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MONTHLY

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CURRENCY WARS? NOT REALLY.

Introduction

In September, Brazilian Finance Minister, Guido Mantega coined the phrase "International Currency Wars". The frustration that Mister Mantega was expressing resulted from Brazil's currency, the Real, rapidly appreciating in value. Since the beginning of September, many financial news providers have adopted the term "currency wars" to describe how, in their view, countries are implementing policies designed to devalue their currencies in an effort to spur domestic economic growth. We disagree with this notion, as the state of monetary policy in developed and emerging countries can better be explained by traditional measures of domestic inflation and economic activity.

In this *Monthly*, we will discuss the means used by governments to influence the value of their currencies, review the frameworks we use to evaluate monetary policy and exchange rates, and examine the effects of currency movements on economic activity and investment returns.

Government Interference

Currency markets are amongst the largest and most liquid in the world. In aggregate, the New York Fed estimates that over $1.9 trillion in foreign exchange transactions are executed every day. The majority of countries that the United States shares trade and investment relationships with have free-floating currencies, meaning that investors can buy or sell the currency freely in the open market. The biggest exception to this rule is China.

It is widely believed that the Chinese government is keeping the Yuan below its fair market value to give Chinese manufacturers a competitive advantage. Figure 1 illustrates that the Yuan experiences long periods with little or no movement, indicating that market forces are not

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CURRENT TOPIC

Currency Wars? Not Really.

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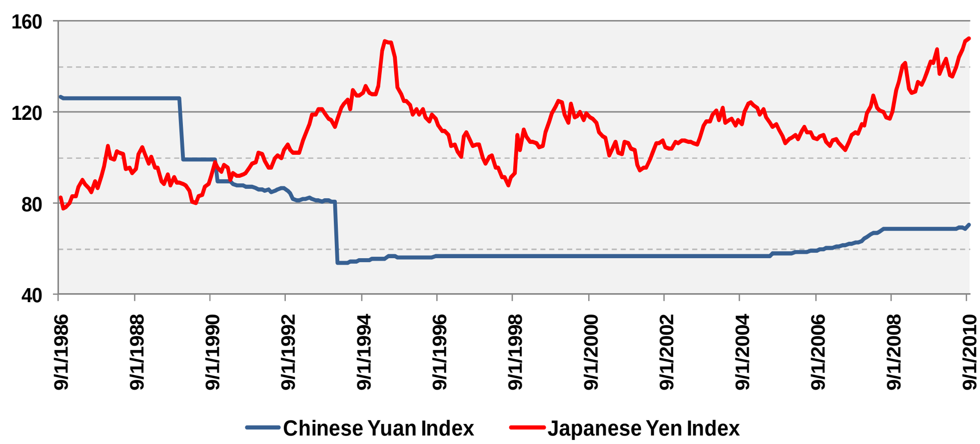
STRATEGY

- *We made no strategy changes during the month of October.*
- *Portfolio strategies remain overweight developed equity markets and underweight bond exposure.*

"THE YUAN EXPERIENCES LONG PERIODS WITH LITTLE OR NO MOVEMENT, INDICATING THAT MARKET FORCES ARE NOT BEING ALLOWED TO ACT"

Figure 1 - Dollar Based Currency Indices



Sources: Bloomberg, Stairway Partners

Currency Wars? Not Really. - Cont'd

being allowed to act. In contrast, the Japanese Yen, which is a free-floating currency, follows a jagged path, which is a pattern exhibited by assets whose prices are allowed to move freely.

Although the governments of countries with free-floating currencies generally let the markets determine exchange rates, they may seek to influence currency markets, from time to time. This influence may take the form of direct intervention, where governments enter the foreign exchange market to buy or sell their home currency. In recent years, direct intervention has become less prevalent. It is believed by many to be an expensive and ineffective tool, because markets most often return to their prior path once intervention is done.

When governments believe there are persistent imbalances due to external forces, they can also implement trade or foreign investment policies to influence the flow of capital or goods and services. An example of this is a recent policy change in Thailand, where a 15% withholding tax was levied on interest income paid to foreign investors. In the end, restrictions on trade and investment often end up harming consumers and investors in both countries.

Lastly, governments can influence exchange rates through moral suasion or "jaw-boning", where officials express their view on what they believe to be the appropriate path for exchange rates. In doing so, these officials hope to move the market by effectively threatening to intervene or implement trade policies, without ever having to actually take action.

Monetary Policy

Central banks, which largely operate independently from elected governments, have also been criticized recently for manipulating currency markets by adopting overly accommodative policies. The belief is that near zero interest rates and quantitative easing are aimed at devaluing domestic currencies. We do not believe that this is the primary motivation.

Many of the world's central banks, including the US Federal Reserve, have explicit objectives of maintaining price stability and fostering economic growth. In our November 2009 *Monthly* – "When will cash rates rise?" we presented our framework for estimating the level of the Federal Funds Rate using economic variables representing US inflation and economic slack. These variables describe the current state of policy extremely well, as accommodation beyond what can be achieved through zero interest rates is justified by the high level of unemployment and the low levels of capacity utilization and inflation.

As a result, we believe that the Fed and other central banks are implementing accommodative monetary policies based on the objectives of promoting domestic economic health, not currency manipulation.

Currency Valuation

We have written extensively in the past about our currency valuation process, which is based on the theory of Purchasing Power Parity (PPP). Since products can be shipped across borders and both manufacturing and service jobs can be moved to locations where labor and facilities are least expensive, discrepancies in currency values should be resolved as businesses and consumers move to take advantage of more attractive prices where currencies are undervalued.

If a currency war were truly distorting foreign exchange rates, then one would expect fundamental PPP based estimates to deviate significantly

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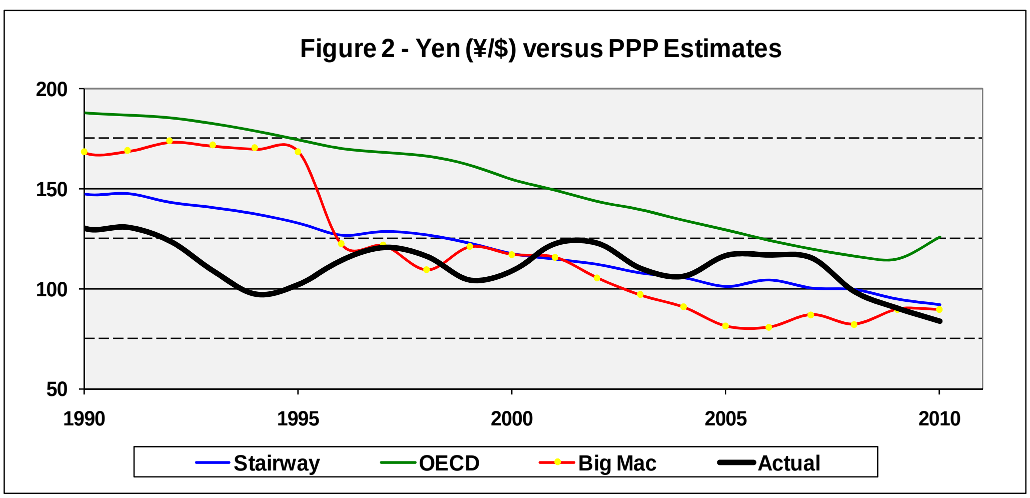

Sources: Stairway Partners, The Organization for Economic Co-Operation and Development, The Economist, Bloomberg

"The Yen is close to fair value and does not indicate that a currency war is distorting its market value"

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

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from market prices. Figure 2 shows the Japanese Yen's exchange rate through time relative to three PPP based models; the Stairway Partners model, the Organization for Economic Co-operation and Development (OECD) PPP model, and *The Economist* magazine's popular Big Mac Index, which we described in our October 2009 *Monthly*. As is the case with *all* of the currencies that we value, the exchange rate for the Yen is close to fair value and does not indicate that a currency war is distorting its market value.

Neither we nor the OECD produce PPP estimates for the Yuan, but *The Economist's* Big Mac index indicates that it is the most overvalued currency of the fifteen that are tracked. This reinforces the notion that China is manipulating the value of its currency.

Economic and Investment Implications

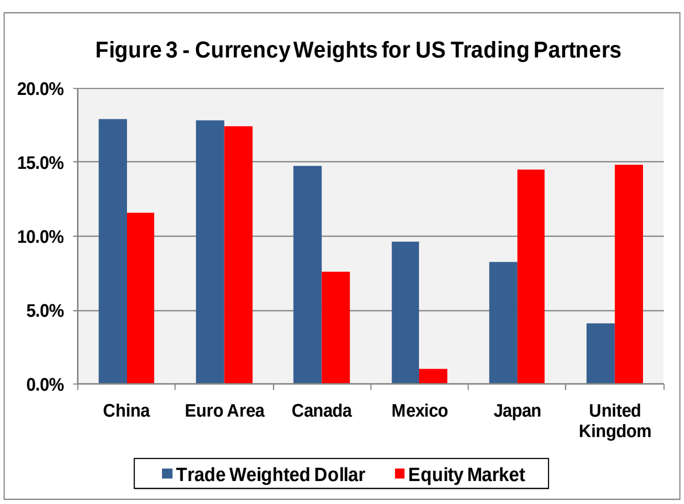
Exchange rate movements affect domestic economies and international investments in several different ways. The value of the dollar has a meaningful impact on the US economy because it influences the price and quantity of goods and services that flow across our borders. Figure 3 shows the six largest trading partners for the United States and their weight in the Fed's trade weighted dollar index. It also shows the size of their equity markets as a percentage of world equity market excluding the US. A currency's weight in the Fed's trade weighted dollar index is a good indicator of its importance to the overall US economy.

The currency in which equities are valued and dividends are paid influence the returns realized by unhedged foreign investors. Figure 3 also shows the relative sizes of the equity markets for our six largest trading partners. Because the relative size of a country's equity market need not be proportional to its US trade flows, a currency's importance to investment returns may differ from its importance to domestic economic activity. For example, movements in the Japanese Yen and the British Pound may have a larger impact on international equity returns for US investors than they do on US economic activity.

Conclusion

We do not believe that a currency war is materially distorting foreign exchange rates. Central bank policies are broadly in line with domestic economic objectives and current exchange rates are close to PPP based value estimates for all of the currencies that we follow. The Chinese government does manipulate the Yuan, but this has been the case for decades and it is not the result of recent economic or market developments.

Currency markets are always volatile and short-term investment results will be driven by short-term market gyrations. We believe that the talk of currency wars is overblown and that investors should not let it distract them from their long-term investment objectives.



Sources: Federal Reserve, MSCI, Stairway Partners

"A currency's importance to investment returns may differ from its importance to domestic economic activity"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	12.6%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	24.7%	5.7%		
Japan	5.3%	3.8%		
UK	26.8%	5.9%		
Emerging	2.6%	10.6%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, other sectors offer better value
2-Year	0.1%	1.8%		
5-Year	-0.1%	2.5%		
10-Year	0.5%	3.2%		
30-Year	3.5%	4.1%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly expensive
2-Year	0.5%	1.5%		
5-Year	0.8%	2.0%		
10-Year	2.2%	2.7%		
US High Yield	4.9%	3.7%	over	Attractive relative to other fixed income sectors
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	0.1%	3.5%		
Japan 10-Year	0.2%	1.2%		
UK 10-Year	0.4%	3.9%		
Emerging Markets Debt	1.2%	3.9%	under	Other asset classes offer better value
Cash	0.3%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.5%	19.2%	-5.4%	Euro is near fair value
Japanese yen	-3.6%	1.7%	-3.4%	Yen is near fair value
UK pound	-2.3%	24.6%	-1.9%	Pound is near fair value

Notes: **As of: October 31, 2010**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.