

Currency Wars

The Managing Director of the International Monetary Fund has recently expressed concern about a potential "currency war".

Dominique Strauss-Kahn believes that many countries are using their currencies as a "policy weapon", which he feels would be a serious risk to the global recovery.

Major currencies are in a "race to devalue", hoping that a lower currency would reduce their debt problems and make exporters more competitive.

What are the benefits of a low currency?

One of the issues affecting European nations like Greece, Portugal and Ireland, is the fact that they do not have their own currency.

The value of the Euro is kept high by the stronger northern European nations like Germany. If the southern European nations had their own currencies, these would be worth much less than the Euro is currently worth.

A lower currency effectively reduces the amount of debt in the eyes of foreign investors, easing their problems.

For example, if £1 was equal to 2 US dollars, then £100 billion of UK debt is worth \$200 billion. However, if the exchange rate was \$1.20 to the pound, then that £100 billion of debt only looks like \$120 billion to a US investor; much less of an issue.

In addition, exporters do very well if the currency is low, since their goods can be made much more cheaply in the eyes of a foreign investor.

The Chinese have become one of the world's biggest exporters. The Chinese government keep the value of the currency artificially low by using their massive trade surpluses to invest money in other currencies, such as the US dollar. The Americans are annoyed at this, feeling that it means their companies cannot compete with Chinese companies.

The IMF is concerned that this row could pose a risk to relations between the two countries. Trade between the US and China is seen as vital for the global recovery.

"A lower currency effectively reduces the amount of debt in the eyes of foreign investors.."

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Japanese Yen

A high currency value can cause real problems to an economy if it is reliant on exports.

The Yen has recently hit a 15 year high compared to the US dollar. As a result, Japanese goods have become more expensive to buyers outside the country.

The Japanese government have recently intervened in an attempt to lower the currency's value against the US dollar. They have also announced they plan to carry out up to \$60 billion of "asset purchases" (similar to Quantitative Easing in this country) with the aim of stimulating the economy and returning inflation to positive territory. They hope this will weaken the currency.

Japanese Equity Investments

Currency issues can have a massive effect on equity investments.

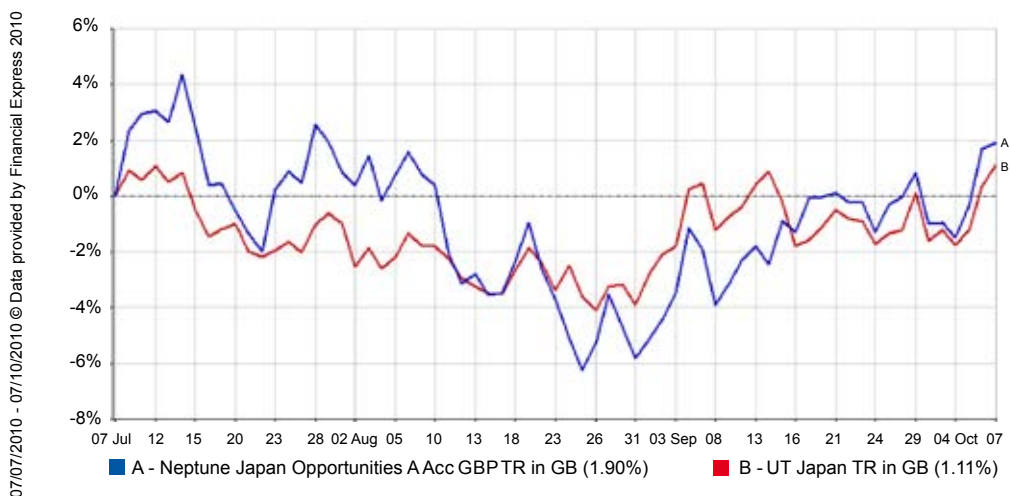
Despite domestic issues there are some fantastic global companies listed in Japan, where most of their sales are made overseas. However, the high currency is causing big issues and hampering returns.

One fund we use for our Japan exposure is the Neptune Japan Opportunities fund.

Fund manager, Chris Taylor, has been hedging the returns back to Sterling for nearly a year in the belief that at some point the government would have to intervene to reduce the currency's value. Taylor argues that this is essential in order to raise Japanese corporate profits and therefore the tax revenues of the government, and also to raise full time employment.

This currency position has led to underperformance of the fund since we bought it last year. However, the consensus amongst fund managers was not only that Japanese companies do offer excellent value, but also that the Yen had to fall at some point before their shares could start to perform. We felt that if all these fund managers were right, Neptune ought to outperform any fund that was not hedging currency.

Though it has taken longer than anticipated, Taylor's positioning is now starting to pay off and the fund has moved upwards by almost 9% since the government intervention:



As always, when we buy funds our intention is to hold them for the long term. However, we will not hesitate to sell a fund if we disagree with the manager's positioning, even if the fund has performed well in the past. Equally, we are happy to back a skilful fund manager through periods of underperformance, provided we understand the reasons and agree with their outlook.

Diversification

Currency movements are notoriously hard to predict, which is why trading is often referred to as currency speculation!

We believe in diversified portfolios, investing in a number of asset classes. Having investments across a broad range of currencies helps this process, as it reduces correlation between markets. Regular rebalancing ensures we sell high and buy low, not just assets, but currencies.

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Market Views | October 2010

General Economic Overview

GDP growth is expected to be muted but positive. There is the possibility of more quantitative easing (QE) in the UK and the US which could boost all asset classes.

Core inflation is expected to fall but the headline numbers may increase when the VAT changes take effect in January. Inflation could become more of a concern in the long term. We believe interest rates will remain low throughout most of 2011.

Asset class key

+ positive

- negative

= neutral (normal behaviour)

+5 strongly positive

-5 strongly negative

Equity Markets

Equities are now looking fair value based on current earnings. However, earnings continue to be revised upwards and if next year's projections are correct there is still some scope for reasonable growth. However, after the large moves we have seen in the past month we are not as positive as we have been.

We believe that high quality, internationally focused companies should outperform as they have not seen the same growth as poorer quality stocks.

Outlook

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Fixed Interest

Gilt yields remain very low, making corporate bonds look attractive in relative terms. However we do not believe this is sustainable in the long term, even with further QE, and a fall in gilt prices would have a knock on effect on corporate bonds. In a low interest rate, low inflation environment, fixed interest still looks reasonable value. However, we are now slightly negative over the next 18 months after seeing such strong returns recently.

-1

Commercial Property

The rental yield on the commercial property index remains very attractive relative to other asset classes. However, we expect overall returns to cool after a decent recovery phase and we don't expect much capital growth over the next 12 months.

Property funds are sitting on high cash levels which is a drag on returns.

-1

Residential Property

We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.

-5

Cash

With interest rates remaining at record lows, returns on cash are as low as they have ever been, and we don't see that changing for some time.

-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.