White Paper

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G10 Currencies:

A Monetary Policy Analysis

Merk Monetary Score™ favors currencies of New Zealand, Australia and Canada; disfavors currencies of the UK, Switzerland and Eurozone*

MERK FUNDS™
The Authority on Currencies™

**As of March 31, 2012*

Introduction

We present a methodology by which currencies can be systematically ranked based upon economic fundamentals and policy choices. This analysis is the first in the *Merk Policy and Economic Analysis* series that focuses on developing a methodology by which investors may rank currencies in terms of attractiveness. We consider three broad categories used to assess the relative attractiveness for a currency's outlook: monetary policy, fiscal policy, and the economy. Within each category, we develop a score for each currency, a Merk Monetary Score™ , Merk Fiscal Score™ , and a Merk Economic Score™ . Additionally, we aggregate the metrics into an overall Merk Currency Score™ . Such findings may be useful in supporting investment decision-making across countries and regions.

The focus of this particular report is to rank currencies based upon a monetary policy framework. Within this category, we focus on specific metrics that we consider to be bellwethers for long- and short-term economic health, price stability and ultimately, to have a significant implication on relative currency strength or weakness. We analyze data for each of the "G10" currencies in concert with one another, determining a ranking methodology, which is used to ascribe the Merk Monetary Score for each currency.[1]

We find that, as of March 31, 2011, the Australian dollar and Canadian dollar appear the most compelling two currencies based upon our Merk Monetary Score. Conversely, our methodology ranks the Swiss franc and British pound as the two least attractive currencies within the G10 universe based upon monetary fundamentals.[2]

Merk Monetary Score

We believe each respective central bank has a substantial impact on the overall outlook for the value of its currency. Generally speaking, we favor central banks that follow more refrained, less expansionary and unconventional measures, with a focus on traditional monetary policies. We believe central banks that have a strong and demonstrated commitment to fostering price stability tend to protect against the erosion of purchasing power of the respective currency. We view a currency like any other asset: economic theory tells us that when the supply of an asset increases, without any offsetting increase in demand, all else equal, that asset should fall in value. When central banks engage in expansionary and/or "non-standard" policies such as quantitative easing ("QE"), they expand the supply of currency; with no offsetting increase in demand, we consider this action should naturally put downward pressure on the respective currency.

Furthermore, we believe central banks that have demonstrated a strong commitment to fostering price stability incentivize international investment in those local economies, as the perceived inflationary risks of the currency tend to be contained. Price-stable environments may lead to lower levels of volatility and business risks, creating greater clarity surrounding the future economic environment, which is extremely important from a business standpoint. Such dynamics may underpin strength in the local economy and, in turn, the currency. Conversely, inflationary environments not only erode the purchasing power of a currency relative to other nations, but may also increase the levels of business investment risk.

We analyze various metrics in assessing currencies from a monetary policy perspective. We consider the consumer price index (CPI) and the producer price index (PPI), along with market-based expected inflation measures,

1) "G10" currencies: Australian dollar, British pound, Canadian dollar, Euro, Japanese yen, New Zealand dollar, Norwegian krone, Swedish krona, Swiss franc, U.S. dollar

2) Merk investments may or may not use this analysis in determining currency allocations. Please visit merkfunds.com for the most recently published currency allocations of the Merk Funds.

to be important indicators in assessing the effectiveness of a central bank's commitment to the objective of price stability. We also consider the change in the size of a central bank's balance sheet, as a proxy for the absolute change in money supply. Ultimately, those central banks that are meeting the objective of fostering a price stable environment may lead to more attractive currencies in comparison to those that are not.

While some central banks, such as the Federal Reserve (Fed) in the U.S. have a mandate to also foster maximum employment, we incorporate the impact of the unemployment rate onto currencies into the Merk Economic Score, to be discussed in a forthcoming analysis.

Below we provide a breakdown of the overall monetary policy assessed components for the G10 currencies.

CPI Analysis

The first monetary policy metric used in this analysis is the local measure of inflation, specifically the consumer price index (CPI). Due to differences in calculation methodology across nations and regions, we attempt to normalize by assessing the present level of CPI against the target level set by each local central bank. Such methodology assumes each local central bank's target level of inflation is indicative of a price stable environment. From the below table, we see that New Zealand and the U.S. exhibit the lowest variance from "price stability", while the UK and Switzerland are furthest from the respective target levels of price stability[4].

Switzerland scores poorly despite its low inflation rate because it is under-shooting the central bank's inflation target. The reason under-shooting the inflation target may be negative for the currency is because it may prompt the central bank to engage in measures to induce inflation or otherwise pursue a more activist approach not necessarily helpful to the value of the currency. As such, the methodology employed looks at the absolute deviation from the inflation target.

CPI vs Target, %	U.S.	Euro Area	Japan	UK	Switzer-land	Australia	New Zealand	Canada	Norway	Sweden
Last Reported CPI Y/Y%	2.3%	2.7%	0.3%	3.5%	-1.0%	3.1%	1.8%	2.6%	0.8%	1.5%
Deviation from Target	0.3%	0.7%	0.7%	1.5%	2.0%	0.6%	0.2%	0.6%	1.7%	0.5%
Rank	2	6	8	9	10	3	1	5	7	4

We also assess market-ascribed estimations for upcoming year CPI against the target level deemed to be "price stable" by each respective central bank.[3] As shown below, market estimates infer that Canada, Australia and the Eurozone are most likely to achieve price stable environments in 2012, while Switzerland and Japan are least likely.

CPI Y/Y % forecast 2012	U.S.	Euro Area	Japan	UK	Switzer-land	Australia	New Zealand	Canada	Norway	Sweden
Expected Inflation Y/Y%	2.3%	2.2%	-0.3%	2.6%	-0.5%	2.7%	1.7%	1.9%	1.4%	1.2%
Deviation from Target	0.3%	0.2%	1.3%	0.6%	1.5%	0.2%	0.3%	0.1%	1.1%	0.8%
Rank	4	2	9	6	10	2	4	1	8	7

3) All data in this release are sourced from Bloomberg unless otherwise specified
4) Market forecasts are taken from Bloomberg estimates

We further analyze the three-month change in the market's consensus forecast for current year CPI. We ascribe a higher ranking to a currency when the market considers that expected CPI for the upcoming year has moved towards target and a lower ranking if it has deviated further from the central bank's target rate of inflation. We find that the market's estimates have improved over the preceding three months for both Australia and New Zealand, whereas the expectations for inflation relative to target have deteriorated for Switzerland and Sweden.

CPI Y/Y: Change in forecast for 2012	U.S.	Euro Area	Japan	UK	Switzer-land	Australia	New Zealand	Canada	Norway	Sweden
Last Forecast for 2012	2.30%	2.20%	-0.30%	2.60%	-0.50%	2.70%	1.70%	1.90%	1.40%	1.20%
Deviation from target	0.30%	0.20%	1.30%	0.60%	1.50%	0.20%	0.30%	0.10%	1.10%	0.80%
Previous Forecast	2.10%	1.90%	-0.28%	2.55%	0.10%	3.30%	2.40%	1.90%	1.55%	1.50%
Prev Dev from target	0.10%	0.10%	1.28%	0.55%	0.90%	0.80%	0.40%	0.10%	0.95%	0.50%
3-Month Change	0.20%	0.10%	0.02%	0.05%	0.60%	-0.60%	-0.10%	0.00%	0.15%	0.30%
Rank	8	6	4	5	10	1	2	3	7	9

PPI Analysis

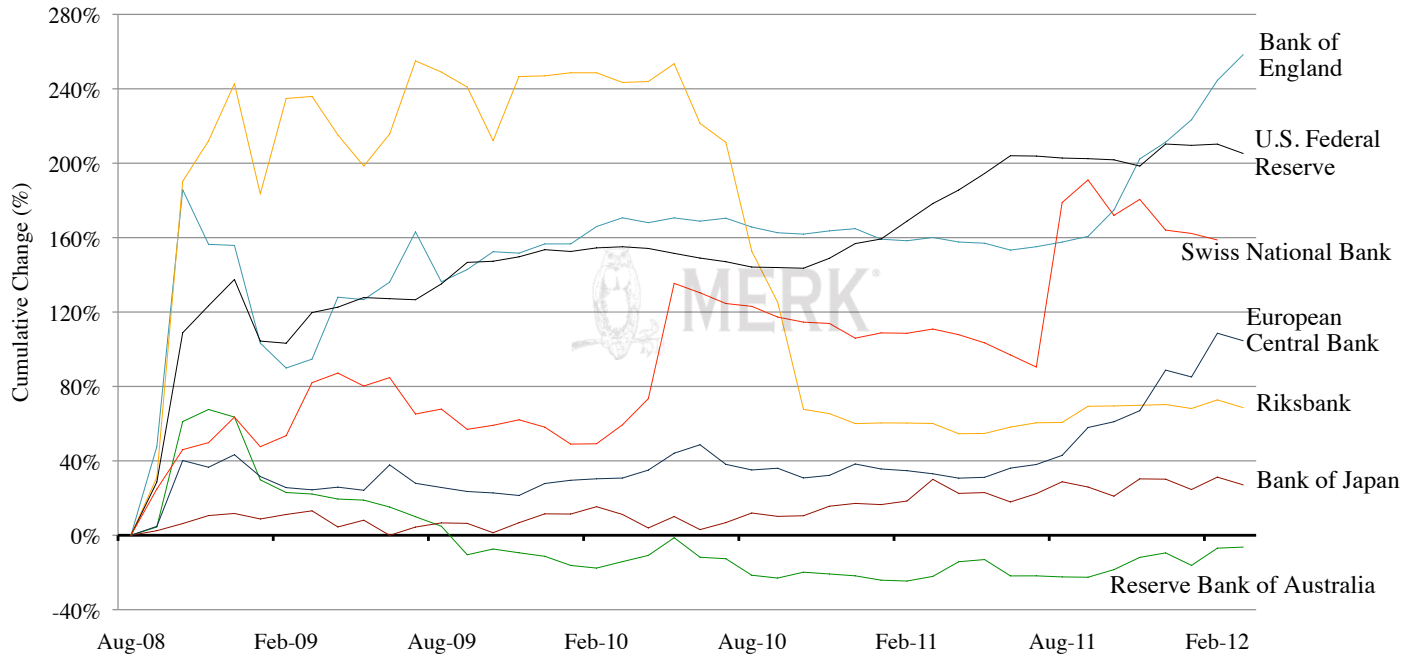
In addition to CPI, we also assess PPI. We believe PPI pressures represent costs to the supply chain that will ultimately show up in final goods prices included in the CPI; therefore volatility in PPI may threaten price stability. Based on most recent numbers, Australia and Canada both appear to be experiencing the least PPI inflationary deviation relative to the target level of CPI. Conversely, Norway and Switzerland appear to be experiencing much larger deviations in PPI inflation from target CPI levels.

PPI vs Inflation Target, %	U.S.	Euro Area	Japan	UK	Switzer-land	Australia	New Zealand	Canada	Norway	Sweden
Last data point	2.90%	3.60%	-0.60%	2.50%	3.10%	2.90%	3.40%	1.68%	6.60%	0.50%
Deviation from Target	0.90%	1.60%	1.60%	0.50%	2.10%	0.40%	1.40%	0.32%	4.10%	1.50%
Rank	4	8	7	3	9	2	5	1	10	6

Central Bank Balance Sheets

We rank the various currencies according to the cumulative change in each respective central bank's balance sheet. We consider that a positive change in a central bank's balance sheet can be used as a proxy for the additional money that has been printed, oftentimes via non-standard monetary policy measures, such as quantitative easing. In particular, since the onset of the global financial crisis in 2008, many central banks around the world have embarked on easing policies in an attempt to reinvigorate their local economies. When a central bank expands the supply of currency, with no offsetting increase in demand, we consider that action should naturally put downward pressure on its respective currency. The chart below outlines the change in select central bank balance sheets since the onset of the financial crisis.

Cumulative Change in Central Bank Balance Sheets (Since August 2008)



Source: Merk Investments, U.S. Fed, ECB, BOE, BOJ, SNB, RBA, Riksbank

We rank each country by the absolute cumulative change since the onset of the financial crisis in 2008, along with the most recent six-month change[5]. As the chart above highlights, and the following table outlines, the Bank of England and the U.S. Federal Reserve have been the most prolific of the G10 currency central banks in increasing the absolute size of their balance sheets, thus generating the lowest ranks based on this metric. Conversely, the Reserve Bank of Australia and the Norges Bank (Norway's central bank) have been the most refrained regarding balance sheet expansion. Indeed, the Reserve Bank of Australia actually reduced the size of its balance sheet since the onset of the financial crisis.

6-Month Change in Central Bank Balance Sheet	U.S.	Euro Area	Japan	UK	Switzerland	Australia	New Zealand	Canada	Norway	Sweden
6-month change %	0.9%	29.5%	0.9%	37.5%	-7.2%	20.9%	-8.8%	3.4%	0.3%	-0.4%
Rank	6	9	5	10	2	8	1	7	4	3

Overall Merk Monetary Score

Our overall monetary policy ranking assessment of the various G10 currencies takes each of the above metrics into consideration. We weight fundamental data according to our assessment of its relative importance in determining the overall category ranking. Notably, we give most weight to central bank actions, while also emphasizing market expectations about future inflation.

Please find below the Merk Monetary Score for each of the G10 currencies analyzed above.

5) Data source: U.S. Fed, European Central Bank, Bank of Japan, Bank of England, Swiss National Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, Bank of Canada, Norges Bank and Riksbank

Merk Monetary Policy Score	U.S.	Euro Area	Japan	UK	Switzer-land	Australia	New Zealand	Canada	Norway	Sweden
Overall Rank	4	6	8	9	10	1	3	2	7	5

As depicted, we consider that Australia and Canada demonstrate the most favorable monetary policy fundamentals, while Switzerland and the UK appear least favorable. Investors may want to take such analysis into account when considering investing across these regions and in these currencies.

The next installment of our Merk Policy and Economic Analysis series will delve into fiscal policy, examining a number of fiscal policy-specific fundamental data points, and ultimately provide readers with a Merk Fiscal Score. Please register with us to be alerted when the next analysis in this series is published.

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About the Authors

Axel Merk is the President and CIO of Merk Investments, manager of the Merk Funds. An authority on currencies, he is a pioneer in the use of strategic currency investing to seek diversification. Axel Merk is a sought after speaker and author on topics ranging from the economy, gold and currencies to sustainable wealth and personal finance, as well as a regular guest and contributor to the business media around the world.

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The Merk Mutual Funds ("Funds") may be appropriate for you if you are pursuing a long-term goal with a currency component to your portfolio; are willing to tolerate the risks associated with investments in foreign currencies; or are looking for a way to potentially mitigate downside risk in or profit from a secular bear market. For more information on the Funds and to download a prospectus, please visit www.merkfunds.com.

Investors should consider the investment objectives, risks and charges and expenses of the Funds carefully before investing. This and other information is in the prospectus, a copy of which may be obtained by visiting the Funds' website at www.merkfunds.com or calling 866-MERK FUND. Please read the prospectus carefully before you invest.

Since the Funds primarily invest in foreign currencies, changes in currency exchange rates affect the value of what the Funds own and the price of the Funds' shares. Investing in foreign instruments bears a greater risk than investing in domestic instruments for reasons such as volatility of currency exchange rates and, in some cases, limited geographic focus, political and economic instability, emerging market risk, and relatively illiquid markets. The Funds are subject to interest rate risk, which is the risk that debt securities in the Funds' portfolio will decline in value because of increases in market interest rates. The Funds may also invest in derivative securities, such as forward contracts, which can be volatile and involve various types and degrees of risk. If the U.S. dollar fluctuates in value against currencies the Funds are exposed to, your investment may also fluctuate in value. The Merk Currency Enhanced U.S. Equity Fund may invest in exchange traded funds ("ETFs"). Like stocks, ETFs are subject to fluctuations in market value, may trade at prices above or below net asset value and are subject to direct, as well as indirect fees and expenses. As a non-diversified fund, the Merk Hard Currency Fund will be subject to more investment risk and potential for volatility than a diversified fund because its portfolio may, at times, focus on a limited number of issuers

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