Investment Strategy Update

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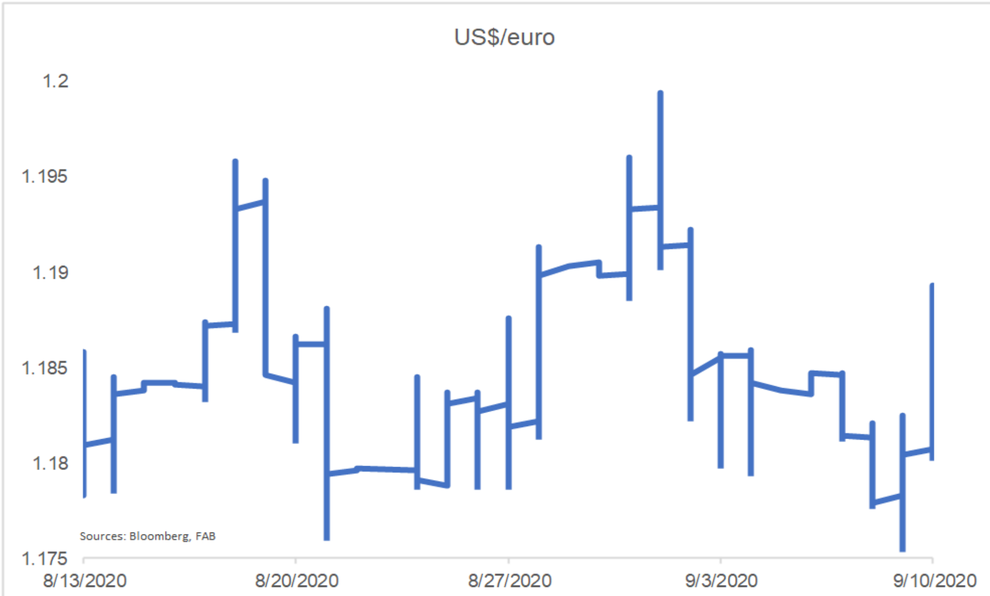
The stage is set for more central bank currency intervention

- **European Central Bank states that there is no reason to overreact to currency strength in its policy statement, but that the Governing Council discussed it at length.**
- **Euro shoots up more than 0.8% amid the lack of action by the central bank.**
- **The common currency is nearing US$1.2/euro, a level it has only traded over for a short period during the past five years and which last prompted ECB action.**
- **Aside from the ECB, the Swiss National Bank is also facing a challenge as the US$/franc level approaches 0.9.**
- **The FAB AAC remains underweight equities while favouring gold and investment-grade debt.**

If European Central Bank (ECB) Chairwoman Christine Lagarde was expecting to succeed in talking down the euro during her press conference, she failed. Madame Lagarde said that the Governing Council of the ECB discussed the currency's strength and its impact on inflation at length during today's meeting and that policymakers are watching that closely. However, she did not indicate that the currency had reached a level which would warrant action, yet.

The trading after the release of the policy statement and following her remarks is reminiscent of the bond market reaction to her comments in March that the ECB was "not here to close spreads." She had to quickly reverse the stance and take the opposite path after bond premiums for peripheral EU countries spiked.



This time, Madame Lagarde seemed more cautious but it still seems like the ECB was hoping that simply by indicating they are watching the currency strength they may have curtailed it. The fact that it did not work suggests that the rhetoric will become louder and that some sort of additional easing is more likely in the central bank's next policy meeting.

In the meantime, the euro could continue to strengthen and some analysts suggest it could move as high as US$1.22/euro. To be sure, the currency found significant resistance at US$1.2/euro when it approached that level last week, but once that number is overcome, the currency could keep moving.

Such high levels can be a drag for a region which depends heavily on exports for economic growth. And this comes at a time when the EU is going through its worst recession in the bloc's history. Plus, a strong currency makes imports cheaper and adds to deflationary pressures.

The euro jumped about 0.8% after the ECB failed to say they would target euro strength

Hence, while the ECB's mandate does not directly include paying any attention to the currency, the euro's effects on inflation and growth make it meaningful. And when former Chairman Mario Draghi cut rates to –0.5% a year ago, before his departure, he seemed to be targeting the currency.

Before the ECB acts again to curtail the strength of its currency, however, its inaction may force another central bank in the region to do so. The Swiss National Bank is in a tight spot as the US$/franc rate is nearing 0.9. A measure of cash that commercial banks hold with the SNB, an early gauge of intervention, increased by US$1.5 billion last week. And until either the ECB or the SNB act, the US dollar is likely to continue to weaken.

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