We have developed a model for valuation of currencies based on fundamentals. We have monitored the model results for about a decade and witnessed a numerous situations when a currency exchange rate diverts from fundamental equilibrium, but on all occasions so far sooner or later it reverts to its fundamental value as indicated by the model.

At the time of writing, there are discernible imbalances for several currencies, namely:

- **GBP: overvalued by 60%;**
- **AUD, CAD: overvalued by 20%;**
- **CHF: overvalued by 25%;**
- **JPY: slightly undervalued (<5%);**
- **EUR: slightly overvalued (<10%).**

Unless the fundamentals change, we expect the currencies under consideration to go through a correction from the exchange rate levels as on 31/12/2007.

The Valuation Model

The idea of this research originates from observations in foreign exchange markets in early 90's where amid uncertainty one thing was fairly certain – if inflation increases, the „inflationary" currency gets stronger, at least in short or very short term. On screens one could see how „inflationary" currency appreciates immediately after news on increased inflation figure, or after interest rates hikes by central banks as they usually increase the interest rates in response to increasing inflation.

The prevailing economic textbook wisdom at the time suggests that it should be otherwise: higher inflation is bad for economy and what is bad for economy should be bad for currency. However, in real market situations, this may be true in situations of hyperinflation, but have no empirical evidence of such correlation in relatively low (below, say 5%) inflation environment.

We did a case study in order to test several hypothesis from a perspective of a currency trader, seek empirical evidence if inflation data, coupled with other macroeconomic data, can be used to build a profitable trading model.

In the model, the key parameters are money supply, GDP growth and inflation data. A discerning feature of the model is that it presumes that **higher inflation** (as long as it remains moderate and poses no threat to functioning of economic system) **induces strengthening of domestic currency**. The rationale behind the thesis is that higher inflation "ties up" more money to serve the domestic economy and less of it is available for exchanging into foreign currency. Generally, what is a bad deal for domestic population (less purchasing power, higher interest expense) looks rather a good deal for an investor holding such currency.

How could Valuation Model be Applied to Currency Trading?

In our opinion, the model is not practical to use as a stand-alone trading system. However, it can be useful for long-term bets and as an additional indicator.

There are a number of reasons limiting its value as an indicator for shorter term trading. One reason, as Keynes once noted, is that "markets can remain irrational longer than you can remain solvent", i.e. if a currency is overvalued by 20% doesn't mean that it will correct immediately - it is more likely to follow a technical trend for another 10 -15% before the correction takes place. Another reason -- any model is simplification of reality and it is too broad to indicate exact entry and exit price levels.

Nevertheless, *if for whatever reason you are considering a short trade in GBP, AUD or CAD, then at the moment our model confidently confirms the direction*.

Full text regarding foreign exchange valuation model is available to managed account customers on request.

We will keep the data up-to-date publish the valuation results on trades4U.com quarterly.■

Graphs below indicate divergence from fundamentals as indicated by our foreign exchange valuation model for the period from Y1994 to Y2007. The green lines indicate divergences, the values on the left side of the graphs indicate percentage points.