

THE 'CRISIS' IS BEHIND US

By Kit Juckes, The ECU Group plc

The world is not back to 'normal' but it is in a lot better shape than it was at the start of 2009. The worst financial crisis and subsequent recession since the 1930s has not turned into a repeat of the Great Depression, and for that we can thank the exceptionally aggressive response from the world's central banks, led by the US Federal reserve. Mind you, the Fed must accept a huge slice of responsibility for getting us into this mess, with ludicrously accommodative monetary policy early in this decade. Let's also not forget that the 'cure', which helped to avoid economic Armageddon, has involved pumping vast amounts of liquidity into the global economy and saddling governments with huge debts.

'Reflation' is the name of the game and with fiscal and mone-

tary policy as helpful as possible, inventory levels far too low for any kind of revival in demand and falling prices giving some support to household incomes, the economic data can continue to flatter. Longer term, there are multiple threats to this recovery and that is why policy-makers and economists are so quick to warn that 'it will be different this time' and that the rebound will be very gradual. Governments need to raise taxes and cut spending in order to reduce gargantuan deficits, households need to continue to reduce debt levels and the corporate sector is still fighting loan-shy banks.

All of that is for the long term however. Right now, one striking feature of this economic recovery is just how synchronised it is. There was talk of 'decoupling' between the major

economies before the 2008 crisis and there has been more talk since about who would recover first, who would lead and who would lag. But in reality, the economic impact of a sudden and dramatic freezing-up of bank lending and capital flows that followed the collapse of Lehman, as well as the destruction of US demand that was triggered by the collapse of the US housing market, hit everyone at the same time. As US housing has stabilised and as central banks work to restore order to the banking system, everyone benefits together. So all indicators of orders, and of business and consumer confidence, as well as any other leading indicators of future economic activity, are pointing towards a significant improvement.

Another major characteristic of the cycle has been the collapse

of that most out-dated economic indicator, the velocity of money. The velocity of money measures the ratio of GDP, the output of the economy, to the money supply; i.e. how many times money circulates to generate growth. Very fashionable when money supply targeting was in vogue, it is a somewhat forgotten indicator, but it has collapsed over the last year in many major economies (see Figure 1). That reflects a huge injection of money by central bankers, which has not caused a corresponding increase in economic activity because money is increasingly hoarded by under-capitalised banks, over-leveraged households and fearful corporations. Why does this matter? It matters because until central bankers can get the money they inject into the financial system to move

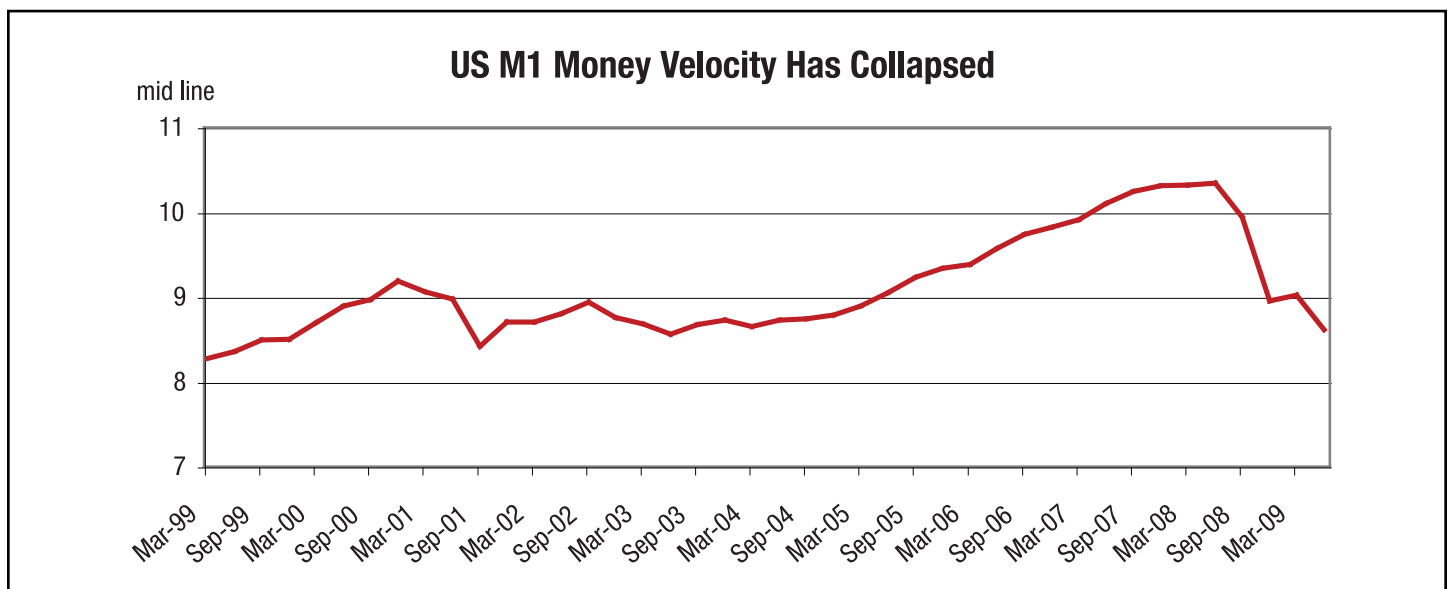


FIGURE 1

around it more productively, they will continue to err on the side of further policy accommodation. That is, rates will stay low, quantitative easing tactics (the central bank directly buying securities from the banks) and other alternative policy measures, will continue. And, if they don't work (i.e. if NOTHING makes the banks lend and the people and companies borrow), we will be back talking about the Great Depression mark II). And if it does work – if the huge amount of money washing around the system does start to have to take effect economically – the central banks will need to be prepared to act quickly to mop it up, unwinding extraordinary measures and raising interest rates sharply. In short, the exceptional collapse of money velocity provides us with an unusual amount of volatility and uncertainty in the future. That is why there are opposing armies of economic commentators who are betting on permanent recession, rapid recovery, deflation and inflation.

Central bankers are still committed to reflation at almost any price, in order to avoid disaster, and, as a result, there are there are signs of improvement in financing. The outright yield on the iTraxx Crossover index, a basket of 50 5yr credit default swaps with ratings averaging BB, rose from 8% to a penal 14% during 2008. Investors were not interested in taking on credit risk at any price and for borrowers, even the 14% yields on the

CDS index was largely illusory as the ability to borrow money all be evaporated. With rates staying low and spreads falling, the yield on this index has now fallen below 9% and public debt markets are increasingly 'open for business' as investors search for yield. This in turn can open the way for increased corporate investment and a recovery in M&A activity, which has not altered the fact that bank lending remains very restricted, and this summer has seen further reductions in outstanding consumer credit in the US and UK. Small and medium-sized businesses which depend on bank lending rather than public debt markets are also still finding funds very hard to come by – adding further to the need for interest rates to stay low. However, lower corporate yields, increased new issuance volumes and a recovery in M&A are all clear signs that credit conditions are slowly beginning to improve.

A gradual thaw in lending conditions raises three major issues for borrowers. The first is what to do about the duration of borrowing when rates are at historically unprecedented levels. The second is what to do about the currency denomination of debt. The third is what to do about debt levels given that a reasonably lengthy period of low rates will surely be followed by a very sharp rise when the all clear is sounded and policy-makers try to return to 'normal'.

Rates in the European swap markets range from 0.8% for 3-month money, through to 1.7% at 2yrs, 2.75% at 5yrs, and 3.6% at 10 years. For now and for months to come, rates will remain on hold and the case for remaining in floating rate debt will be pretty strong. However, because the price of re-liquefying the global financial system is a huge increase in outstanding money supply, it is likely that the 'exit strategy' from current extraordinary policy will involve a very sharp increase in rates, when they do start to go up.

Borrowing in foreign currencies has long been an attractive way for the shipping industry to reduce funding costs and reduce debt. Since the start of the 1990s, 3-month Libor rates have averaged nearly 4 1/2% less in JPY than in USDs. That's a monthly interest bill (for anyone lucky enough to borrow at Libor!), which was 1_ times larger in USD as in JPY. Sounds good but over the same period, the USD has fallen from USD/JPY 143 to 92, increasing the USD value of any JYP debt by 55%. That eats up a big hunk of the interest rate improvement achieved with a JPY debt. At the moment, interest rate differentials between currencies are as narrow as they have ever been – all central banks having cut rates to unprecedented levels. But that won't last forever, and indeed as economic recovery is seen, it won't even last for very long. Consequently, taking advantage of

low borrowing costs is going to be extremely attractive again going forwards, while the need to manage the foreign exchange exposure will also remain paramount.

The difference between managed multi-currency debt, and straightforward single foreign currency debt, is that the objective of a managed multi-currency debt strategy is to reduce the size of a liability, as well as to reduce interest costs. In the current climate, with a sharp rise in interest rates likely in due course, but not for the next year at least, the need to reduce debt levels is clear. Whatever currency a debt is denominated in, interest rates will be low for the next year or so, but not for much longer than that.



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ECU was founded in 1988 and is the UK's leading multi-currency debt manager. The company pioneered the concept of multi-currency debt management in the UK, and now offers a range of currency programmes (USD, EUR & GBP benchmark) to companies and private clients for managing multi-currency loan facilities and margin foreign exchange accounts. www.ecugroup.com