Currencies in an Uncertain World

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Renewed dollar weakness

The dollar has been on a downtrend since 2002, but held up well for much of 2004. Its decline resumed in September, accelerating in the past month.

2004 currency winners and losers

	% change vs US dollar		
	Jan-Nov 04	**Jan-June 04**	**July-Nov 04**
Japanese yen	+3.9	-1.8	+5.6
Euro	+3.0	-3.5	+6.8
Sterling	+3.3	+1.3	+2.0
Swiss franc	+6.2	-1.2	+7.3
Australian dollar	+3.6	-7.5	+12.0

All winners against the dollar – especially in the second half of the year! Much of the appreciation has been in the past month, particularly the **yen**.

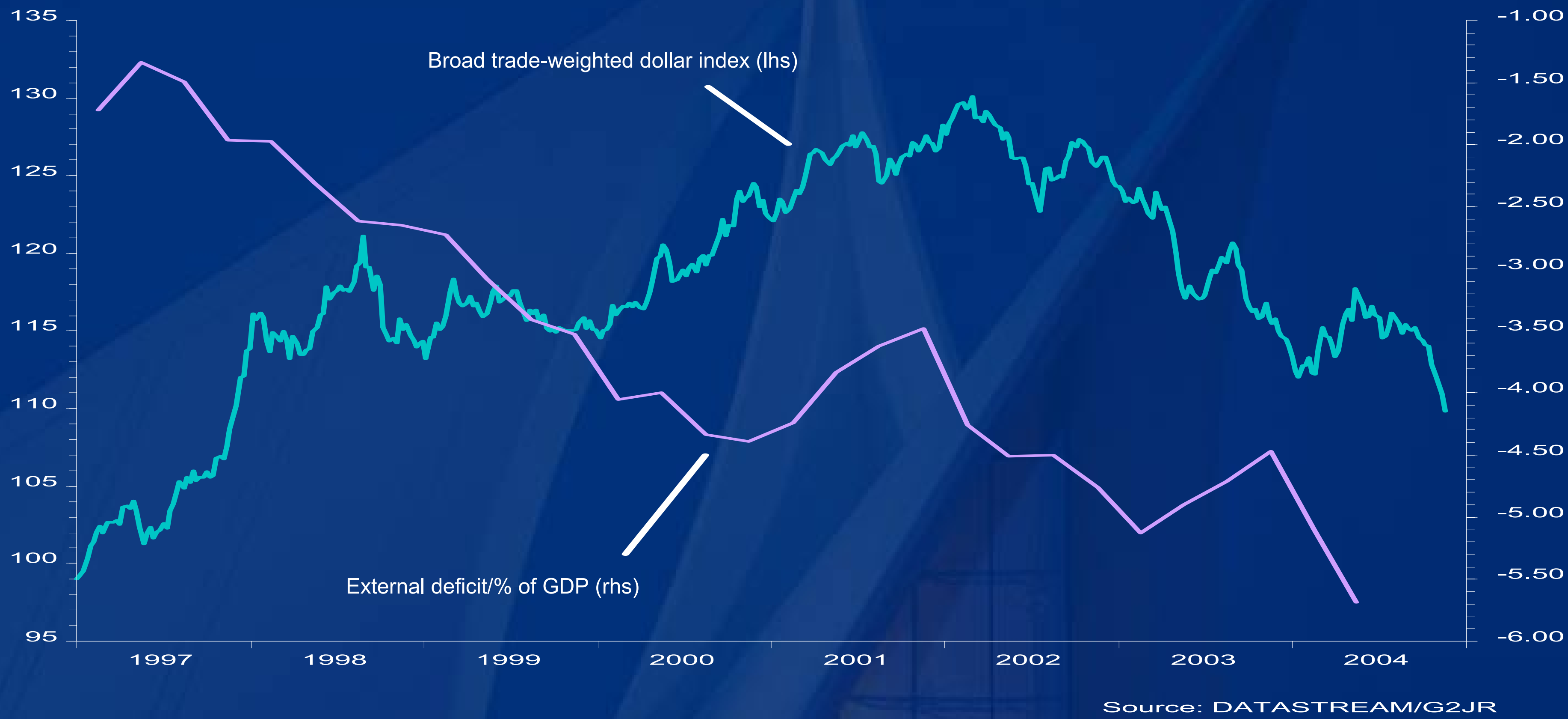
Sterling has risen only slowly because of expectations of UK rates peaking.

The **Swiss franc** has benefited as a "safe-haven" currency; high interest rates and commodity prices have supported the **Australian dollar**.

Factors driving currencies in 2004

- Economic growth
  - Confidence in the US economy helped the dollar in H1 2004
- Higher interest rates
  - US Fed action anticipated ahead of June’s move; helped in H1
  - Australia’s relatively high interest rates, UK rate hikes
- The US current account deficit
  - Getting larger, increasing US net debt and US depreciation risk
- Oil/ Commodities
  - Oil at $50+/barrel led to worries about US and Japanese growth
  - Commodity currencies, eg the Aussie dollar, sterling, benefited
- Politics
  - Bush’s victory quickened US$ decline: is deficit reduction a priority?
  - Geo-political uncertainty has favoured the Swiss franc

The trade-weighted dollar and the deficit

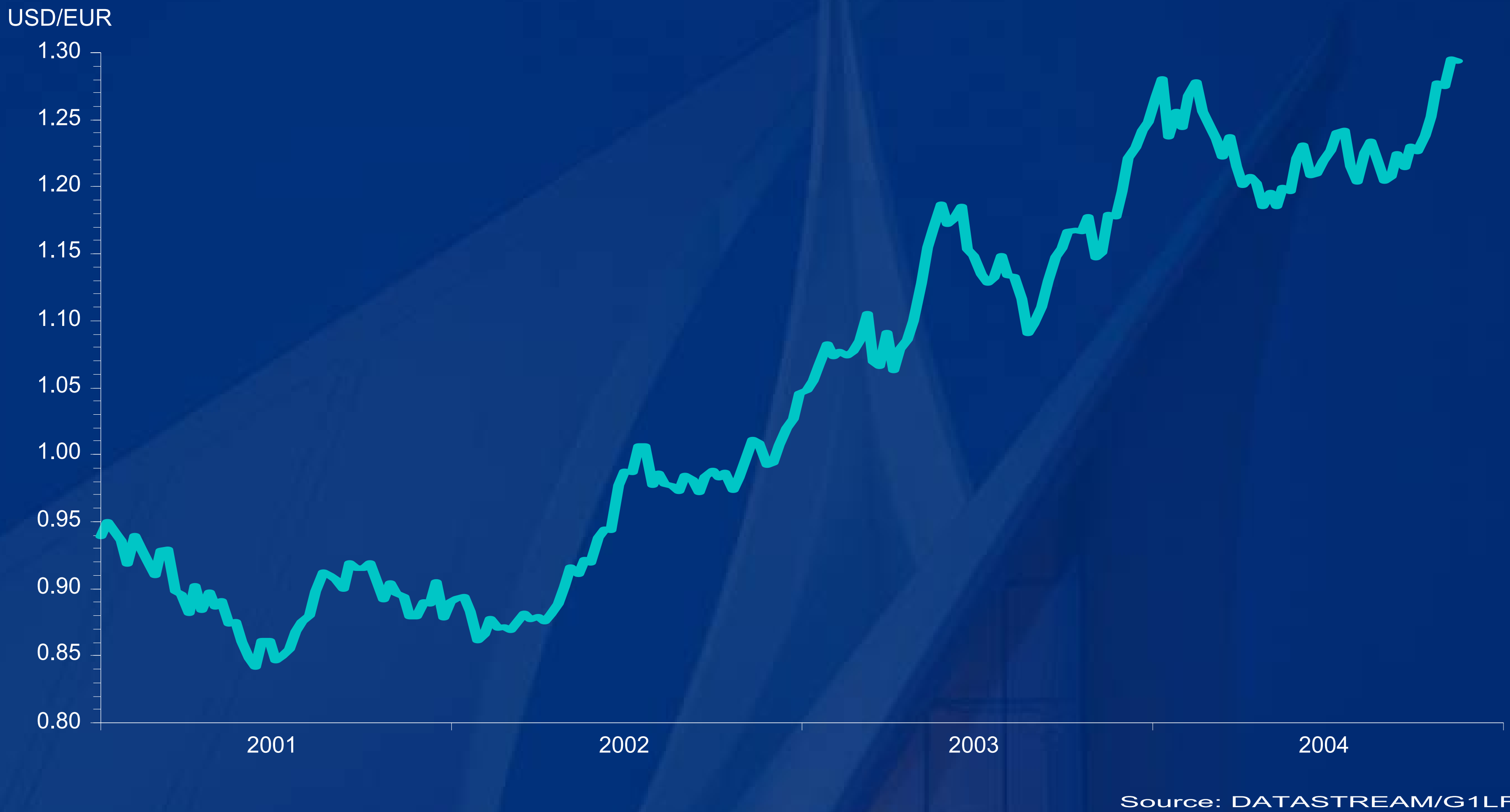


The USD broad TWI has to fall around 30% from its 2002 high to get the external deficit to a long run sustainable level – around 3% of GDP. The TWI is down around 15% so far – so more USD slippage is likely over the long run.

Three scenarios for the US dollar and the economy

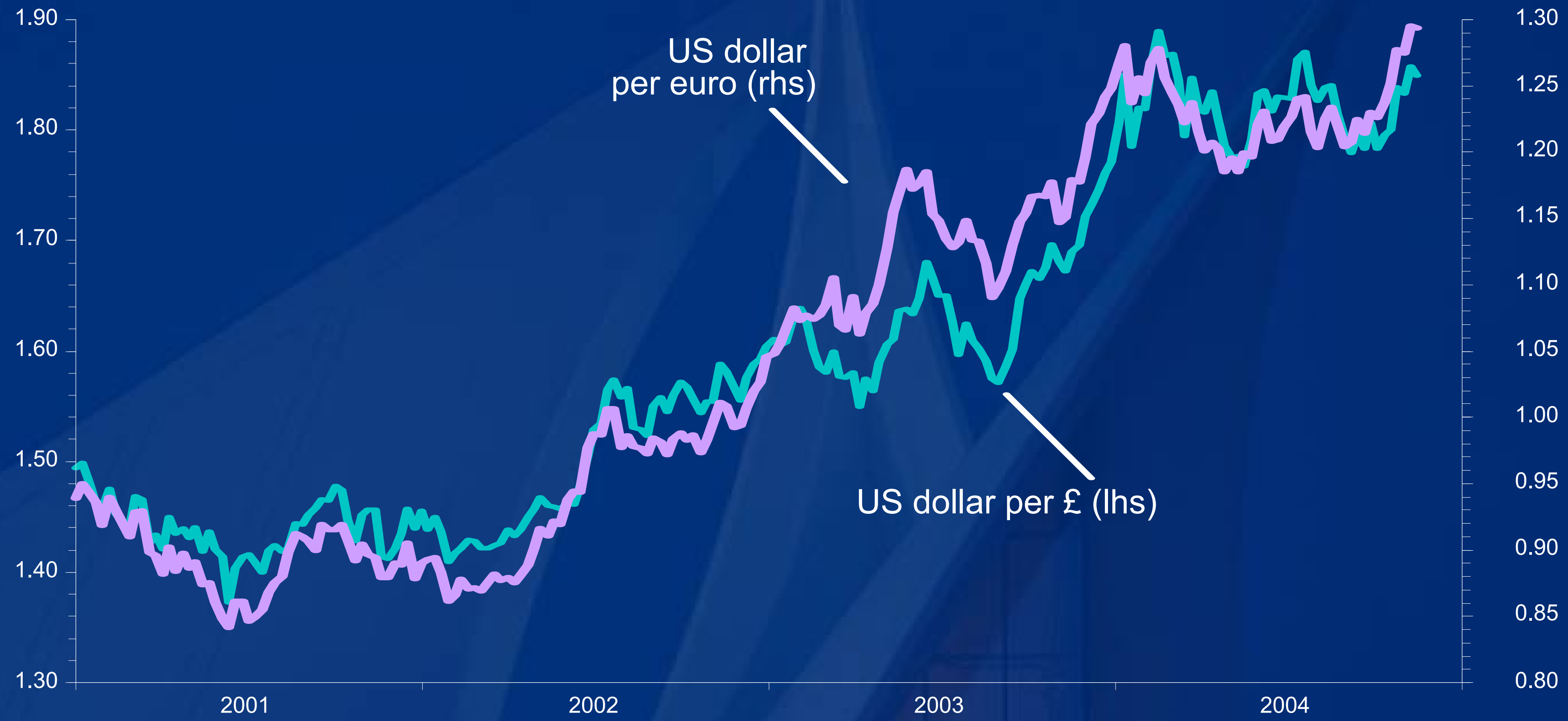
- **<u>Growth stays around trend – 70% chance</u>**
  - growth stabilises around 3.0-3.5% pa; inflation drifts higher
  - Fed raises rates steadily, Fed Funds at 3.5% by end-2005
  - the USD weakens. Our forecast: to USD1.32/EUR in 12 months
- **<u>"Overheating" fears re-emerge – 15% chance</u>**
  - growth moves above trend
  - bond prices crash, yields soar, the Fed hikes more aggressively
  - the USD rallies to $1.20/EUR
- **<u>GDP growth slows below trend – 15% chance</u>**
  - higher oil prices/ consumers, businesses pull back sharply/ a "shock"
  - deflation fears re-emerge, the Fed stays on hold
  - the USD falls to $1.40/EUR

Euro: staying strong next year



Forecasts: in 3 months time: 1.26, in 12 months time: 1.32. The dollar should rally near term as the Fed keeps hiking rates. But it will probably be a temporary, cyclical bounce. The euro should be stronger than current levels for most of 2005.

Sterling: should stabilise against the dollar



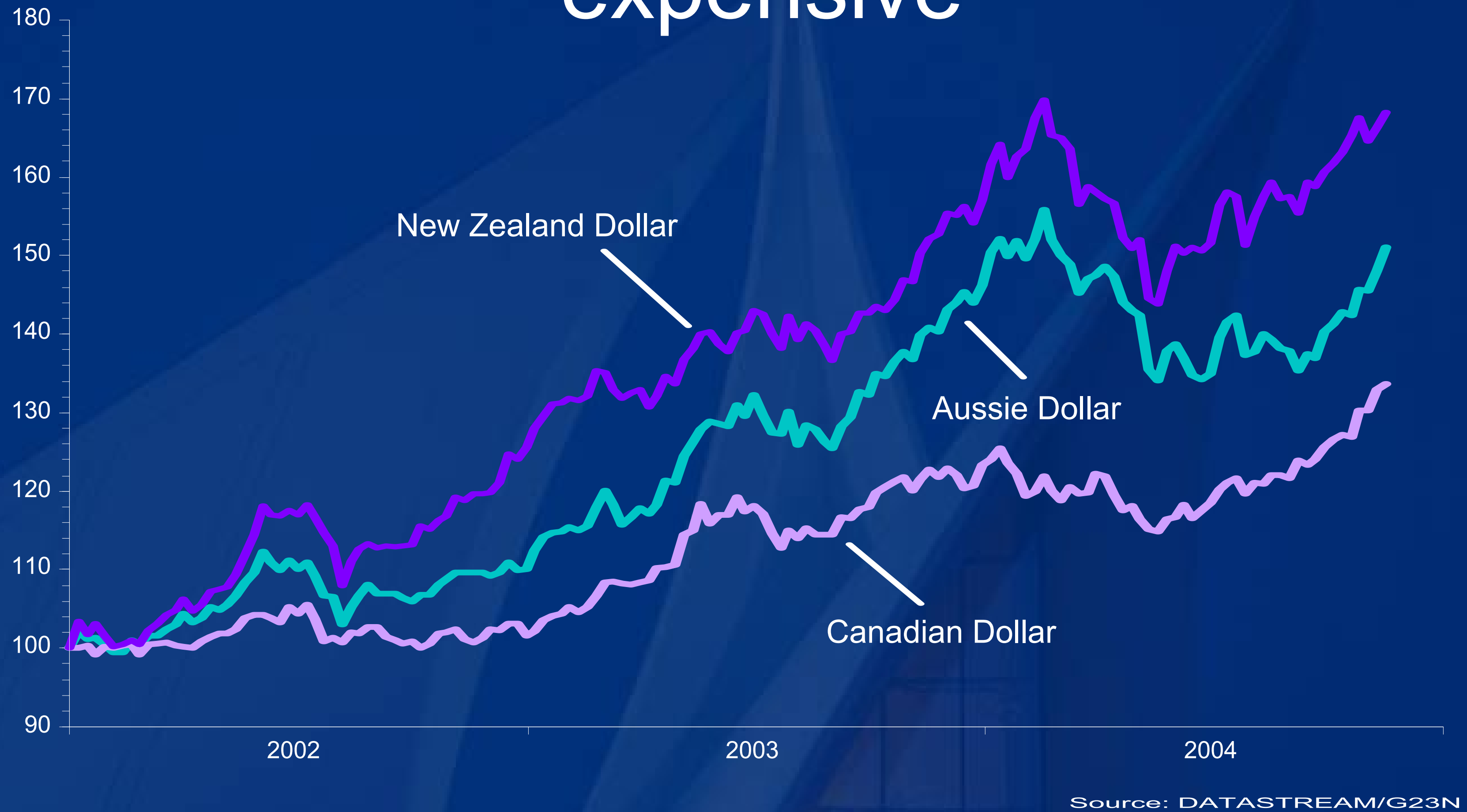
Source: DATASTREAM/G1LI

Forecasts: in 3 months: 1.80, in 12 months: 1.86. Sterling should eventually weaken a little more against the euro as UK GDP growth stays on a slower track. EUR/GBP forecast: in 3 months time: 0.70; in 12 months: 0.71.

Yen: still cheap compared to other majors

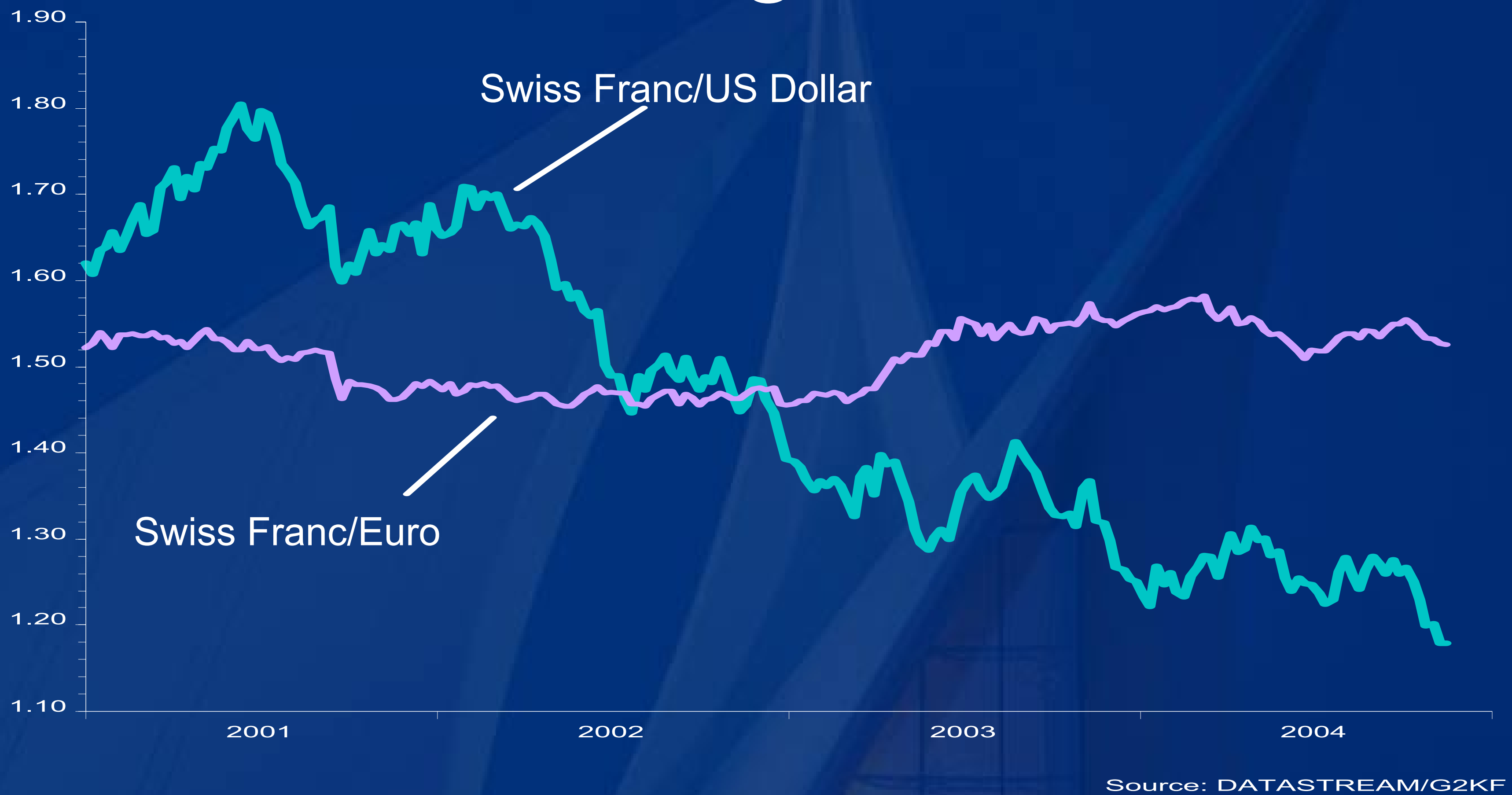
Forecasts: in 3 months: 108; in 12 months: 102. Japan's upswing looks durable, Japanese equities should also move higher, and China should allow the CNY to revalue. But BOJ intervention will limit further appreciation.

AUD/NZD/CAD: all look too expensive



The CAD looks the least vulnerable, the NZD the most. The RBA will probably raise rates again in early 2005, but the yield differential with the US is likely to narrow, taking the AUD weaker: 0.75 in 3 months, 0.73 in 12 months.

Swiss franc: even stronger, long-term



Forecasts: in 3 months 1.21, in 12 months 1.14. The low relative yield should take the Swiss franc weaker against the euro near-term. But the Swiss franc should benefit from euro strength over 12 months. CHF/EUR in 3 months: 1.53, in 12 months 1.51.