility within a trend, such as the signs of strength in the current weak dollar period, but as long as the dollars remains on the trend, it always comes back to the underlying fundamentals.

Q: What are the fundamentals that pushed us into this period of a weak dollar?

A: The weak trend, which began in 2002, is based on a couple of factors. First, the administration instituted tariffs on steel. Whenever a protectionist measure is introduced, the currency is harmed. Investors started to look at the fundamentals of the dollar and

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question whether they should continue to buy dollars.

At the same time, the U.S. current account deficit reached a level of 4.5% of the GDP. Historically, whenever that level had been reached in other countries, it has been an indicator of future currency problems. Although in the case of the U.S. those problems are less severe, the deficit harmed the dollar and pushed it into a weak trend.

Today the current account deficit has grown to about 6% of the GDP, so we haven't seen any step towards correction. That means that the weak dollar trend will probably continue because it requires up to \$3 billion a day in foreign investments to finance the deficit. In addition, when you lower the interest rates, like the Fed recently did, that lowers the yields on the investments that foreigners would buy. So, going forward, I see the major problem in the U.S.'s ability to attract \$3 billion in foreign investment every day without a significant adjustment in dollar price in the international markets.

And when a country has a problem attracting enough foreign investment to cover its deficit, there are only two things that can happen to correct this trend. The first one is raising interest rates to attract foreign investments. But with the Fed cutting rates, I doubt that we will see a sudden turnaround. That seems to be out of the question because raising the rates would have brought the economy to its knees.

The second possible measure is allowing the currency to be debased, or allowing the currency to get weaker. In

that way, when foreign entities buy assets in the U.S., they have to convert their currency to dollars. If they can buy them at a cheaper dollar price, that's means that they are buying the asset at a discount. Comparing the two measures, the choice for currency debasement is pretty obvious. That is what we see happening right now and that's going to continue until the deficit is corrected.

Q: As a larger economy, we have managed to sustain low interest rates for years without the inflation picking up. Nevertheless, do you think that a slowdown, combined with higher inflation and weaker currency, is possible?

A: Yes, in fact I believe that this is where we are heading. The economy has already been slowing down. The job growth is much slower, affected by the mortgage and the housing meltdown, whose effect goes far beyond the housing market.

However, as an 'old school economy' person, I believe that there's nothing wrong with recessions. When we were in a short recession 4 or 5 years ago, the Fed brought us out of that very quickly by lowering interest rates down to the bone and enticing people to spend. But we never really got a chance to clean out the excess of the previous boom. The past recessions haven't killed us; they have made us stronger for the next growth period. I believe that the longer you put off the inevitable, the worse it will be when it actually comes around.

So I believe that a recession is coming, that interest rates will be much lower, and that the dollar will be weaker. The Fed will cut interest rates at least once or twice this year and the dollar will ease further down, especially against the Asian currencies. Most individuals in the U.S. don't notice the decline of the purchasing power of the dollar because many of the goods they buy

are made in Asia and the dollar hasn't lost ground against the Japanese yen and the Chinese yuan. Since 2002, the euro is up 64% against the dollar but the yen is up only 15% and the yuan is up only 10%.

But we will never get a correction in the deficit until those currencies do increase against the dollar. That's why Henry Paulson, the U.S. Treasury Secretary, is always hitting on China to allow its currency to float. If that happens, our manufacturing will become more competitive. In other words, their goods will become more expensive and we could get some control over the spending and the current account deficit.

That means that the 'strong dollar' policy doesn't really exist despite that fact that in the past six or seven years all the Treasury Secretaries talked about it. At the same time, they also talk about Japan and China floating their currencies, which would lead to a weaker dollar. So we started currency investments as diversification, but we moved into a tactical approach because we believe that, going forward, the dollar will continue to be weak.

Q: Starting with the premise of a weak dollar, how do you select the currencies to invest in?

A: I believe that when you select currencies, you should view the currency as the stock of a country and analyze it in the same way as stocks. You should look for countries with good balance sheets, strong leadership, and reasonable yield.

A very important factor is the positive balance of payments because it means that this country's economy will not be dragged down by deficit spending. The strong leadership also includes evaluation of the ability of the central bank to provide price stability and to fight inflation. The yield is also impor-

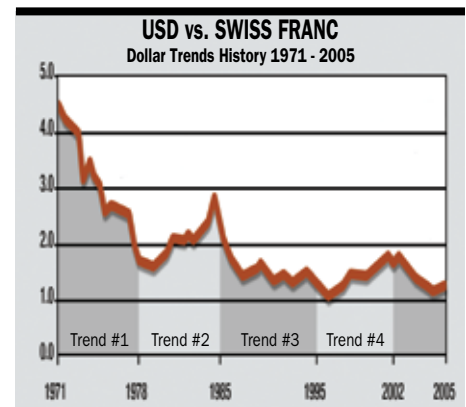
tant, although it is not a main reason for buying a currency. After all, it is the currency movement against the dollar that determines the return, not the yield. But the interest helps to offset downward movements of the currency, so it is also an important part of the decision.

In addition to those top three factors, we also look at the composition of the country's GDP, whether the country produces something or whether the GDP is mostly made up of government spending. For example, in the current bull market for commodities, the strong producers of commodities like Australia, New Zealand, Canada, Brazil, South Africa, and Norway, have been the best performing countries. A great part of that demand comes from China and China has not slowed down despite the forecasts, so the demand for commodities remains strong.

Q: Historically, the U.S. represents the only economy that has managed to sustain both leadership and a trade deficit for more than five decades. What usually happens to the nations who live beyond their means?

A: The issue is debatable and economic historians point out that never a country run a deficit that large. In the last five years that deficit has multiplied to a huge amount without a currency crisis, or devaluation. But we have never seen any country devalue its way to prosperity. Forward-looking, if we can't work ourselves out of this situation, we'll probably see a currency crisis.

I think that the only country that can get away with mounting deficit is the U.S. because of its power and the strength of its economy. However, there is a point when the deficit just becomes too big, even for the U.S. At some point, the central bank of China, Japan, or another Asian country will say, "No more," and will stop buying the U.S. debt.



Trend #1: 1971–1978, 7 years

- 4.30-1.50
- Swiss franc up 186%
- US investor converting to DEM-CHF-JPY combo
- +131% / 17% simple annual

Trend #2: 1978–1985, 6 years

- 1.50-2.85
- USD up 47%
- US investor converting to DEM-CHF-JPY combo
- -39% / -6% simple annual

Trend #3: 1985–1995, 10 years

- 2.85-1.20
- Swiss franc up 138%
- US investor converting to DEM-CHF-JPY combo
- +171% / 17% simple annual

Trend #4: 1995–2002, 7 years

- 1.20-1.72
- USD up 30%
- US investor converting to DEM-CHF-JPY combo
- -36% / -5% simple annual

When that happens, we will see the interest rates rising or the dollar weakening. No one really knows when this can happen. It may never happen if we work ourselves out of that situation but, in the meantime, investors should diversify and protect themselves against a possible currency crisis.

Q: Could you illustrate how currencies provide the benefit of diversification to a portfolio?

A: During the first weak dollar trend, which lasted from 1971 through 1978, the Swiss Franc gained 186% against the dollar. The combination of Deutsche Mark, Japanese Yen, and Swiss Francs returned 131%. The next trend was a strong dollar trend from 1978 to 1985 and during that time the Swiss Franc lost only 47% against the dollar, so it preserved its relative strength.

In the next weak dollar trend, brought about by the Plaza Accord in 1985 and lasting until 1995, the Swiss Franc was up another 138% against the Dollar and the simple combination of Deutsche Mark, Japanese Yen, and Swiss Francs had a return of 171%. The next strong dollar trend lasted for 7 years, when in office was Robert Rubin, who believed that the strong dollar was in the best interest of the U.S. During that time, despite the boom of technology stocks, the dollar only gained back 30%. So, there is an actual trend of a downward slope for the dollar.

In the period 2002 to present, the Swiss Franc has lost its luster as a hard currency because it is no longer backed 100% with gold. Nevertheless, it gained almost 40% against the dollar and our simple combination of euros, yen, and CHF is up about 50%. I believe that those currency moves very well illustrate how diversification is an important part of an investment portfolio.

Q: Globally, there seem to be two distinct blocks, the dollar and the

euro economies, and many Asian and South American economies are pegged to one of those currencies. Do you think that China may become another anchor, if it revalues its currency?

A: Yes, absolutely. China has slowly loosened the rein on the currency over the last couple of years. Now it allows a wider trading band on a daily basis and the currency has gained 10% in the last year. The IMF believes that China's currency is probably 25% to 40% undervalued and, given a free reign, we may see the yuan becoming a strong currency that a lot of people would invest in.

We have also seen Kuwait, a relatively small economy, drop its currency peg to the dollar and that move has been beneficial to them. Saudi Arabia is also on the verge of doing so and it is a much larger country to test those waters. In general, I expect these countries either to allow their currencies to float or to attach them to a different currency, right now probably the euro.

Q: The hard currency is a luxury that most nations cannot afford. Germany went through a very difficult time to sustain its currency after it united with East Germany at a very expensive one-to-one ratio. What is your view on event of merging the old Deutsche Mark and the Eastern German Mark?


A: Yes, it was an important development. Many of the EU problems with the euro in 1999 were a direct result of all the debt that had been built in taking Eastern Germany back on. To meet all of the requirements of the Maastricht Treaty, they sold gold. It was the only way that they could lower the deficit and made the euro a viable currency. But they had a lot of gold that they could sell, while we don't have that luxury in the US.

The safety net of Germany, their wonderful reserve, is just not available

to us. We depend only on the faith of the government that foreign countries would support the dollar. I hate to bring war and politics in a discussion of the economy. It is an expensive war, there are monetary problems, and it is hard to get full accounting of the war expenses.

Q: The currency markets tend to be more volatile than the equity markets. What signs should investors watch for?

A: There are two different types of currency investors. There are currency day traders, or people who worry about the day-to-day data, central bank talk and monthly economic data. The investors, who buy currency for long-term diversification, are looking for signs that show if the trend is still in place or if it is over. Obviously, trends don't end or begin on a particular day, and there's always plenty of indication that a currency is through its trend.

In the past, we would look for any type of central bank intervention, which is an indicator that a currency may be at the end of its run. The central bank usually has very deep pockets, and if it is selling the currency, then it seriously affects the market. Other factors include changes in the interest rate and falling GDP. These factors eventually weigh on a currency, even if it is not immediately. After three or four reports of declining GDP, you will most probably see lower interest rates and a weaker currency. 

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