

From the Desk of Jeppe Ladekarl - The “Ugly” Duckling - aka the Danish Krone

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JEPPE LADEKARL
Partner, Investments

“HIS OWN IMAGE; NO LONGER A DARK, GRAY BIRD, UGLY AND DISAGREEABLE TO LOOK AT, BUT A GRACEFUL AND BEAUTIFUL SWAN. TO BE BORN IN A DUCK’S NEST, IN A FARMYARD, IS OF NO CONSEQUENCE TO A BIRD, IF IT IS HATCHED FROM A SWAN’S EGG”

HANS CHRISTIAN ANDERSEN “THE UGLY DUCKLING”

A cornerstone of Danish monetary policy since 1982 has been the fixed exchange rate regime, though the years until 1986 saw frequent adjustments to the central rate. The Danish central bank (the Nationalbanken), since the introduction of the euro, seeks to maintain the Danish krone (the DKK) within a tight band of +/- 2.25 % around a central rate of 746.038 DKK/EUR (before the euro was established, the peg was maintained against the Deutschmark). The policy has been very successful leading to low and stable inflation and is deeply ingrained in the real economy with full political backing.

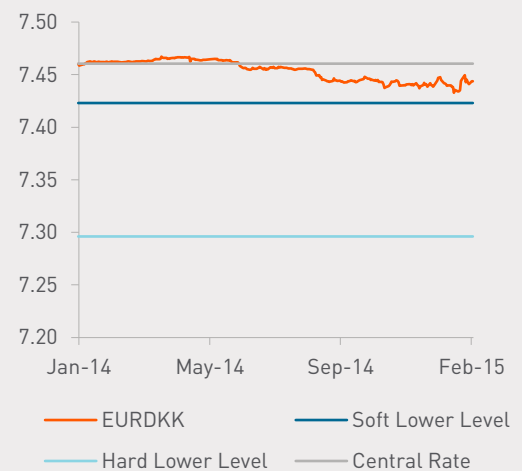
The peg has come under pressure lately with the Nationalbanken and the government taking several steps to reduce inflows and manage the impact on the exchange rate:

- 1) Interest rate reductions: three times during January to minus 50 bp .¹
- 2) Suspension of government bond issuance. The government will not issue bonds in 2015. This reduces the supply of government bonds and forces all purchases to be made in the secondary market, putting further downward pressure on rates across the yield curve.
- 3) Intervention in currency markets.

While it is not yet clear what kind of impact

the interest rate reductions or suspension of government bond issuance will have on inflows, we do know how much the Nationalbanken had to intervene during January to maintain the peg. Denmark’s foreign exchange reserves grew by 106 billion DKK in the month – an increase of almost 25% - to a total of 564 bn. In % of GDP, the monthly increase was close to 6%. Total foreign exchange reserves now stand at around 28% of

EXHIBIT 01: EURDKK EXCHANGE RATE (JANUARY 2014 - FEBRUARY 2014)



Sources: Bloomberg



GDP, comparable to Japan but still far below the Swiss 90%+ of GDP.

It is not our central scenario that the Nationalbanken will have to abandon the peg. The DKK can still be allowed to fall (appreciate) against the euro. The Nationalbanken typically keeps the DKK much tighter against the central rate than the +/-2.25% band would entail, not allowing the DKK to appreciate more than 50 bp with a “soft” bottom of the band being 7.423 and the formal level at 7.2962.

In the case where the Nationalbanken lets the krone appreciate toward the floor, the Bank has a backup in place. Where the SNB stood alone in fighting inflows and holding their peg, that is not the case for Denmark. Under the ERM II agreement, the ECB can be called upon to intervene to help defend the DKK peg. This would allow the ECB to absorb some intervention, though calling on the ECB should be considered as a last resort.

We do not actively trade the DKK in our active currency program. However, clients with exposure to the Danish krone through investments in Danish equities or fixed income should consider the risk and/or opportunities related to the unlikely event of a break in the peg. We do not expect that exposures are large on a relative or absolute level. The weight of the Danish markets in various indices is typically low (less than 1%). Where the exposure is unhedged, there will be a potential for gains in connection with a break of the peg (though one should expect domestic Danish equities to fall if the currency appreciates substantially). In the case of hedged exposure, one should expect to lose both on the hedge and the underlying equities (the impact on bond portfolios may be positive if the break of the floor happens in conjunction with a significant reduction in policy rates). In general, that should result in only marginal

impact on overall portfolios even in the event of a break of the peg.

That said, the options to manage the risk are relatively straightforward: reduce or eliminate the hedge if in place, or proxy hedge through the euro. The potential risk in the case of outright removing the hedge will, in the case of the peg being maintained, be related to a continued depreciation of the euro, and with it the DKK. Being “underhedged” against the benchmark will cost. Proxy hedging with the euro has the potential for underperforming a direct hedge if the DKK weakens from its current level. The “soft upper level” of the band is about 1% away from the current spot rate; that level, at least in the short to medium run, should be considered a line in the sand for the Nationalbanken. I’m sure they would welcome the opportunity to intervene at the other side and bring down the foreign exchange reserves should some weakness materialize. In the case of an appreciation toward the “hard floor” (but where the peg is still maintained), there is still potential for a gain of about 2%. If the peg breaks, the immediate gain is hard to predict but it could be substantial.

To reiterate, it is not our central case that the Danes will abandon the current policy. The credibility of the peg was hard fought for. As such, the ugly duckling of the 80ies has turned into somewhat of swan. The Danes will be loathed to see that leave the local pond.

If you wish to discuss this further, do not hesitate to get in touch.



Endnote

¹The Nationalbanken is changing rates almost quicker than I can type. On February 5th, the interest rate on certificates of deposits was reduced by an additional 25 bp to minus 75 bp. Some Adjustable Rate Mortgages are now financed with mortgage bonds that carry negative yields.

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FIRST QUADRANT, L.P. | 800 E. COLORADO BLVD. SUITE 900, PASADENA, CALIFORNIA 91101
MARKETING SERVICES INFO@FIRSTQUADRANT.COM | OFFICE 626 683 4223 | WEB FIRSTQUADRANT.COM
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