



SPECIAL REPORT

Global Currency Overview 2008 – Q2 Update A Special Industry Report from Custom House

By Mark Frey

In the Custom House Global Currency Overview 2008, delivered at the beginning of this year, our Custom House Economics Team made a case for a modest general US Dollar (USD) rebound by the conclusion of the calendar year. That forecast was built around a key assumption that the U.S. Federal Reserve would slacken the pace of monetary accommodation by year's end. This was due to the building inflationary pressures in the U.S. economy which would allow the U.S. to exhibit slowing and perhaps even recessionary rates of growth in Gross Domestic Product (GDP) as the market worked its way through the so called credit crisis.

Although we forecasted a rather modest Dollar recovery by year-end, it will clearly come off of lower levels than we originally predicted, thereby requiring an adjustment to some of our original currency forecasts. That being said, any substantive bounce in the USD will clearly be dependent on a move on the part of the U.S. Federal Reserve to a more neutral stance with respect to monetary policy.

The Dollar's Performance in 2008

Daily Chart of USD Index



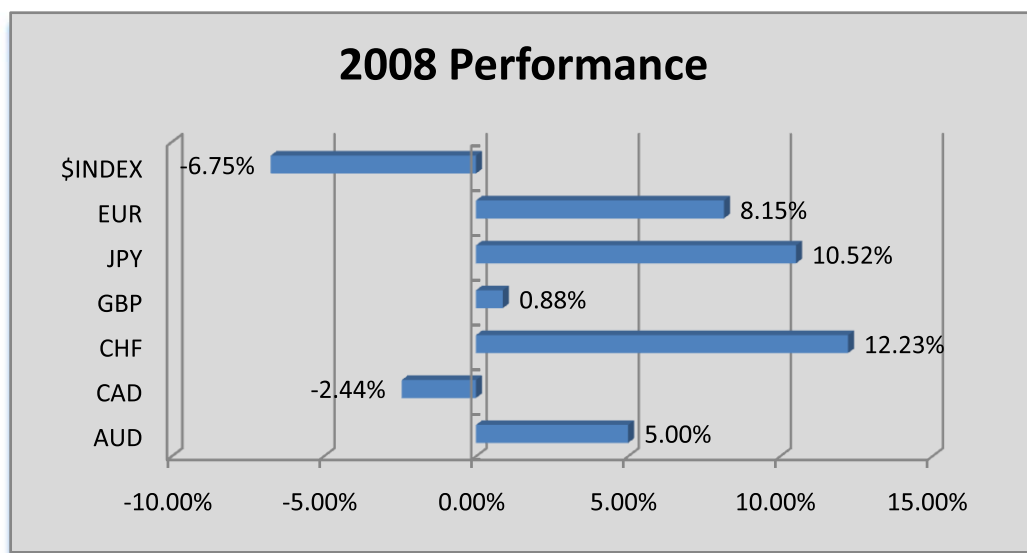
The Dollar continued its dismal performance that began in earnest back in the fourth quarter of 2005 when, believe it or not, the Dollar Index was trading over 92.50. Since that point, the index has shed more than 22 percent of its value to the end of March, where we are currently trading around 71.50.

The first three weeks of January saw the Dollar stage a modest rally, recouping nearly a full percent before the FOMC's surprise inter-meeting rate cut of 75 basis points on January 22nd. That move, on the part of the Fed, sent a strong message to the market that they would do what they must to support economic growth at the expense of the second part of their mandate being inflation targeting.

However, that rather bold policy move sent another signal to currency traders; that the Fed was abandoning the Dollar and attempting to re-inflate a U.S. economy that was struggling with declining asset prices. Traders sold the greenback aggressively while the Dollar has truly become a carry trade funding currency for those who wish to go long or buy the Australian (AUD) and the New Zealand Dollars (NZD). Even the long struggling Japanese Yen (JYP) and Swiss Franc (CHF) have rallied substantially to start the year, in line with our original forecast.

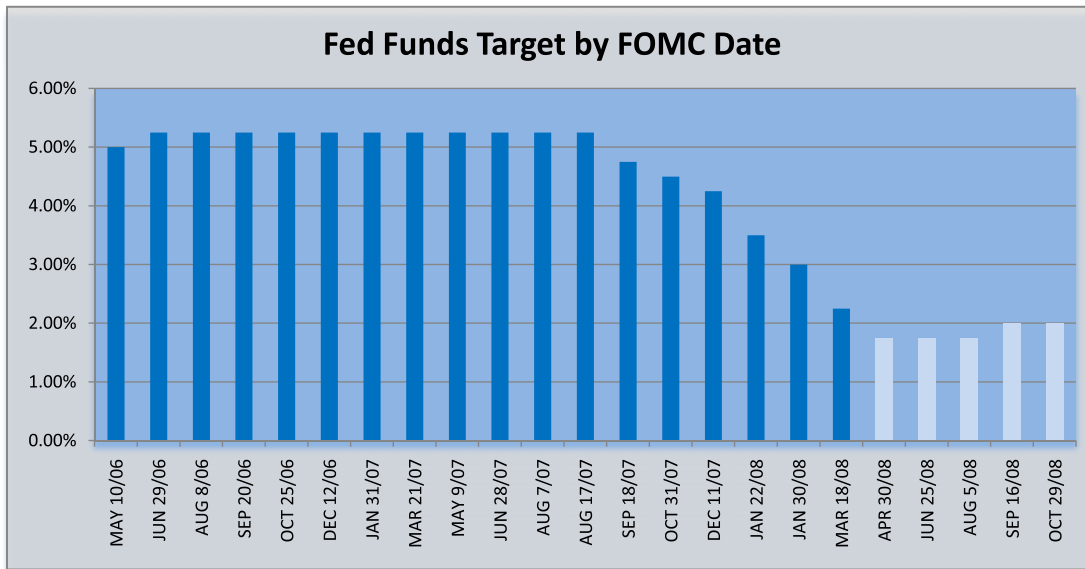
Amid an increasingly risk averse investment climate, shorting the greenback seemed to be a safe, not to mention profitable bet, as U.S. rates are roughly equivalent to those in Switzerland and only 1.75% above those of Japan. Suddenly, the Yen and Swiss Franc don't seem to be quite as low yielding, at least in relative terms.

March saw the Euro trade to an all-time high of 1.5904 vs. the Dollar, while the AUD hit a generational high just under 95 cents. This is in line with the fact that we highlighted short-term upside risk in our original forecast. In fact, of the major currencies, only the Canadian Dollar (CAD) is currently trading at levels lower than where it began in 2008 as the Canadian economy struggles with the fact that its largest customer is mired in what is increasingly looking like a recession. After hitting fresh highs on a near daily basis as the Dollar index mined new lows in early March, commodities corrected lower before marching forward yet again as Q1 came to a close.



From a technical perspective, the Dollar Index is now trading close to six big figures below the 200-day exponential moving average, while the relative strength is showing the USD to be moving back into well over-sold territory after a short-term bounce in the third week of March. The market is now considerably over-extended and the short Dollar trade is in no doubt beginning to become a bit crowded. That being said, a technical recovery at this point will only deliver a brief respite for the Dollar. What the greenback truly needs is a reduction in the monetary stimulus now provided to the U.S. economy via the Federal Reserve's target rate.

Federal Open Market Committee Policy and the Credit Crunch



After at first failing to acknowledge the impending disruptions to financial markets as a result of the credit problems first coming to light in August 2007, the Fed has since moved their Federal Funds Target Rate aggressively lower in an attempt to both spur the economy and alleviate the pressure on distressed homeowners and financial entities. The surprise inter-meeting 75 basis point interest rate reduction that was delivered on January 22nd was subsequently followed by two additional cuts, bringing the total reductions to 3% since the onset of the crisis. In addition, the Fed has invoked a number of other measures in an effort to help restore normal operations to many financial markets, many not seen since the Great Depression.

Although the Fed certainly looks poised to deliver at least one more cut, if not two, the argument could be made that Bernanke and company are more or less pushing on a string at this point. That is, additional cuts by way of the law of diminishing returns will have progressively less real impact on the economy other than to fan inflationary pressures, with very little to be gained in the way of restoring consumer or business confidence. Three percentage points of interest rate relief, if that's all it would take to win over decision makers, should be enough to do the job. Rather, interest rate cuts alone will likely not be sufficient as they will do little to help homeowners who have already been foreclosed upon as well as those institutions that have already realized and taken write-downs for significant financial losses.

Although we acknowledge that we are likely no where near a resolution to the credit market issues at hand, the Fed is going to have to address the building inflationary pressures in the U.S. economy at some point by removing some of the monetary stimulus that has and will still be delivered, we estimate that the losses and turmoil will persist well into 2009. The real interest rate is now effectively negative, as inflation is running well above the Fed's Target Rate of 2.25%. In fact, for each of the past 4 months the year-over-year Consumer Price Index (CPI) has registered over 4.0%. It is for this reason that the Fed will have to first signal a change to a neutral stance on rates before reversing course with the beginnings of a modest tightening cycle coming before the close of 2008. Not until the Fed sends the market a clear signal of a firm change in policy will the Dollar be able to consolidate its losses on a broad scale. Though the likely pace of the resultant interest rate tightening will be substantially less aggressive than the rate at which monetary stimulus has been applied, even a modest tightening of policy will likely be enough to positively influence the overall sentiment with respect to the Dollar, thereby yielding a consolidative bounce, as modest as it may be.

Domestic Economic Conditions

U.S. employment, after experiencing years of solid growth has been under increasing pressure over the past year, even before the advent of the credit crisis in August. Payroll numbers have declined steadily from 177,000 new jobs created in March 2007 to net losses of 22,000 and 63,000 in the past two months. Analysts' consensus forecasts are now pointing to a figure in the range of 40,000 in losses for March as well.

Those employment losses are translating into a marked decline in consumer sentiment with both the Michigan Consumer Sentiment Index (CSI) and Consumer Conference Board (CCB) posting significant declines since autumn.

The Michigan CSI has fallen from a reading of 80.9 in October, 2007 to 70.5 for March, while the CCB reading has declined steadily from 95.2 in October to 64.5 in March. In both cases, consumers' future expectations are increasingly negative, pointing to a likely continued down-tick in consumer spending ahead. In fact, after showing a great deal of resilience heading into the 2007 holiday shopping season, consumers did in fact begin to hang on to their hard earned dollars with increasing vigour beginning in December. Two out of the last three months have resulted in negative sales growth from U.S. retailers.

Although we have not yet met the technical definition of a recession, which is defined as two successive quarters of contracting GDP, economic growth did slow to a snail's pace at 0.6% in Q4 2007. The first quarter of 2008 will however likely take care of the first part of the definition as we are forecasting a 0.3% decline in U.S. GDP for Q1. At this point, it seems unlikely that we will see a material rebound in economic activity in the second quarter, given the deteriorating employment picture as well as the increasingly negative tone of consumers' view of the economy's future economic prospects.

Commodity Pressures

Commodities experienced their first real corrective down-turn in prices since the onset of the credit squeeze in August and September. After hitting an impressive high of 422.12 in mid-March, the Commodity Research Bureau (CRB) Index shed more than 10% of its value before picking right back where it left off on renewed, general USD weakness as the quarter draws to a close. At this point, the recent correction seems to be little more than a rationalization in a sector that seems to have gotten a little bit ahead of itself.

Crude inventory levels remain persistently high from a historic perspective. Although there are indeed still some geopolitical concerns in the marketplace including Iraqi insurgency causing supply problems in the port of Basra, the fundamentals don't appear to support oil prices over \$100, let alone \$110.

After hitting a nominal record spot price over \$1,030, gold has corrected lower as some of the nagging supply concerns in South Africa are being resolved. That being said, gold bugs are quick to point out that while many other commodities, including various metals, have traded to new inflation adjusted highs, gold still has a long way to go before hitting the real price levels achieved in December of 1980, which would be just above \$2,000.

However, in an environment where long commodity positions serve as a proxy trade for shorting the Dollar, it is hard to argue that commodities are driving the Dollar lower but rather it is the weak Dollar that is driving commodities. Any change in sentiment regarding the prospects for the greenback will likely take the froth out of commodities, regardless of the long-term demand growth stories originating in the developing world.

The U.S. Trade Deficit

Despite recent improvements in the U.S. trade deficit, Treasury Secretary Paulson still finds the U.S. economy in essentially the same predicament as it was one year ago. The January trade balance came in at a reading of -\$58.2B, largely unchanged from February 2007. The recent improvements are in fact off of a spike that pushed the deficit to -\$62.4B as recently as November 2007, which was exceeded only by the -\$63.0B posted in March of 2007. It is certainly somewhat concerning to many traders that despite a 10% drop in the Dollar Index over the past year, there has been no discernable improvement in the U.S. balance of trade. This, combined with the fact that U.S. Government Budget Deficit has ballooned to -\$175.6B in the month of February, with no firm date on a potential withdrawal of U.S. forces from Iraq pending the outcome of the Presidential election, leaves those hopeful of a slaying of the twin deficit albatross still dreaming the seemingly impossible dream.

If we go way back in time to January 2002, when this largely one-way decline in the Dollar first began, one of the key drivers of the Dollar weakness was the ballooning twin deficits. Although this is a significant structural imbalance that cannot be corrected overnight, it is extremely concerning that we are not yet seeing significant improvements. The simple fact of the matter is that this issue hasn't gone away, it is simply being overlooked at the present time due to larger challenges facing the U.S. economy. In short, the twin deficit tells us that either the Dollar has further to fall before this imbalance can be corrected or as the Dollar bull's hope, the trade deficit simply hasn't caught up to the movement in the Dollar due to the lag effects inherent in trade flows.

Exchange Rate Flexibility in China

In discussing the unprecedented fall in the USD over the last 6 years, many industry pundits postulate that the Dollar would be in even worse shape if the Chinese Yuan (CNY) were allowed to float freely in the market, citing China's unwillingness to allow for exchange rate flexibility. However, the actual evidence doesn't support such a conclusion as

strongly as it once did, in that although the CNY is still likely undervalued by as much as 15 to 20%, the Chinese have in fact been allowing their trading unit to appreciate at a much more aggressive pace.

Following the Yuan revaluation in July 2005, the Chinese unit appreciated a further 1.6% in the subsequent 12 months, followed by a 5.44% increase in the following year. Somewhat surprising to many is that the Yuan has already increased 7.23% vs. the Dollar in past 8 months, marking a significant increase in the rate of appreciation. However, with a quick check to acquire a notion of relativity, the Dollar Index over that period has posted declines of 4.1%, 6.5% and 10.9% respectively, showing that the Yuan still clearly hasn't kept pace.

Still, a quick overlay of the charts will demonstrate that the CNY has been tracking against the Dollar Index relatively well, showing a loose correlation between the two units. In addition, it is extremely likely that the CNY would continue to appreciate against the Dollar, albeit at a slower rate, even if the Dollar were to stage a recovery or consolidative move in the price action, thereby either reducing or inverting the correlation. Therefore, it seems as though the rate of CNY appreciation is not a significant determining factor in the future direction of the Dollar, but rather, it will continue to appreciate more or less in line with the scale of relative growth in the Chinese economy going forward.

The Possible Removal of the Dollar Pegs in the Middle East

Similar to the situation in China, many Middle Eastern currencies currently pegged to the USD are widely considered to be significantly undervalued by as much as 20 to 30%. In the case of Qatar, central bank officials have mused publicly that they are contemplating a revaluation or perhaps even a removal of their Dollar peg as soon as early April in favour of a trade weighted basket of major currencies and trading partners. Although it is highly unlikely that other nations in the region will follow suit immediately, there is a significant degree of probability that there will be material upward valuations of all of the currencies in the region within the next two years. Unquestionably, this event risk will weigh heavily on the Dollar should Qatar in fact move forward in the weeks ahead.

Updated forecast for the End of 2008

Mar 27/08 Update | 2008 Year-end FX Forecast

Currency	Current Spot	Original Forecast	Updated Forecast
EUR-USD	1.5800	1.4200 to 1.3800	1.5100 to 1.4700
USD-JPY	100.00	102.50 to 98.50	no change
GBP-USD	1.9950	1.9000 to 1.8500	1.9500 to 1.9000
USD-CAD	1.0200	1.0700 to 1.1000	1.0500 to 1.0800
AUD-USD	0.9200	0.8200 to 0.7900	0.9000 to 0.8400
NZD-USD	0.8050	0.7200 to 0.6900	0.7400 to 0.7100

Note: We still see near-term risk from broad-based USD declines in Q2 as the Federal Reserve continues to apply monetary stimulus by way of further interest rate cuts. Not until the Fed acknowledges a change in policy will the Dollar be able to form a substantive base for gains, likely in the latter half of Q3 or early Q4.

About the Author

Mark joined Custom House in 2001 in the Custom House Calgary office before moving to his current position in the Treasury Department at the company's global headquarters. As Head Trader, Mark is ultimately responsible for the company's FX (Foreign Exchange) position, risk and cash management, as well as the implementation of Custom House's corporate hedging policy and the management of our inter-bank trading relationships. He is also responsible for relationship development with present and prospective clients, as well as their advisors. A graduate from the University of Calgary school of Economics, Mark is a candidate in both the Chartered Financial Analysts and Canadian Derivative Markets Specialists programs. He is also a regular contributor for industry focused magazines and the World Market Update newsletter writing on topics related to risk management, hedging and emerging market currency trading.

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