

AQUILA FLASH



Aquila & Co. AG | 29. January 2018

The US-Dollar's current weakness doesn't mean that it can't fall substantially further

We present equilibrium or fair value exchange rate estimates for the world's four most important currencies. These purchasing power parity (PPP) estimates suggest that both the British pound and the yen are significantly undervalued. Despite the US dollar's current weakness the American currency still looks a bit overvalued to us. The Euro has room to move higher against the Swiss franc.

Long-term, currency movements are determined primarily by relative inflation rates.

Over long time periods relative inflation is the key determinant of currency exchange rates. If country A has a yearly inflation rate of 20% and country B has zero inflation then over time the currency of country A will fall on average around 20% per year against the currency of country B. In this way the competitiveness of high inflation country A is maintained against that of low or zero inflation country B. Were this currency adjustment not to take place country A could suffer a destabilizing loss of competitiveness over time.

PPP estimates give good indications as to which currencies are overvalued and which are undervalued.

One can calculate PPP rates on the basis that these are the exchange rates which over time will maintain a country's competitiveness. The usual assumption is that the real exchange rate stays constant, even if it is not exactly "1".

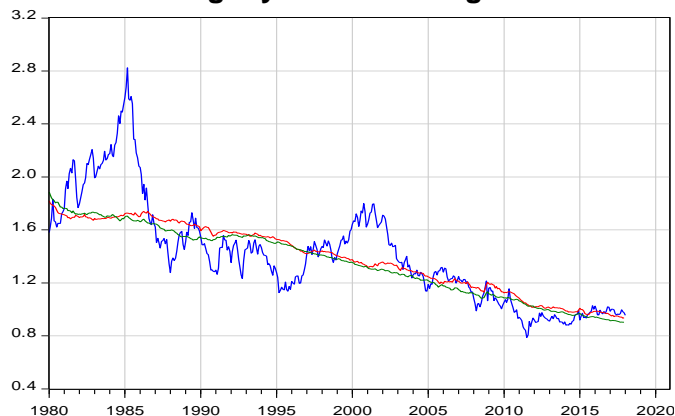
If a currency is markedly overvalued relative to PPP estimates, the price competitiveness of the relevant country will deteriorate, as goods abroad will be significantly cheaper than those in the domestic market. Demand for goods produced domestically will

decline while demand for goods produced abroad will rise, resulting in an increasing trade deficit. Very high external deficits – meaning a country imports far more goods and services than it sells abroad – are an indication of currency overvaluation.

Can you make money on the basis of PPP estimates?

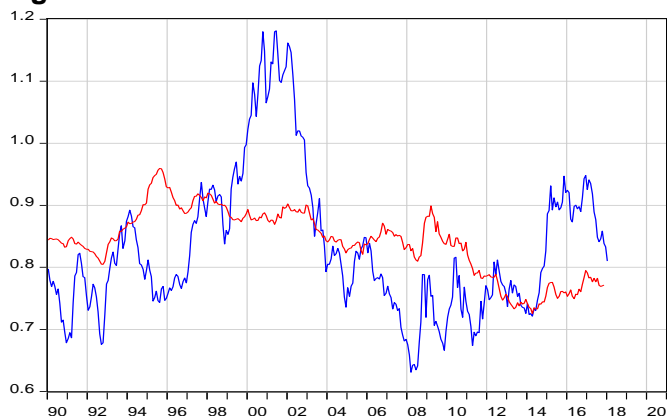
Long-term the answer is "on average, yes". But it is really only when there are large divergences between currency values in forex markets and PPP estimates that those PPP estimates are useful as an investment tool for trading currencies. Other factors are also relevant to investment success in the currency markets – momentum and the cost of carry or interest rate differentials. We will discuss these other factors in a later publication.

The USD is slightly overvalued against the CHF



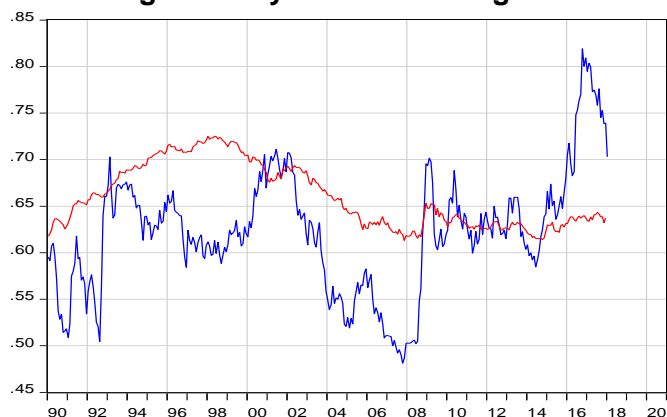
The fair value US dollar exchange rate against the Swiss franc is 0.937 on the basis of relative producer price indices (red line) and 0.903 using relative consumer price indices (green line).

Against the USD the EUR is still undervalued



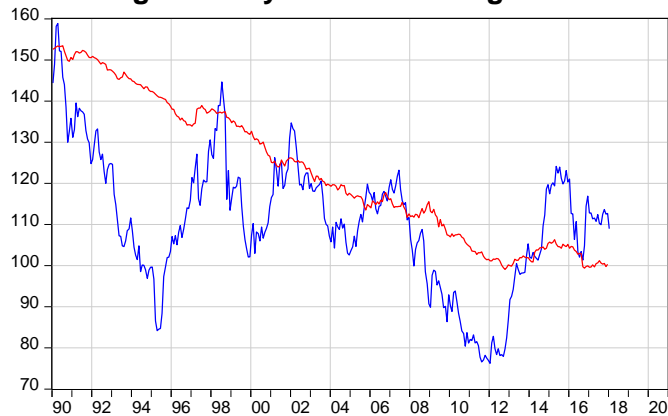
Estimated fair value for the euro against one US dollar (red line) is 0.77, suggesting the euro is still slightly undervalued against the US unit. Our fair value estimate for the Swiss franc against the euro is 1.217. Thus the euro is still somewhat undervalued against the Swiss franc.

GBP is significantly undervalued against USD



Our PPP estimate for the pound against one US dollar is 0.64, which compares with 0.70 currently in forex markets. Thus the British pound remains one of the most attractively valued currencies in the world. We estimate a fair value for the Swiss franc against one British pound at 1.464, which compares with the current market rate of 1.344 francs per pound. Thus the pound is also substantially undervalued against the Swiss franc. However the UK's Brexit saga develops we think that a lot of bad news is already in the price of Sterling.

JPY is significantly undervalued against USD



For the Yen-Dollar cross, our fair value estimate is 100 Yen per US dollar. The equivalent estimate for the Yen against the Swiss franc is 106.7. Thus the Yen, which currently trades at nearly 116 to the Franc, is significantly undervalued against the Swiss currency.

Thus the US dollar looks somewhat expensive against all other major currencies.

US Treasury chief Mr. Mnuchin has expressed himself happy with the US dollar's current weakness as this will boost the competitiveness of US exporters. Mr. Mnuchin's Davos comment irritated among others IMF Managing Director Christine Lagarde who warned of the dangers of a currency war.

Although the US dollar is now at its lowest level against the Euro since December 2014, we believe that it can fall still further without becoming "really cheap".

US dollar weakness boosts the US economy and tends to push up inflation. This is why we forecast that the US Federal Reserve will put up US interest rates four times this year.

Contact: Thomas Härter, CIO, Investment Office
Tel.: +41 58 680 60 44