Alford Associates, Inc.
217 East Road
Alford, Massachusetts 01266 USA
telephone 1-413-232-3146
email special@alfordinc.com

Independent Research Providers to the Professional Investment Community

January 2009

Special Report

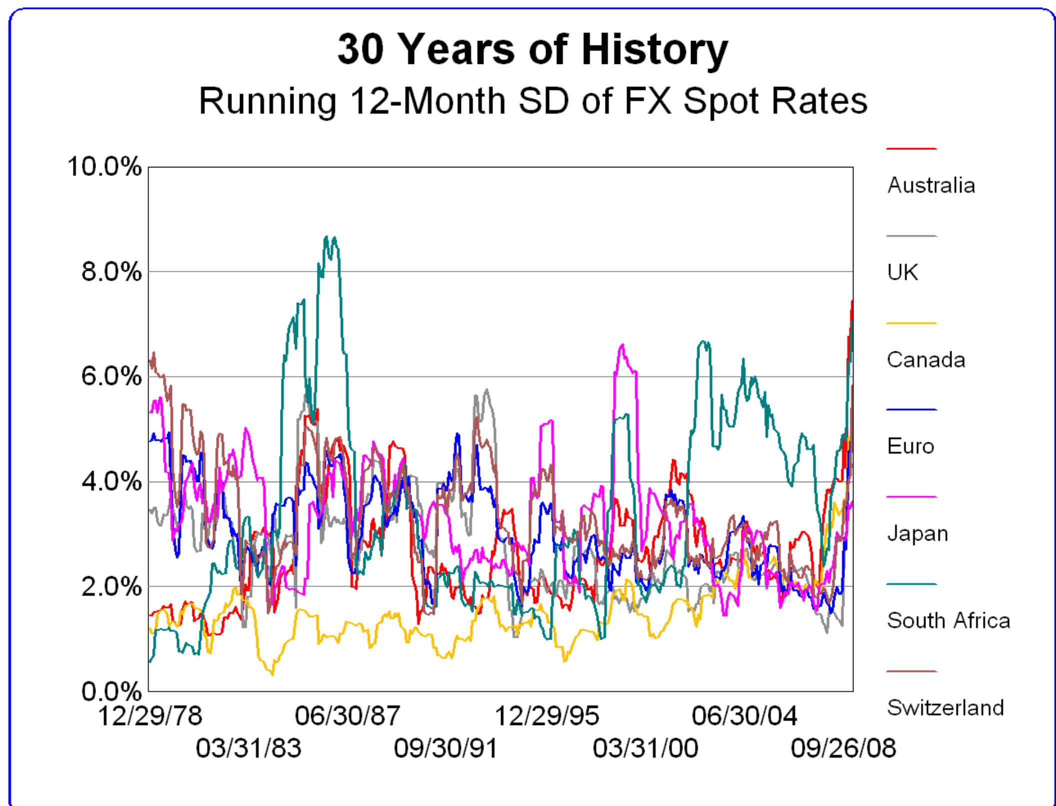
The Impact of Uncertainty

Risk Aversion, Volatility, Flight to Quality and All That

No investor, with the possible exception of Rip Van Winkle, needs to be told that we are living in a period of high volatility. Our purpose here is to put recent FX experience in the context of historical experience, and to comment on why the dollar has done well in this period (and how long its rally might continue).

First, let's take a look at a long (30-year) history of volatility of dollar cross rates. Pardon the spaghetti-like appearance of this chart, but a couple of general points can be made before taking a more focused look at a shorter (10-year) period (next page).

Observation number one is that, although the rand has, on average over this period, been the most volatile of the currencies on the chart, it has by no means always been at the top of the rankings in that regard. Every other currency (except for the Canadian dollar) has had that distinction at one time or another.

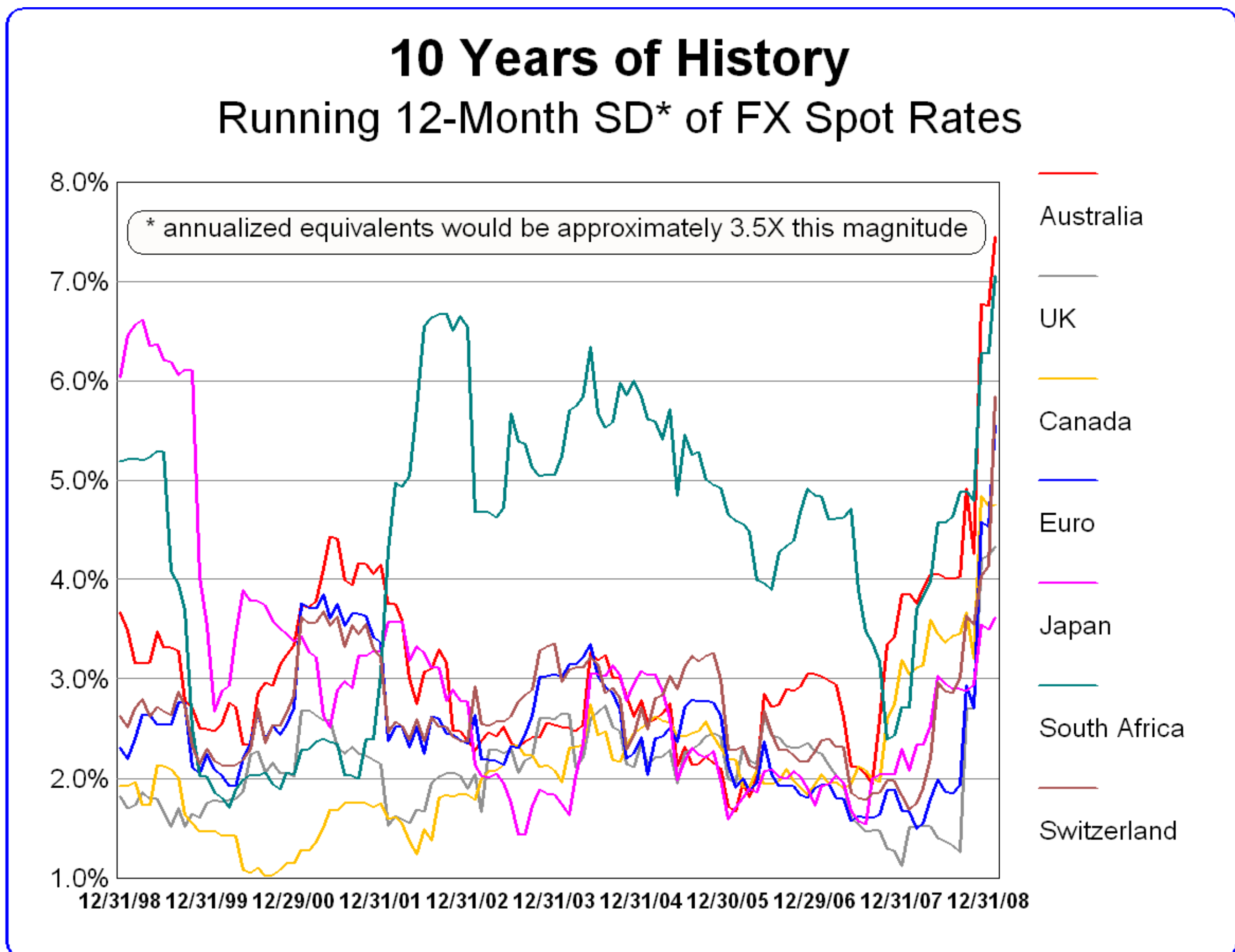


Two, ignoring the recent flare-up in the rand, it's pretty clear that we've been going through a period of historically low volatility over the past few years.

As a cautionary reminder, the level of volatility in a currency says nothing about either the direction or magnitude of its change in value. The euro, for example, has enjoyed very low volatility over the past few years, at a time when it doubled in value from its low point. It moved up in dollar value very slowly and steadily, for the most part, until quite recently, when it became more volatile, and also lost part of its gains.

Our measure of volatility here, by the way, is the standard deviation of spot rate changes (no allowance is made for carrying costs), measured monthly (at month-end), and calculated over a 12-month moving window. We use this relatively short window because it shows changes in behavior quite quickly, such as the recent run-up in the variance of just about every currency. A longer window (such as the more traditional 60-month look) would show the same general pattern, but would be considerably smoothed out. [NB: these are not annualized numbers*]

Here, then, is the promised 10-year view, which gives a better opportunity to see recent trends relative to the past few years.

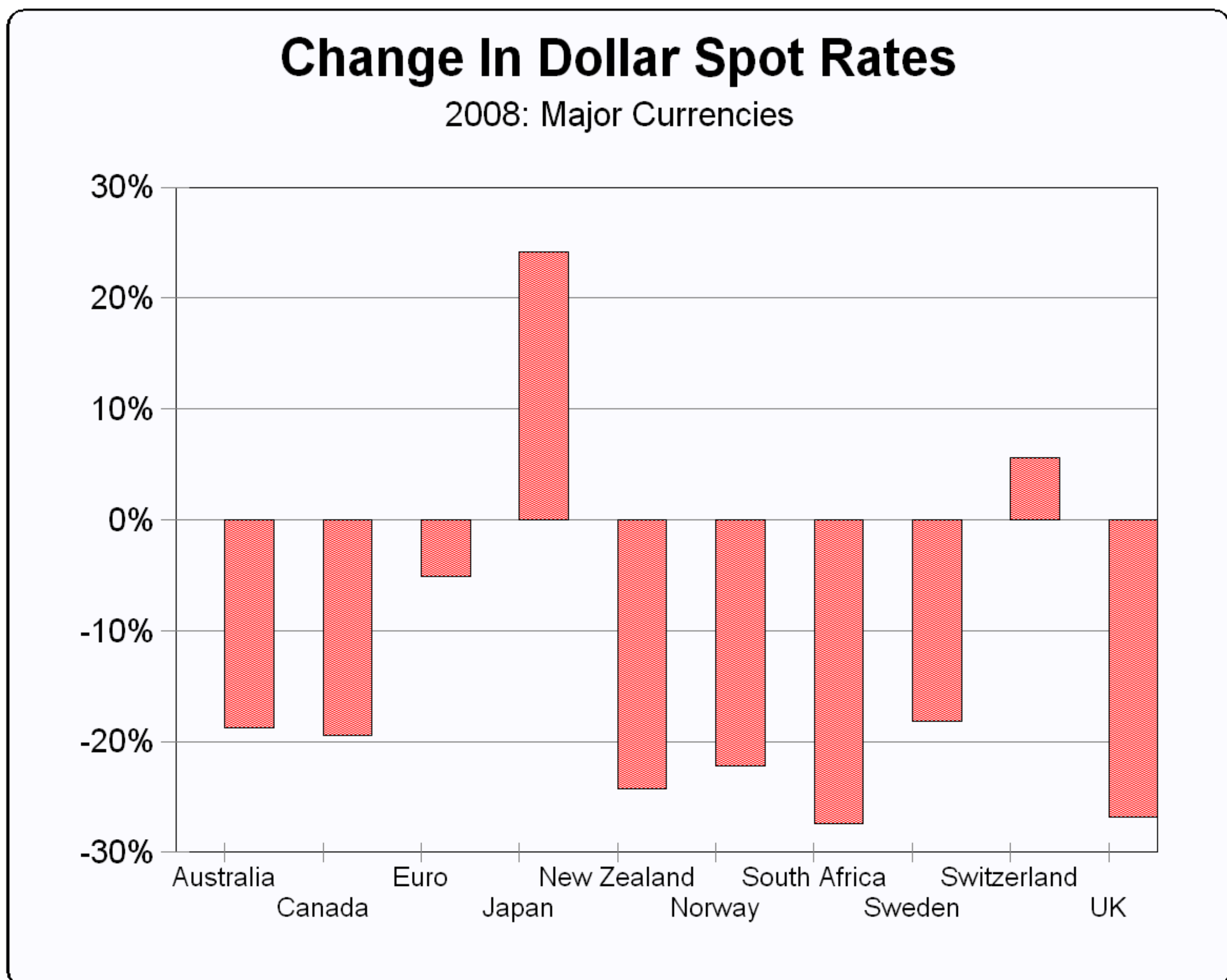


Of all the currencies shown here (which were arbitrarily selected as being representative), only the loonie has shown a (slight) downturn in volatility over the past couple of months.

These two charts make it clear that we have returned to high, though not unprecedented (except for the Australian dollar) levels of volatility in FX rates.

Looking Ahead — What Does This Mean for the Dollar?

As uncertainty has increased during the recent global downturn, as reflected in the FX volatility shown in our preceding charts, the dollar has moved higher. This was a rather predictable response on two counts. One, the so-called "carry trade" stopped being the no-brainer it had been during the prior extended period of low volatility. It had been possible to borrow at low (next to zero) interest rates in yen or Swiss franc, for example, and to loan out securities (or bank deposits) in higher-interest-bearing currencies, such as the Australian dollar, the pound, or even (for a time) the dollar or the euro. And, as long as the exchange rates between these pairs of borrowing and lending currencies remained fairly stable (i.e. within the interest rate spread), it seemed like a pretty riskless way to make money. That, obviously, is no longer the case, so that much, if not nearly all, of the money that was tied up in that strategy was switched back into the original currency. That means that there was high demand for yen and francs and negative demand for the high-interest-rate currencies. As a result, take a look at what happened for all of last year. Here is a chart of FX changes during 2008, relative to the dollar:



© 2009 Alford Associates, Inc.

Notice that only the yen and the franc outperformed the dollar last year (again, this chart does not include any allowance for carrying costs, but as can easily be seen, those costs would be quite small relative to the moves of most of the currencies). This brings us to our second point of why the dollar outperformed all of the other currencies (and, to some extent, the yen and franc may have benefitted from this factor as well). It's the old "safe haven" play. As the expression goes, when the US catches a cold, the world gets pneumonia. Despite (or perhaps, in some ways, because of) increased global linkages in economic activity, no country is immune from the turmoil set off in the US. Not that the States were alone in committing the blunders (some would use stronger words!) that led to the bursting of the real estate bubble and meltdowns in the financial markets.

Still, the dollar remains the world's reserve currency, and the US treasury market is considered the safest in the world, so in times of doubt, that is the place investors park their money, creating great demand for dollars, despite their low current yield.

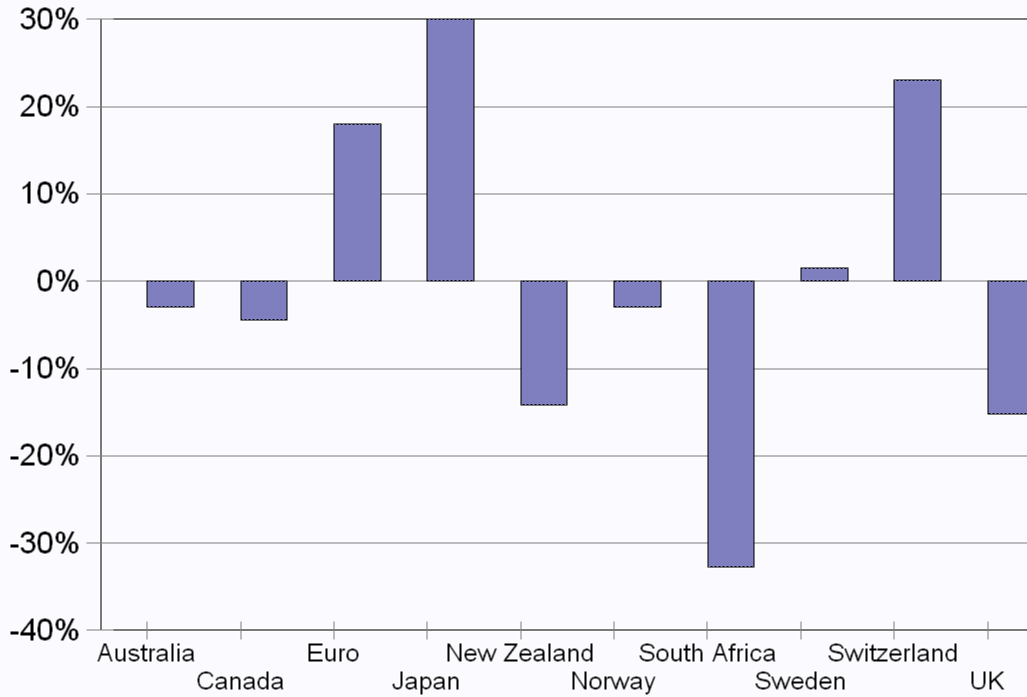
What can we expect over the next few weeks and months? We have been calling for near-term strength in the dollar for some time now, and that has come to pass. For how long will it continue? Well, of course, that is an unanswerable question, but our current near-term (one- to three-month) forecast gives about an 80% chance to that trend continuing over at least that length of time. Our hunch is that it will go on a bit longer, but the ultimate turnaround (and we remain bearish on the dollar longer term) will depend on the shape and timing of the recovery in the global economy (don't hold your breath, is our current advice).

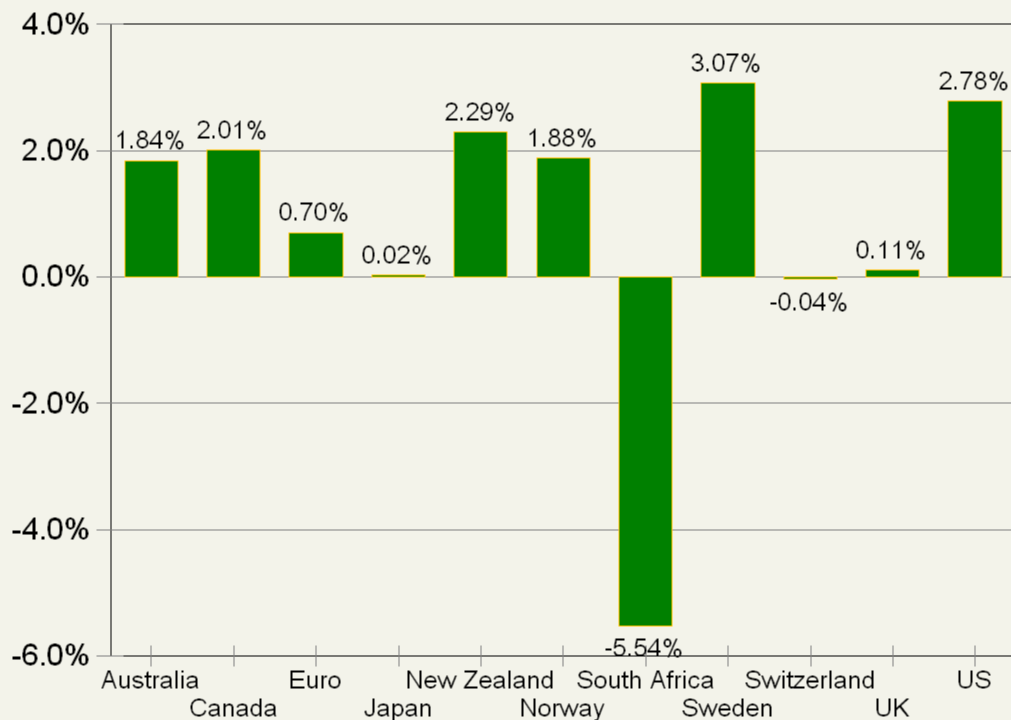
Over the entire course of 2008, we had been bearish on the dollar (short term) in the early part of the year, and that served us well until it didn't. We ended the first half of the year with a 6.8% annualized rate of return in our paper portfolio (details of which are available in any one of our weekly reports), which, by coincidence, was the long-term (10-year) track record of this portfolio as of the end of 2008, but the performance started to flag in August, as our forecasts adjusted to the new reality, and we switched to a bullish short-term view on the dollar by late summer. We ended the year with a one-year performance of 26.2%, obviously well above average, reflecting the fact that we essentially called for the results that you see in the chart on the previous page.

Taking A Longer View

We finish up with a few graphics that take a longer view of history and try to explain two other factors that may have been at play here (other than the ones mentioned already). Of course, there are many, many other economic realities that affect FX rates that we will not touch on here, such as inflation, the price of oil, GDP growth, and a host of others. We will confine our look to real interest rates and to valuation (which, indirectly, is inflation, insofar as it impacts the measure of economic valuation that we calculate).

The two charts on the next page are related. They don't cover the same currencies, but they make two points. One is that taking a 3-year view (top chart) shows that the dollar has not been nearly as dominant over that whole time frame as it was in 2008. The second point is that real interest rates (not surprisingly) might very well explain at least part of the differential performance. We let the reader be the judge.


3 Year Change In Dollar Spot Rates
2006-2008: Major Currencies
30%
20%
10%
0%
-10%
-20%
-30%
-40%
Australia
Canada
Euro
Japan
New Zealand
Norway
South Africa
Sweden
Switzerland
UK

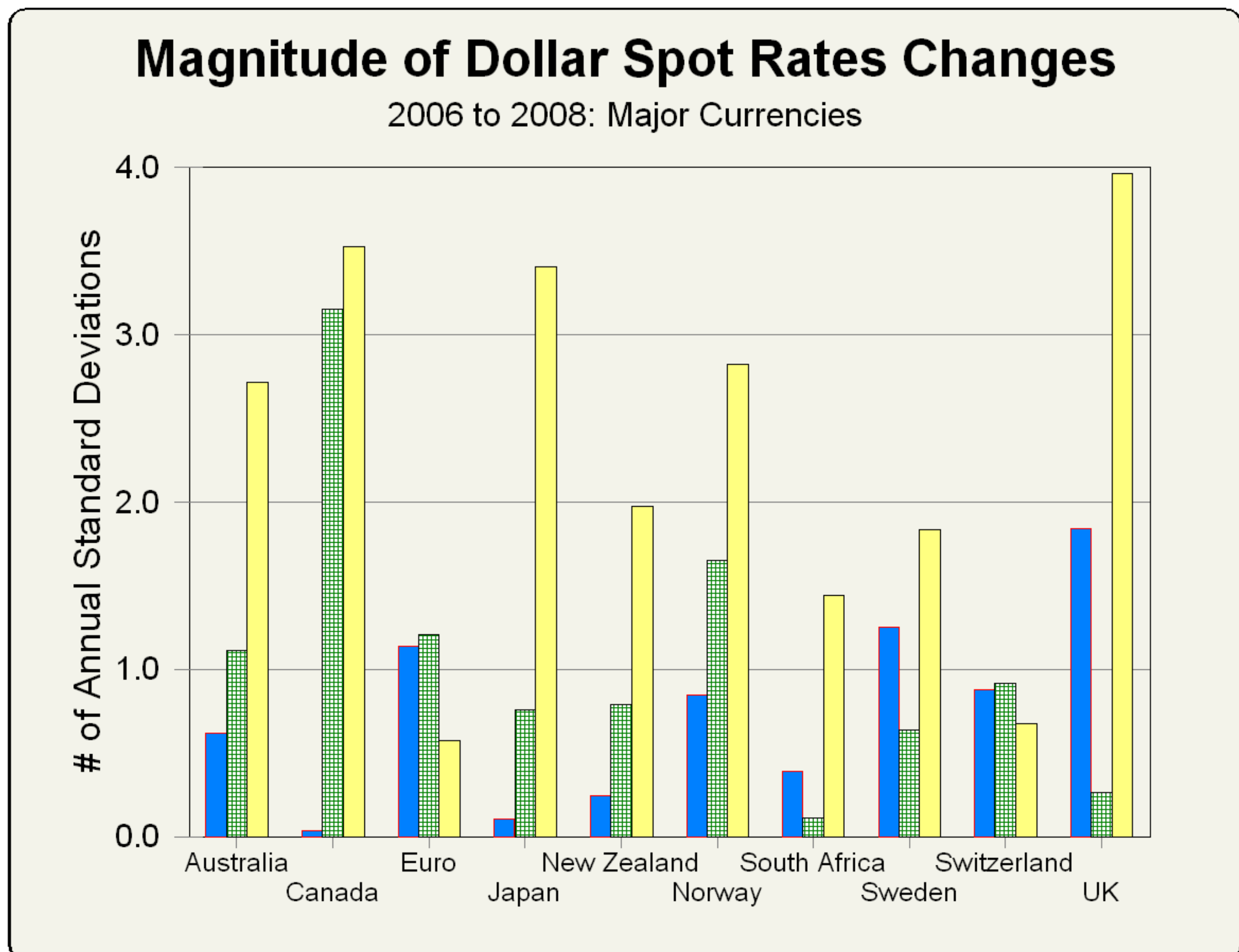

Real Interest Rates
End of 2008
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
1.84%
2.01%
0.70%
0.02%
2.29%
1.88%
-5.54%
3.07%
-0.04%
0.11%
2.78%
Australia
Canada
Euro
Japan
New Zealand
Norway
South Africa
Sweden
Switzerland
UK
US

More Historical Perspective

We have four more graphics to share, and they are fairly self-evident (we hope), so we will simply make the point that, although recent months may have seemed (and, in fact, were) in many ways unprecedented, they have not taken us to a place we've never been before. As a result, we can have some confidence that the Laws of Markets (whatever they are!) have not been suspended, and that careful analysis can still bear fruit.

So, here, in closing, are those graphics, with short explanatory commentary. Stay tuned to our weekly commentaries for how things are shaping up in our forecasts; we have no reason to believe that our methodology has been invalidated by recent extreme events — if anything, this seems, to us, like a time to be even more disciplined than ever.

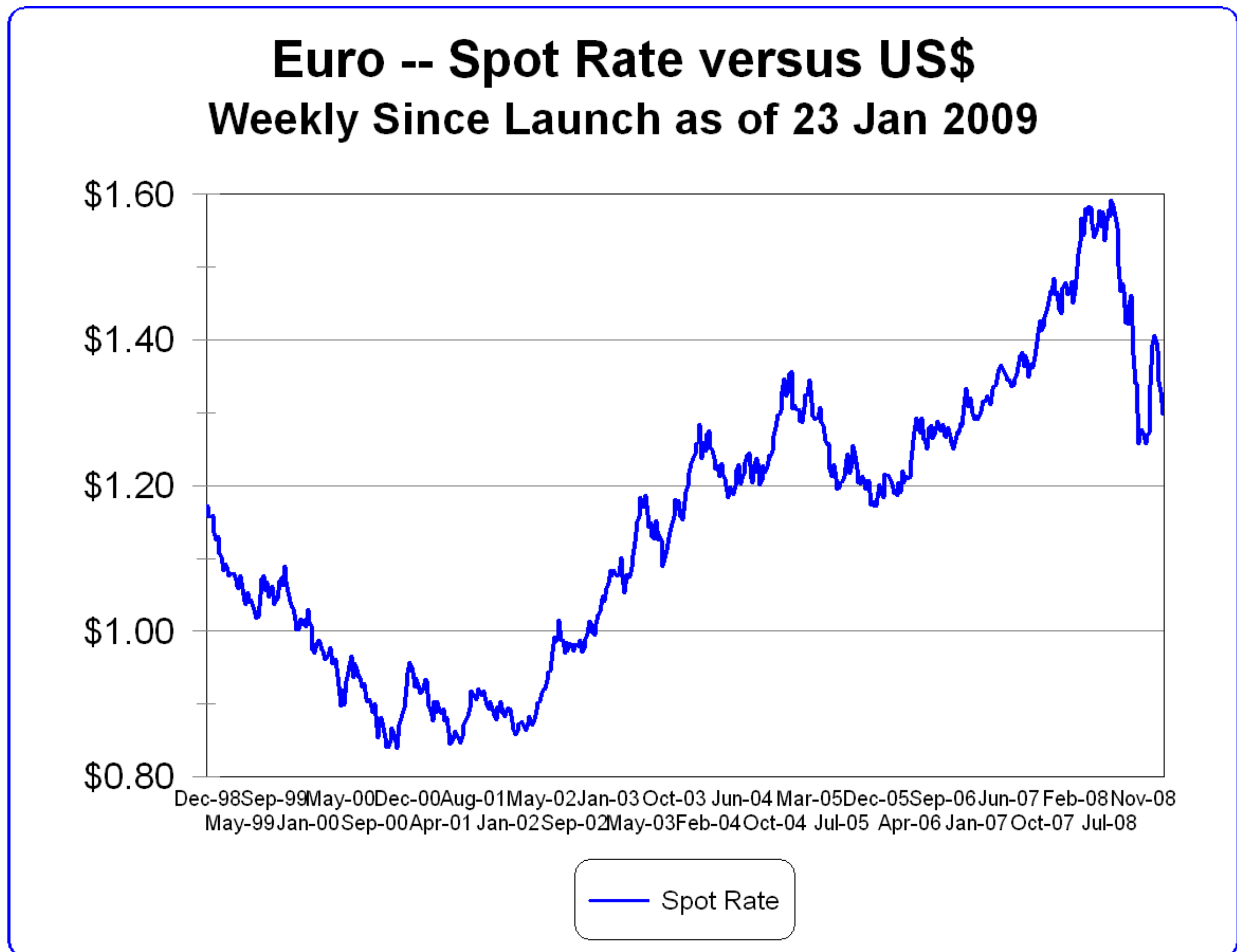
Our first chart some of our readers may have seen already, since we did publish it previously. It makes the point that the most recent year has been highly volatile (no surprise there!) as measured by standard deviation units. Each currency has a bar for 2006, 2007, and 2008. In most cases (the euro and the franc being the



exceptions), the 2008 bar is the highest. Our unit of measure is monthly changes in the FX dollar cross rates, and our base for comparison is the 60-month period

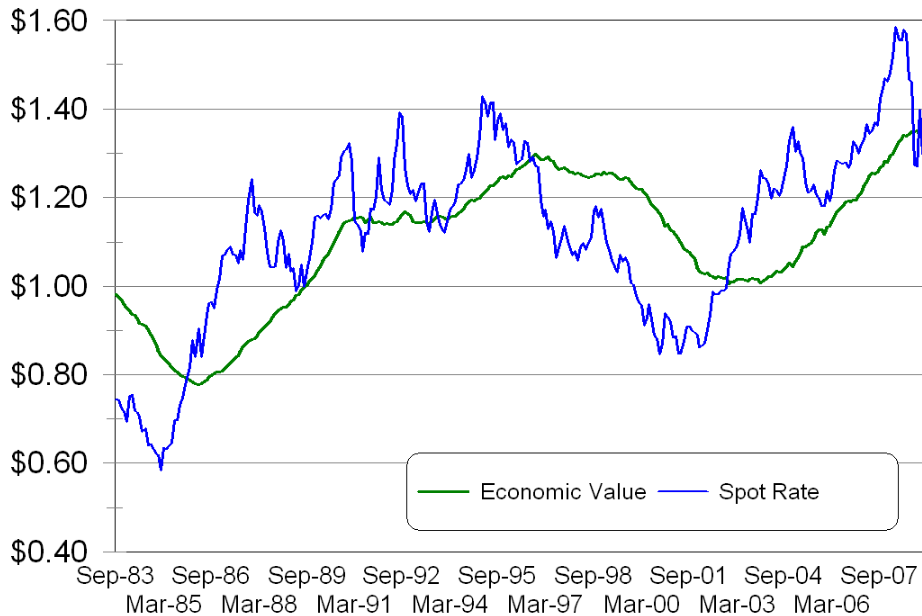
preceding the start of each year. If we had used a longer base period, the results would not have been as dramatic, since the low volatility in the first two years contributed to making 2008 look more volatile than it would in a longer historical perspective. Still, sometime being dramatic can drive home a point, even if it isn't the best approach from the purist's point of view.

The next graph puts forth the history of the euro's pricing in dollar terms since its official launch. It started out at just under $1.20, fell to almost 80¢ in the early 1990s, nearly doubled, to almost $1.60 fairly recently, and has now fallen back to about $1.30, not too far from where it began life. A lot of profit opportunities for traders, but not exactly an earth-shattering buy-and-hold investment!

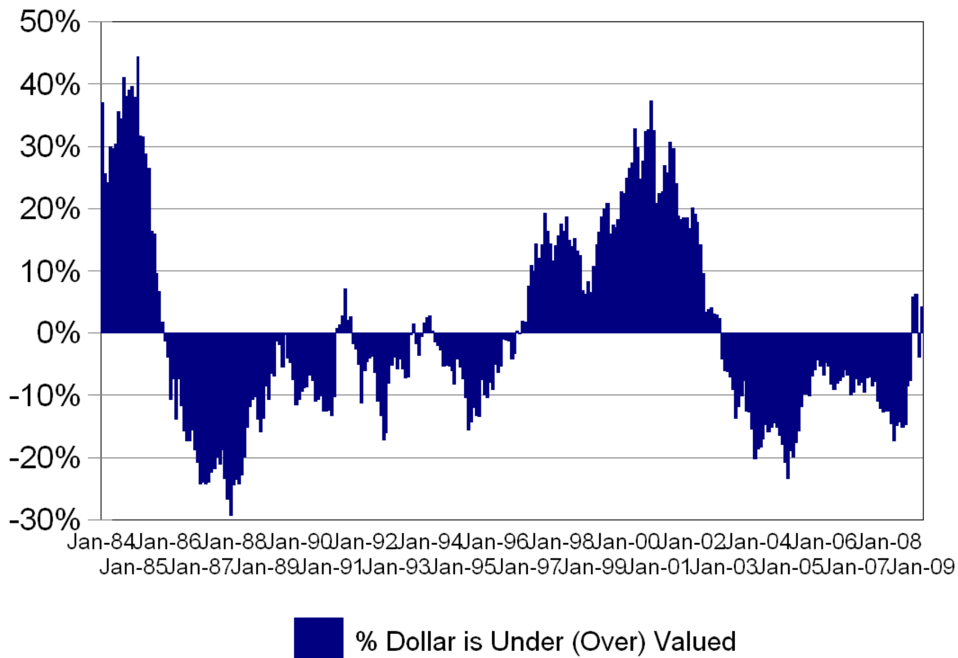


Taking a longer view (and using the DM as a proxy for the euro prior to 1999), we can see (on the next page) that the recent run-up was a blip, and the current level is well within historical ranges, both at an absolute level and when compared with our calculation of its fair value (what we call "Economic Value" — which is essentially a PPP calculation, but we don't want to call it that because there are so very many ways to calculate that, we don't want to mislead).

In other words, there's nothing in this chart that inherently tells us what to expect. A retreat from an historic high might, in retrospect, seem quite predictable, but we are no longer there, so, stay tuned, as we said.



Our final chart takes the information on the chart above and translates it into a difference. In other words, in measures the extent of over- or undervaluation of the dollar, based on our calculation of the euro's fair value, and expresses it in percentage



terms. By this measure, we're right in the middle of historical experience, and there is little reason to think that the past helps us predict whether the next move will be up or down. Again, stay tuned; our future forecasts will be very dependent on how the global economic picture unfolds in coming weeks and months.

This report was prepared by
Michael F. Wilcox, CFA
michael.wilcox@alfordinc.com

Additional information is available upon request. Send email to:
moreinfo@alfordinc.com

Important Disclosure

This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete. Certain assumptions may have been made in this analysis which have resulted in any returns detailed herein. No representation is made that any returns indicated have been or will be achieved. Changes to the assumptions may have a material impact on any returns detailed. Past performance is not necessarily indicative of future returns.

The foregoing has been prepared solely for informational purposes, and is not an offer to provide investment research, consultation, or advisory services. Alford Associates, Inc., its employees and affiliates may have positions in, and may effect transactions in securities and instruments relating to the currencies mentioned herein and may also provide significant advice or investment services to clients who trade in such securities and instruments.

The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors.