Black Swan Capital

Currency Currents

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Quotable

"He who controls others may be powerful, but he who has mastered himself is mightier still."

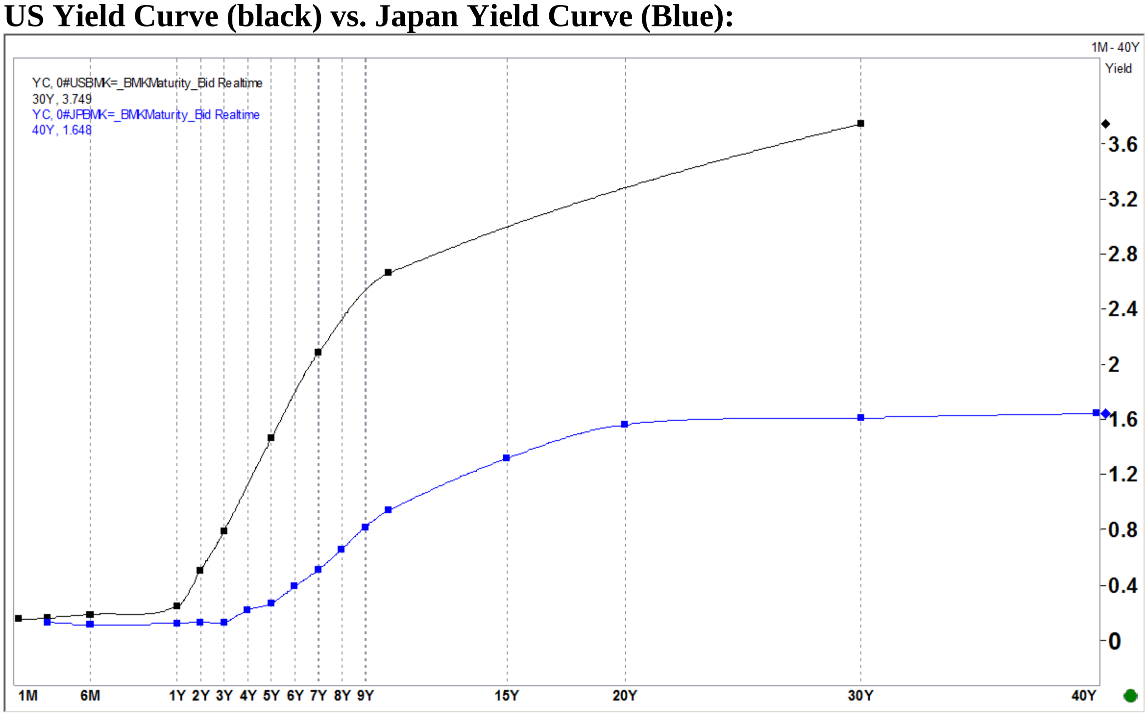
Lao Tzu

Forex Trading - The word of the day is debt.

Japan is doing a hefty amount of buying of US debt. China's recent reduction, according to reported TIC data, in its US Treasury holdings has been getting most of the attention as it marks the second month in a row. But Japan's buying in the most recent month has mostly counteracted China's move.

It's common knowledge that Japanese companies (the current primary source of demand for Japan's 14 straight weeks of overseas bond purchases) typically park money in Japanese Government Bonds. But in seeking returns combined with safety, Japan is soaking up record amounts of Treasuries, according to the weekly numbers on capital flows put out by Japan's Ministry of Finance.

US Yield Curve (black) vs. Japan Yield Curve (Blue):



Some analysts are blaming Japan's appetite for Treasuries, and the resulting decline in yields, as reason for the US dollar's recent weakening phase. Reuters explains it this way:

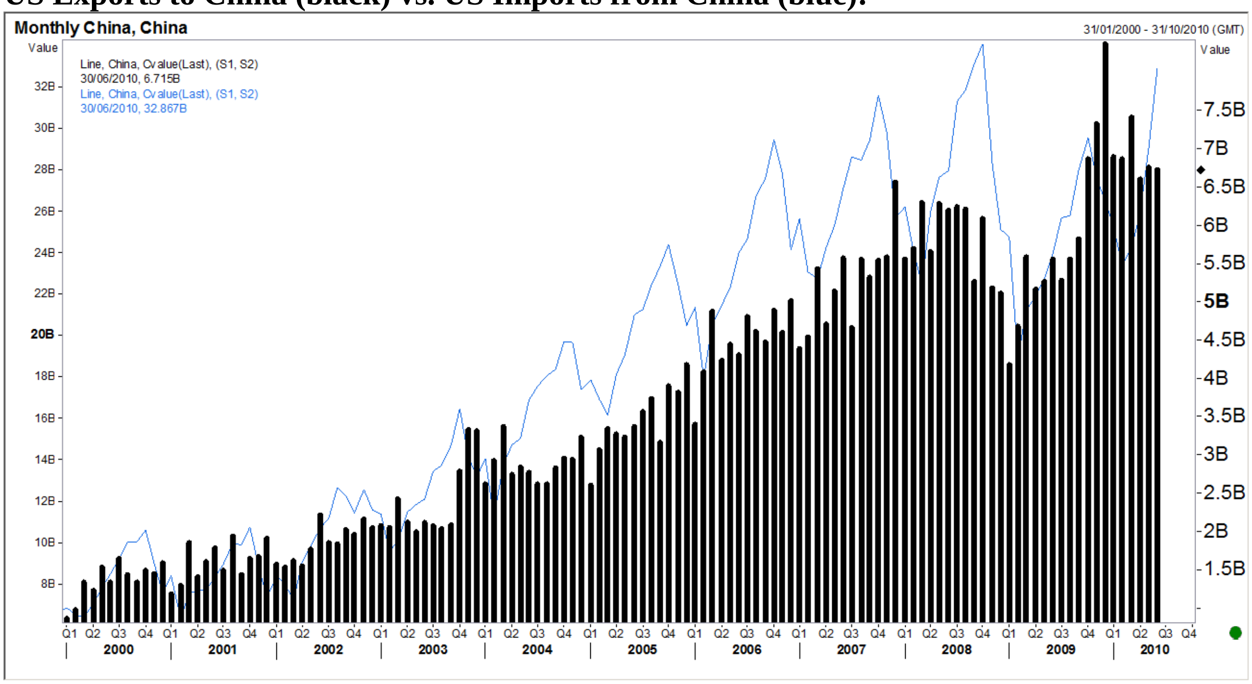
> Japanese banks unwilling to take on currency risks buy the bonds by borrowing cash in dollars, and can still enjoy decent returns as short-term dollar interest rates are near zero. And when they use yen funds to buy overseas bonds, they hedge against currency volatility.

So while it does take US dollars to purchase US debt, the impact on the dollar is different when dollars are borrowed rather than purchased in a straight-up foreign exchange transaction. This borrowing of dollars at extremely low short-term rates (i.e. carry trade) tends to weigh down its value.

China, in relieving itself of some US Treasuries, has funneled money into European, Japanese, and South Korean debt. Most recognize this as a change in preference, a bullish perspective on the euro and the yen and a bearish perspective on the US dollar. But there could be a something a bit more selfish going on.

Mostly despite the recent value of the dollar, the US trade deficit with China has been growing.

US Exports to China (black) vs. US Imports from China (blue):



China is happy with that, as it fits nicely with the growth model in which China is most confident. Of course, that growth model has been called into question and the fix can be summed up as 'rebalancing.' As a reminder: rebalancing means a shift within deficit nations toward savings and export growth and a shift within surplus nations toward spending and consumption. A shift in the former necessitates a shift in the latter. China *is* the latter.

Extending the dots from the rebalancing thematic, there may be more to the recent shift of Chinese money out of US bonds and into European paper that goes beyond the standard view China is worried about the US…it may have nothing to do with that and all to do with picking off its major global competitor--Germany.

Criton Zoakos of Leto Research argues:

> Europe has now become the new big target of China's currency manipulation, which suits Europe fine as it is desperate to find buyers of its impaired, crisis ridden and massive Euro-denominated sovereign debts. A second reason why Europe is not complaining about China's currency manipulation is the fact that Germany, alone among European economies, is enjoying a growing trade surplus with China even as Europe overall has a growing deficit. In fact, Germany in the first half of the year has become totally dependent for its growth on trade surpluses with China.
>
> But China's special favorable treatment of Germany comes at the expense of all the other Eurozone economies and has exacerbated the gap between Germany and the European periphery. This has forced the periphery further along the path of deflation while Germany is under increasing inflationary pressures. The European Central Bank is discovering that China's purchases of junk European sovereign debt may have alleviated the Euro debt crisis temporarily, but by strengthening the Euro it has made more difficult the ECB's job of enforcing an one-size-fits all monetary policy over all Eurozone economies.

Is Europe "desperate to find buyers" of its sovereign debt? Indeed. The latest auctions of Irish and Spanish debt were met with sufficient demand, though the ECB may have played a large role, indirectly, in those purchases. Investors are already looking ahead to the auctions in September, October and November to get an idea of whether the supply of debt can be met with sufficient bids. It's expected that Europe will skirt by in September but that there may be an uncomfortably large gap between supply and demand for debt in October and November.

The potential for sovereign debt issues to spook the markets is currently quite high. If it materializes, risk-aversion (aka "risk off") is back on tap ahead of the next European sovereign debt auctions. Expect such a mood to support the US dollar and despite its pitiful available yield profile.

And keep a close eye on China's influence – they may like a stronger euro to help keep European exports less competitive. But if a stronger euro persists, and Germany exports fade, then Europe will likely ratchet back up its criticism of China as a currency manipulator while in the midst of dealing with rising risk spreads among the sick sister single currency member states. That won't be good for the euro and will likely usher back in that phrase that seems to roll so easily off the tongue these days—rising systemic risk.

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