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WEEKLY RESEARCH NOTES

US nay

During the biennial Ryder Cup golf tournament the Americans in the galleries relentlessly chant, "USA, USA". It is highly unlikely that much chanting takes place in the serious-minded milieu of the investment strategy committees that set asset allocation policy at the world's largest institutional investors. However, if they did burst into song, the lyrics might instead be, "US Nay, US Nay".

Rather like Europeans unaccustomed to hearing to chanting at golf (of all things), cross-border institutional investors have tired of things American. The message is the same across asset classes. In equity markets sixty-day flows into the US are now in the 1st percentile. Flows have been higher on 99 percent of previous three-month periods in the decade long history of the Cross-border Equity Flow Indicator, within a hair's breadth of a record low.

The equity strategy team at State Street Global Markets is sticking with an underweight US position in its model portfolio that was first established in September 2006. Institutions are shunning the UK, US and Pacific ex Japan and flows are accelerating in Europe ex UK and Japan.

In foreign exchange markets, after three weeks of tentative buying back of an entrenched dollar short position, investors have started aggressively selling the greenback again. Six-month dollar flows as measured by the Foreign Exchange Flow Indicator have fallen into the 18th percentile (flows higher on 82 percent of all previous six-month periods), the lowest level since late January. In the week beginning March 19th dollar positioning threatened briefly to ascend into neutral territory, but there has been a dramatic volte-face.

For the second consecutive week, speculative investors (principally hedge funds) have also sold the dollar. Futures positions tracked by the US CFTC reveal heavy selling of \$5.3 billion of contracts in the last week to extend the short position to \$18.5 billion. The record dollar short held by speculative investors is \$28.9 billion.

US treasuries are also being sold by foreign institutional investors (see Chart 1). The Sovereign Bond Flow Indicator has recorded persistent selling by institutional investors. Even during the market wobble in late February and early March there was little let up in selling pressure, despite the safe-haven status of US government bonds.

The macro strategy team at State Street now has its largest short dollar position in its portfolio of recommended trades since April 2005, justified by the observation that, "the key theme in the currency market is broad dollar weakness." The dollar's one-year forward expected short-term rate differential against the major currencies in the DXY basket has fallen to 80 basis points, the lowest level since 2004 and the dollar's advance/ decline line is falling to new lows (see Chart 2).

Our Research

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By aggregating and analyzing the holdings, flows and borrowings of institutional investors around the world, the research provides unique insights into institutional investor behaviour and its interaction with global financial markets.

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The US economy is showing distinct signs of faltering. The sub-prime debacle threatens the whole easy credit culture that has kept the US consumer conspicuously consuming. When the Federal Reserve raised rates 425 basis points between June 2004 and June 2006 there was minimal impact on the US dollar's long-term downtrend. If the economy does hit the skids and the Fed starts cutting, as markets fully expect, it becomes even harder to make a bullish case for the currency.

At the same time, the whole issue of trade imbalances and currency misalignment has come back into focus. Last week, the US Commerce Department imposed countervailing duties against Chinese coated free sheet paper. Granted, in the politics of global trade, this represents assault with a peashooter rather than a fully fledged shot across Chinese bows. However, with G7 finance ministers due to convene in Washington soon, this topic looks sure to stay on the agenda.

Bretton Woods II has become the standard shorthand in markets to describe the symbiotic relationship between the twin deficits in the US and the depressed levels of many Asian currencies. The US gets its deficit funded by Asian central banks buying dollar assets, primarily treasuries, to keep their currencies from appreciating and their export-reliant economies growing. In turn, this artificially suppresses the yield on US bonds, which helps support the US economy and keeps consumers in the malls buying Asian exports.

That relationship is as strong as ever. Asian central bank reserves grew by \$128 billion in the first three months of the year, an even faster rate than the last 12-months, which saw reserves grow by \$360 million to \$2.3 trillion. The US needs this central bank sponsorship of its bonds, dubbed by Harvard economist Ken Rogoff, "the biggest foreign aid programme in world history", more than ever. Institutional investors are selling US assets and are showing no signs of stopping anytime soon.

* The next issue of *Research Notes* will be published on April 20th.

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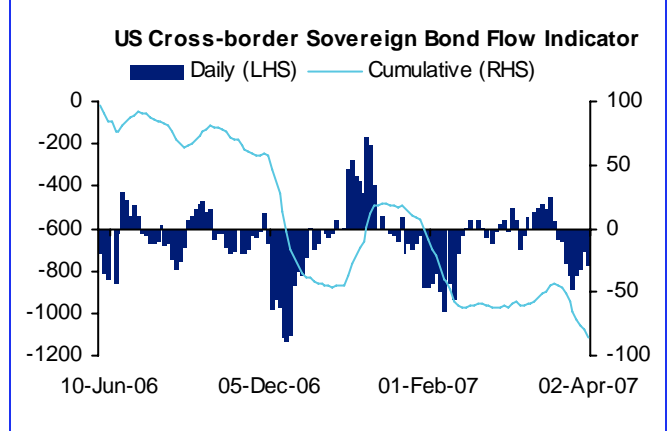
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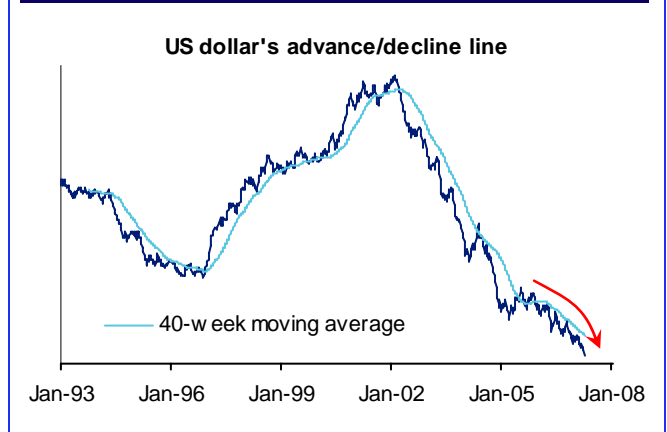
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Chart 1: Investors sell US treasuries



Source: State Street Global Markets

Chart 2: Broad US dollar weakness



Source: State Street Global Markets

