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Investment Publications Highlights

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"In Search of FX Fair Value"

Mark Astley, Ric Deverell, and Bhaveer Shah,
Credit Suisse, October 2013

Developing accurate exchange rate forecasts remains an elusive goal for economists and investors alike. Nonetheless, several accepted methods for determining currency fair values exist. Applying Credit Suisse's own methodology, the bank's currency strategists note that the U.S. dollar appears undervalued relative to most major currencies, with the exception of the Japanese yen.

Market participants have yet to develop reliable currency valuation methodologies despite increasingly sophisticated econometric techniques. Exchange rates commonly deviate from estimated "fair values" for years. Over the long run, however, rates tend to swing toward prices determined by fundamental measures of value—especially when the deviations from estimated fair value are substantial and when market volatility increases.

Three widely published approaches to estimating currency fair values are the OECD's purchasing power parity (PPP)–based method, the Peterson Institute for International Economics' fundamental equilibrium exchange rate (FEER) approach, and the International Monetary Fund's (IMF's) fair value range. The PPP approach is the simplest of the three: "fair value" is simply the exchange rate that equalizes the prices of the same goods and services across two countries. By this measure, for example, today's high cost of living in Switzerland (in an American's eyes) means that the Swiss franc would have to depreciate roughly 35% to reach fair value against the U.S. dollar. PPP theory implies that all else being equal, inflation in one country will lead to a nominal depreciation of that country's currency against that of a country with lesser inflation, while leaving the real exchange rate unchanged.

Unlike currency valuation based strictly on PPP, Peterson's FEER method and the IMF's fair value estimates also rely on forward-looking estimates of relevant macroeconomic variables. Peterson's estimates consider the difference between a country's projected medium-term current account deficit and its estimated equilibrium level. According to this method, the currency of a country with an excessively large current account deficit will have to depreciate to reach fair value. The IMF uses three separate methodologies to create a range of fair value estimates: one approach similar to Peterson's, one based on a country's net foreign asset positioning, and one based on the empirical relationship between exchange rates and a broader range of macroeconomic variables.

Credit Suisse's methodology for modeling fair values is most similar to the third of the IMF approaches. It starts with PPP, but incorporates additional "real" economic variables: productivity, real interest rates, and foreign asset and liability positions. These structural and cyclical variables aim to capture the impact of economic developments that can cause exchange rate deviations from fair value to persist for extended periods of time. For example, according to the Credit Suisse approach, a 1% rise in relative productivity between two countries with similar GDP should result in 1% long-term relative currency appreciation. In terms of a country's external positions, the Credit Suisse model seeks to "punish" gross international liabilities more than it seeks to "reward" gross international assets. The model also accounts for differences in central bank policy rates and "natural" interest rates.

The Credit Suisse model indicates that the U.S. dollar is undervalued against the vast majority of currencies, potentially setting the stage for a multi-year rally. Commodity currencies like the Australian, Canadian, and New Zealand dollars are especially overvalued against the U.S. dollar, having been distorted by a decade of high commodity prices. The British pound and the euro also appear to be slightly overvalued. Sterling's fair value has depreciated significantly over the past few years thanks to high inflation, weak productivity trends, and the United Kindom's large external balance sheet. The lone exception to this trend of U.S. dollar undervaluation is the Japanese yen, which appears cheap relative to the dollar after a massive depreciation in 2013. Given the Bank of Japan's dramatic policy maneuvers, however, there is still considerable uncertainty surrounding the extent of the misalignment.

"Disequilibrium and the Dollar"

Jan Dehn, Ashmore Investment Management, May 2013

Investors that expect U.S. dollar appreciation should remember that the global economy is still stuck in a state of severe disequilibrium, argues Ashmore's Jan Dehn. The path of least resistance for major developed markets currencies—including the dollar—is downward relative to emerging markets currencies, as central bankers in heavily indebted developed countries (HIDCs) allow inflation and currency devaluation to heal their nations' debt problems.

As America's growth improves, many observers expect rising real interest rates to increase the dollar's appeal relative to other currencies. This logic is compelling given the well-established influence of growth and interest rates on exchange rates, and today it is popular to be optimistic about the U.S. dollar.

Some of the dollar's perceived strengths stand on shaky ground, however. America's current growth advantage over Europe derives partly from its higher rate of population growth. Moreover, the Federal Reserve, unlike the European Central Bank (ECB), has a mandate to fight unemployment as well as inflation, and has arguably been more concerned about the former than the latter, creating downside risks for the dollar. The Fed also does not sterilize its quantitative easing, or offset its securities purchases by removing an equivalent amount of cash from elsewhere in the monetary system, while the ECB does. On balance, the case for owning dollars instead of other developed markets currencies is not compelling.

"Dollar bulls" also overlook the fact that the global economy, including the U.S. economy, is still in a state of severe disequilibrium. Public debt levels in developed markets have risen sharply in recent years and continue to increase. Growth and hiring have been tepid. Global imbalances are large—emerging markets continue to accumulate substantial foreign exchange reserves despite having already excessive currency stockpiles. The surest sign that all is not well with the world economy is the absence of inflation in developed markets despite unprecedented money printing and record low policy rates.

For the United States, the journey from today's environment to a sustained equilibrium of pre-crisis growth rates and higher real interest rates is unlikely to be as smooth as dollar bulls expect. When consumers exit deleveraging mode and begin to spend more—Ashmore expects this to occur in 2016, when the ratio of household debt to income returns to its pre-crisis level of 90%—and GDP begins to grow more rapidly, rising inflation expectations will not be far behind. As inflation expectations rise, the Fed will face a choice between continuing today's "dovish" policies and implementing "hawkish" rate increases aimed at keeping a firm lid on consumer prices. Ashmore believes that the high U.S. debt burden will force the Fed down the dovish path, allowing inflation expectations to rise faster than nominal yields, and thus allowing real yields to fall. This will hurt the dollar's value, potentially significantly. An era of higher domestic inflation will also have benefits, however. It will erode the real value of America's debt and create a path back to fiscal health. A weaker dollar will also improve U.S. competitiveness, stimulating growth via exports. A similar path for other HIDCs seems likely.

Surplus countries in emerging markets face opposite pressures. These countries have artificially suppressed domestic demand for decades with currency weakness and excessive trade surpluses. They will be best served by allowing their currencies to appreciate. The transition to domestic-led growth will require significant investment in productivity-enhancing measures that enable these countries' exporters to survive in the face of rising exchange rates. HIDC exports, which will be more competitive after currency devaluations, can help meet this need. In short, investors wondering about the path of the dollar or other HIDC currencies should be mindful of the big picture: an unbalanced global economy and central banks loathe to hike interest rates in the face of suffocating debt burdens. ■