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Japanese Tsunami Rolls Across Global Economy

Market Highlights:

- Economic Risks Weigh on Currency Markets
- Tertiary Effects Felt
- Canadian Dollar Loses Momentum
- European Negotiations Boost Currency

Economic Risks Weigh on Currency Markets

The aftereffects of Friday's Japanese earthquake continued to be felt across the foreign exchange markets over the weekend, with trading dominated by a generalized flight-to-safety impulse. The US dollar, Japanese yen and Swiss franc played their traditional safe haven roles, while the Aussie, Kiwi, and British units traded on a weaker basis.

The Japanese yen saw extremely volatile trading, as investors initially sold the currency in fear, bought for safety, and then attempted to square off their risk exposures in the event of further moves. The Bank of Japan expanded its asset purchase programme, announcing that it would pour 15 trillion yen (approximately $183 billion USD) into the markets in an attempt to bolster confidence and stabilize markets. The central bank also indicated a willingness to step into the currency markets to weaken the yen's value in the event that it rises too quickly.

With large parts of the world's third largest economy knocked temporarily offline, investors are growing increasingly nervous about the impact that may be felt in other major economies around the world. Japanese companies are integral parts of the global supply chain, meaning that disruptions may be felt in a number of advanced industries as component shortages affect production. Many large firms, including Sony and Toyota, have announced plans to shut down some of their Japanese operations for a brief period, transportation infrastructure has been devastated, and rolling blackouts are weighing on manufacturing throughout the country. The possibility of further problems at one of the damaged nuclear plants is an additional economic risk.

Tertiary Effects Felt

There are a couple of second-tier consequences being felt in the currency markets.

The possibility that large insurance payouts will be triggered is exerting downward pressure on the pound sterling, with the United Kingdom home to many of the world's largest reinsurance firms. Rumoured figures have already topped $34 billion USD, and there are many indications that these costs will rise.

High-yielding currencies such as the Aussie and the Kiwi are seeing sharp falls as speculators exit their carry trades. Borrowing in Japanese yen at low yields and lending into the higher-yielding Antipodean currencies became extremely popular in recent years as interest rate differentials widened. However, the inherently leveraged nature of the carry trade can mean that investors are vulnerable to terrible losses in the event that the yen rises in value - as it is doing now. As panicked traders buy yen to repay their borrowings, they cause a self-reinforcing market cycle to occur, pushing up the currency's value more quickly.

These secondary effects are likely to erode quickly as the global economy adjusts, but should be watched closely as they create short-term volatility. Whenever longer-term trends are reversed in the short term, attractive hedging opportunities are created.

Canadian Dollar Loses Momentum

The Canadian dollar has hit stubborn resistance around the 0.97 mark against the US dollar, failing to decisively break through over several consecutive trading cycles. Feeble domestic employment numbers released on Friday were instrumental in lowering interest rate expectations, and weakness across the commodities complex is weighing on Canadian dollar bulls. As protests in the Middle East fail to unseat governments and expectations of global economic growth are downgraded, commodity prices have lost impetus, and the crude oil price has slipped back below the $100 mark.

In a worrisome development, the University of Michigan consumer sentiment index took a dramatic turn for the worse in early March. According to numbers released on Friday, the widely watched indicator slumped to 68.2, from last month's 77.5 reading.

To some, these numbers will be taken as proof that rising oil prices are beginning to take a toll in the real economy. The oil price's 20% ascent over the past few months may be functioning as a psychological tax, making people less willing to spend. Given the US consumer's role in supporting Canadian exports, this may portend underperformance in trade numbers in the coming months. We will be watching these numbers closely in the coming weeks.

European Negotiations Boost Currency

European leaders delivered a positive surprise for the financial markets over the weekend by managing to achieve agreement on the largest components of a plan to reform the euro area and bolster the rescue fund. The currency rose against most of its major counterparts, moving up from sub-1.39 levels against the US dollar as sovereign debt markets appeared to stabilize and risk premia evaporated.

Politicians from the 17 countries that share the common currency agreed to expand guarantees against the European Financial Stability Facility, allowing it to lend up to 440 billion euros to struggling sovereign issuers - up from the 250 billion currently available. They also granted financial relief to Greece, lowering the interest rate charged on the loans outstanding and extending the repayment period four and a half years, Negotiations with the Irish were less successful, with newly elected Prime Minister Enda Kenny refusing to contemplate an increase in Ireland's corporate tax rates in exchange for improved rescue terms. Ireland has functioned as something of a corporate tax haven within the European Union for many years, and is reluctant to move closer in line with other member nations.

Policymakers also drew up an agreement to pursue greater harmonization of economic policies across the Union, including restrictions on government spending and limits on public sector wages. This agreement is non-binding however, meaning that the tough negotiation work remains ahead, along with the market's final verdict on the process. Meetings will continue, with a 'comprehensive package' of reforms due to be released on March 25th.

Political newsflow coming out of these negotiations is likely to dominate euro trading over the coming weeks, potentially driving exchange rate adjustments. Capturing the resulting opportunities is a matter of preparation – talk to your traders about the strongest strategies in this context. Happy trading!

By Karl Schamotta, Senior Market Strategist

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