Black Swan Capital

Currency Currents

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Quotable

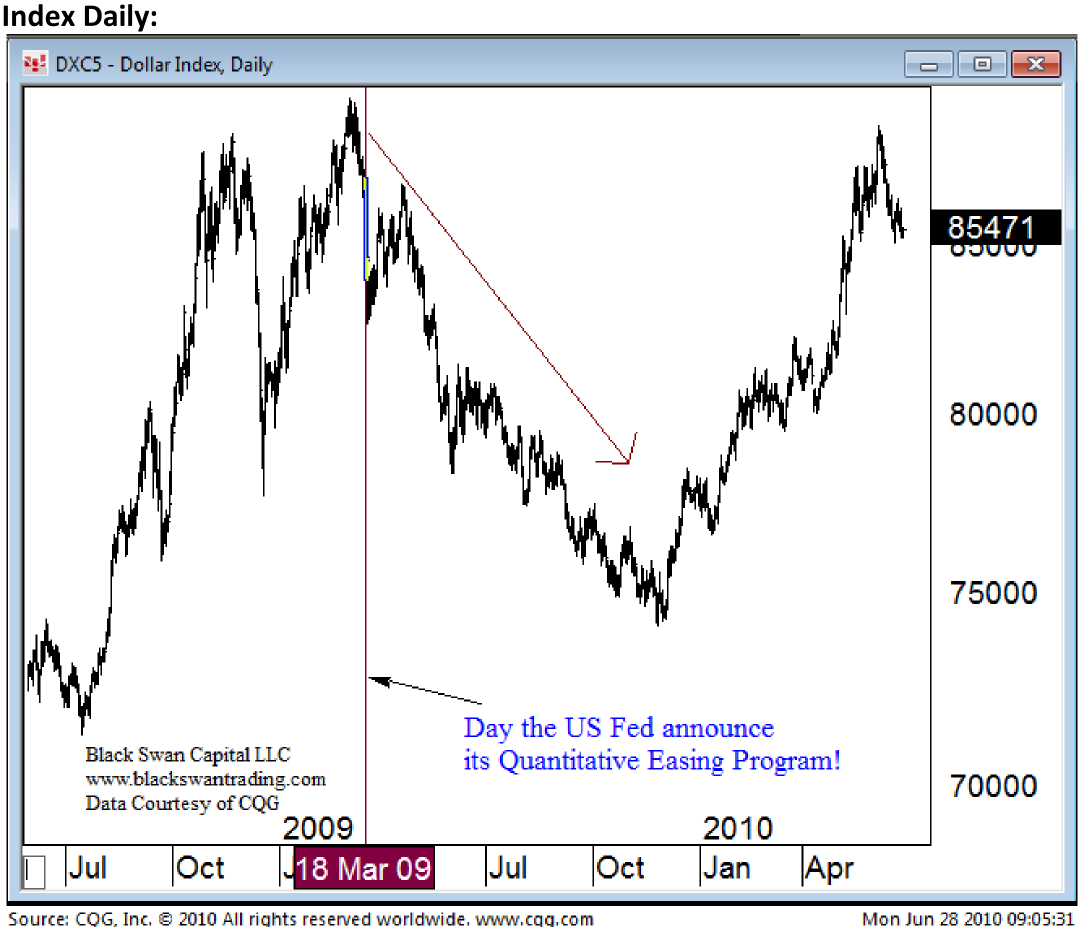
"The charm of history and its enigmatic lesson consist in the fact that, from age to age, nothing changes and yet everything is completely different."

Aldous Huxley

FX Trading – US/China Symbiotic relationship back in play?

You may remember that the US dollar soared in value in the midst of the worst fears during the credit crunch. It peaked in March of 2009; which not coincidently is when global stock markets and risk assets began to soar in value. It was the big quantitative easing moment from the Fed and an explicit signal the US policy was to use US dollar—dollar based credit—to liquefy global credit markets, i.e. a weak dollar policy indeed. We have to be open to the idea we may revisit that period if US policymakers are cranking up the China/US Symbiotic relationship again.

US$ Index Daily:



The ball game changed in December of 2009, as the US dollar bottomed and has been climbing ever since. Global deleveraging and European monetary system concerns changed the backdrop for the buck.

Key question: Was the sharp rally in the US dollar from December 2009 primarily a risk-bid based on eurozone trouble or was there more to it? Answer: We don't know yet. We think there was more, and laid out that definitive (though still guesswork) case in our January *Currency Investor*. But it sure doesn't appear the US can afford to drain reserves from the system now. And despite fiscal fatigue as settled over the US electorate, we can't underestimate the ability of the US government to keep pumping 24/7.

So, are we nearing a mini-version of the weak-dollar policy that led to a big retrace in the dollar move after the credit crunch, ultimately driven by China credit? If so, the dollar correction could be deeper than we expected.

Despite some changes in correlations over the past several months, the dollar index move is still often tied to the mantras of "risk on" and "risk off." Risk on means, of course, there is plenty of liquidity out there -- time for investors to pour into risky assets, stretch for more yield, bid up growth, etc. Risk off means just the opposite, and racing back out of risk helps the US dollar, US bonds, etc.

Let's consider the liquidity spigots versus the drains. Liquidity is the mother's milk of risk assets, if the perception is the spigots are winning, risk assets likely go higher, supporting the idea of continued correction in the US dollar:

Spigots:

1) European Central Banking – Quantitative easing out the yin-yang, but of course calling it another name; someone has to keep the European banking system solvent
2) Bank of Japan – Loose money there as far as the eye can see
3) US Fed – After the most recent economic downgrade of the US economy from the Fed, the idea they will start draining reserves anytime soon is history.
4) US government – Though low on bullets, pipes are wide open
5) Bank of England – Still in loose mode, though making noises about a change

Drains:

1) Eurozone austerity measures – enough said
2) UK austerity measures

Neutral, but leaning toward tightness:

1) Reserve Bank of Australia
2) Bank of Canada

<u>The Big Question</u>: Is China's new exchange rate policy considered a tightening?

Some say yes, obviously it is an effective tightening. But that's not the answer according to the analysts who toil away at Morgan Stanley [our emphasis]:

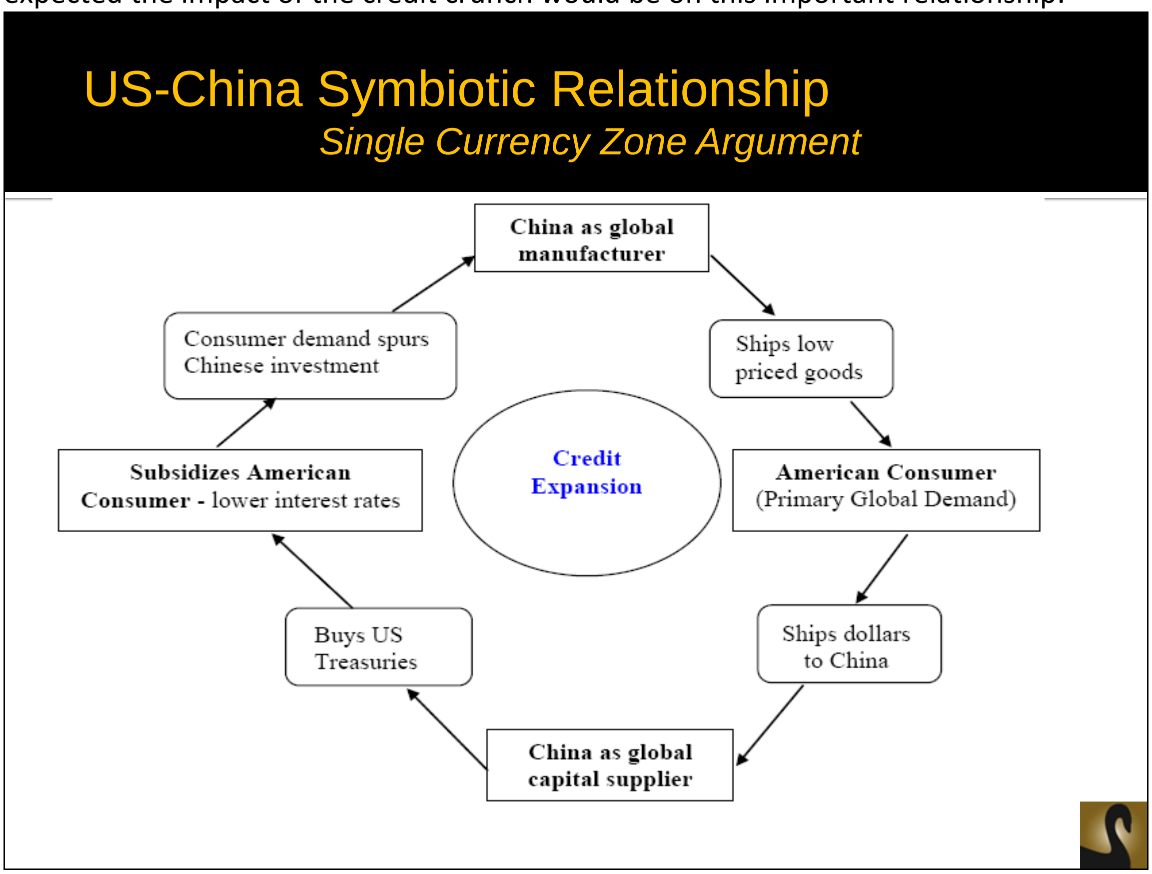
> Ever since Chinese policymakers started their resolute campaign against property speculation, markets have been worried about a policy error that could push such anti-speculation measures too far. **Mindful of fears of a growth slowdown in China, monetary policy is likely to compensate for renminbi appreciation by delaying tightening or even by further easing on some measures.** Our China economist, Qing Wang, previously expected just one policy rate hike in 2H10 and an adherence to the Rmb7.5 trillion credit ceiling for 2010. **He now expects no rate hikes in 2010 and raises the possibility of an increase in the credit ceiling**. Monetary policy is thus playing a much more accommodative role as interest rates and credit constraints together account for the bulk of monetary transmission into the real economy.
>
> But monetary policy accommodation shows that the 'trilemma' is alive and well: <u>The trilemma is a three-way dilemma whereby policymakers can choose only two out of a trio of pegged exchange rate, free flows of capital and independence in monetary policy</u>. The traditional approach of policymakers who want to have their cake and eat it has been to introduce capital and credit controls. Such a system of controls in China (including intervention in FX markets, sterilisation in domestic money markets and credit constraints) has kept capital inflows from influencing domestic credit but has led to an accumulation of a massive quantity of foreign exchange reserves. Managing these controls and reserves, however, gets more difficult as time passes and they do not represent a sustainable solution. The textbook model can lead one to believe that the trilemma exists only for exchange rate regimes that are fully fixed. However, this is not the case, in our view. Even somewhat flexible exchange rate regimes can produce the same constraints, leading to a policy trade-off. In the case of the Reserve Bank of India, for example, the reliance on capital inflows has meant that the RBI has had to walk a tightrope between raising rates quickly, and excessive currency appreciation thanks to 'perverse' inflows of capital.
>
> **The predictability of the new regime could make the trilemma worse**: In theory, the switch from a fully fixed exchange rate to a slightly more flexible one should reduce the constraints of the trilemma. However, most market participants expect a modest appreciation in the renminbi against the US dollar, and this predictability could work to make the trilemma worse in the short run. How? <u>The combination of a predictably appreciating currency and a monetary policy regime that has postponed tightening in order to support growth provides the investor with: (i) increasing returns for capital inflows purely from currency appreciation, and (ii) policy support for the economy and for risky assets.</u> Raising rates in such an environment would invite 'perverse' capital flows of the kind that the RBI has been wary of. Thus, rather than affording some respite from the trilemma, the predictability of the new regime may make the policy constraints of the trilemma worse.

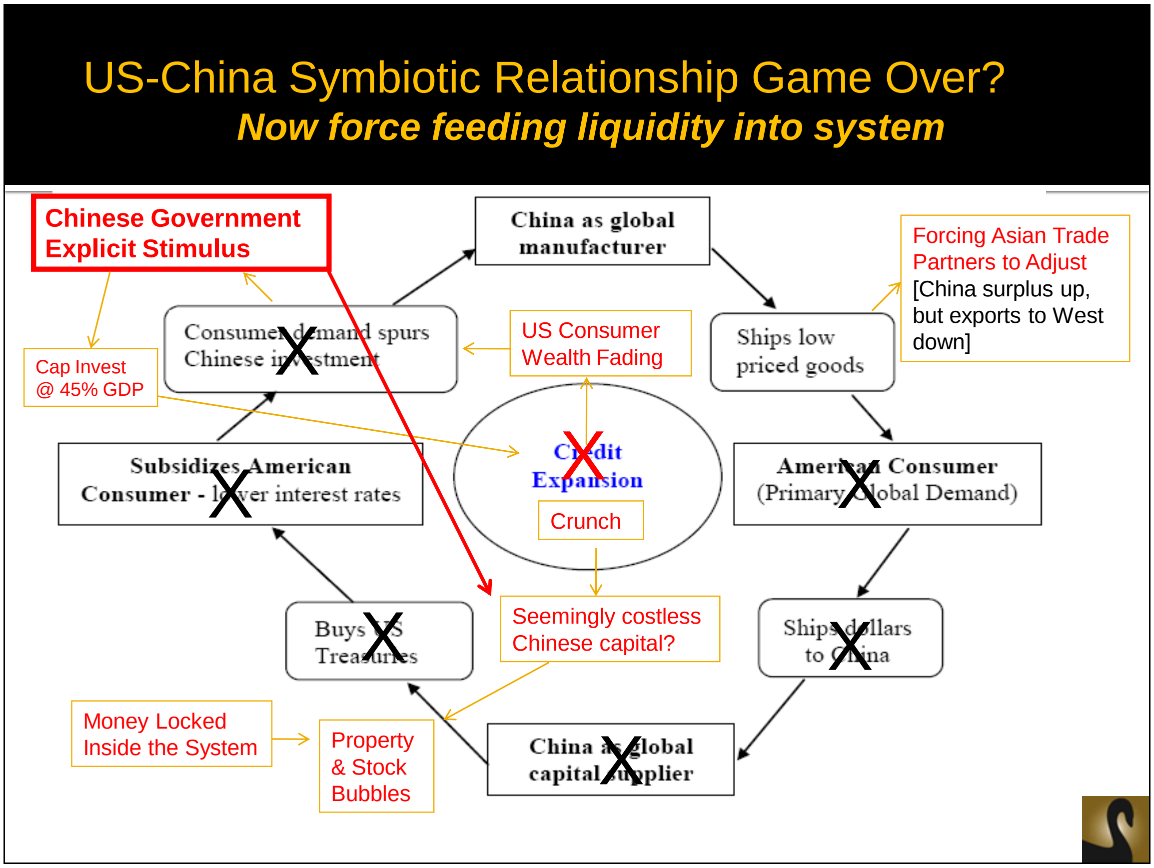
Importing AAA liquidity: Capital flows into China may be exacerbated thanks to an unlikely source - the euro area. Sovereign risks from the euro area have probably prompted not just the ECB but also the Fed to stay on hold for longer, keeping the AAA liquidity regime intact. The fast-growing economies of the world, particularly the ones with fixed or relatively stable exchange rates, import this excess liquidity, and China is high up on that list.

In the near future, more capital inflows, higher reserves and lower yields are the likely outcome. As capital inflows increase, China's system of capital and credit controls will probably lead to an increase in the size of its holdings of foreign exchange reserves. We believe that at least some of these reserves are likely to find their way back into bond markets, keeping yields anchored. Despite an extremely volatile period in developed markets, US markets - and even euro area markets - remain a favoured destination thanks to their size and depth.

Is it possible the US has been soft on China lately because it realizes the symbiotic relationship may be the only policy tool left to provide global liquidity needed to keep this dangerous game alive?

Below is a flow diagram we put together a couple of years ago, the first chart shows the US-China Symbiotic relationship in its full glory; while the second chart overlays in red what we expected the impact of the credit crunch would be on this important relationship:





This relationship is part and parcel to a weak dollar policy as dollar based credit flows to the world once again on the rising US current account deficit.

As we've pontificated here many times before, the US is the only one positioned to take the exports of the globe if Europe is serious about austerity. And interestingly, the additional credit being created *precisely* because China has made a slight change to its currency may be the Trojan horse behind a return to the Symbiotic relationship that served global growth so well, but was also the primary cause of the credit crunch.

Stay tuned.

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Have you heard about *PositionTrader FX*?

We've been getting the same question a lot over the last few days: is it too late to profit from the euro crash; and what about the Aussie ... or yen?

And our answer is:

No.

We've done well in 2010. And we expect to do even better as the halfway point approaches.

For good measure, I've included our year-to-date track record and profit curve here, reflecting through Thursday, May 20.

Here's the bottom line…

We think the Euro is going to par with the dollar – 1:1 – or maybe even lower.

If you've been waiting on the sidelines, now is time to jump in.

If you're not sure how to implement a currency trading strategy, we've got you covered. And we offer a 30-day 100% money-back guarantee if this isn't for you. After that we prorate your refund on a weekly basis if it's not working for you.

This is speculative trading and is not for everybody. If you're cut out for this, jump over now and give it a try.

All the best,

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