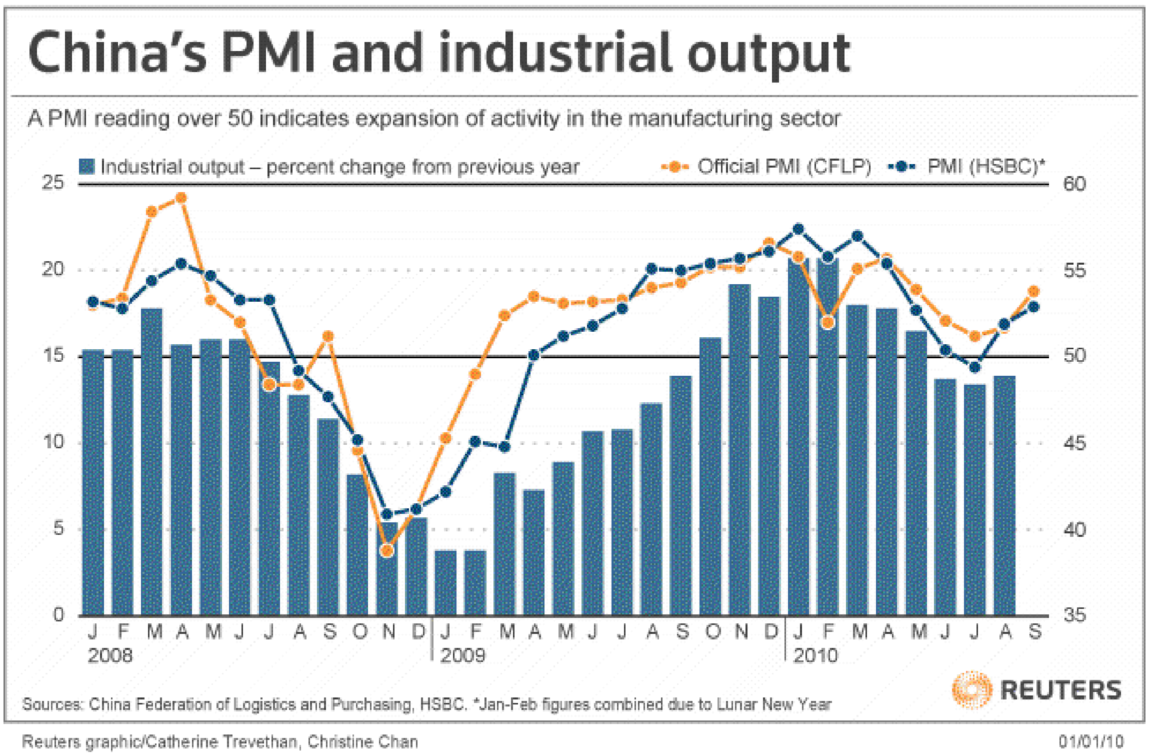
Friday 1 October 2010 www.blackswantrading.com

FX Trading – Operating in a vacuum: China, gold, and trends do end

This morning John Ross sent me this little note:

BEIJING, Oct 1 (Reuters) - Chinese manufacturing picked up steam in September after a mid-year lull, easing concerns of a renewed downturn in global growth ...



He said: "I say we just put that in CCPRO today and start our weekend ... apparently that is all that matters."

And it seems JR is correct. China growth is the trigger for a self-reinforcing downtrend in the US dollar, in the mind of the market, it seems.

We call it a self-reinforcing trend because US bad news is bad for the dollar and US good news is bad for the dollar (yesterday was a good example of that given the better-than-expected jobless claims and strong manufacturing numbers).

We keep asking: Isn't Chinese growth in some way good for the US economy too? Hmmm ... And isn't good Chinese growth somewhat of a reflection of US economic strength given the level of Chinese exports sent to the US? It would seem. Or does all this stuff now exist in a vacuum?

The bad US economic news story makes sense. And the relative poor US growth, even if positive, must be compared to stronger growth elsewhere, i.e. the relative game of currencies. And or course our Nanny Fed circling in the helicopter in the background to add monetary juice should we show the slightest stumble, leads to the natural expectation interest rates in the US will stay low forever. Thus, the US dollar in that story *is* the primary carry trade currency. Borrow dollars to fund all the higher growth and yield stuff outside the US. Thus not only the major currencies are smoking against the dollar, but international stock markets to -- especially those of the emerging market variety.

iShares MSCI Emerging Market Index Weekly:

It has been a nice move indeed. Money is flowing fast and furiously into the EM world -- for a lot of good short- and long-term rationales. The rationale we are talking about here is the dollar as the funding tool for a lot of this move -- back to the good old "center outward to the periphery markets" stuff that has always been the source of liquidity for EMs past, but many are now questioning whether this is the case now. Seeming to believe that somehow EMs now fund themselves despite the fact that they have no capital market depth to speak of. No matter, as we said, all this stuff is operating in a vacuum.

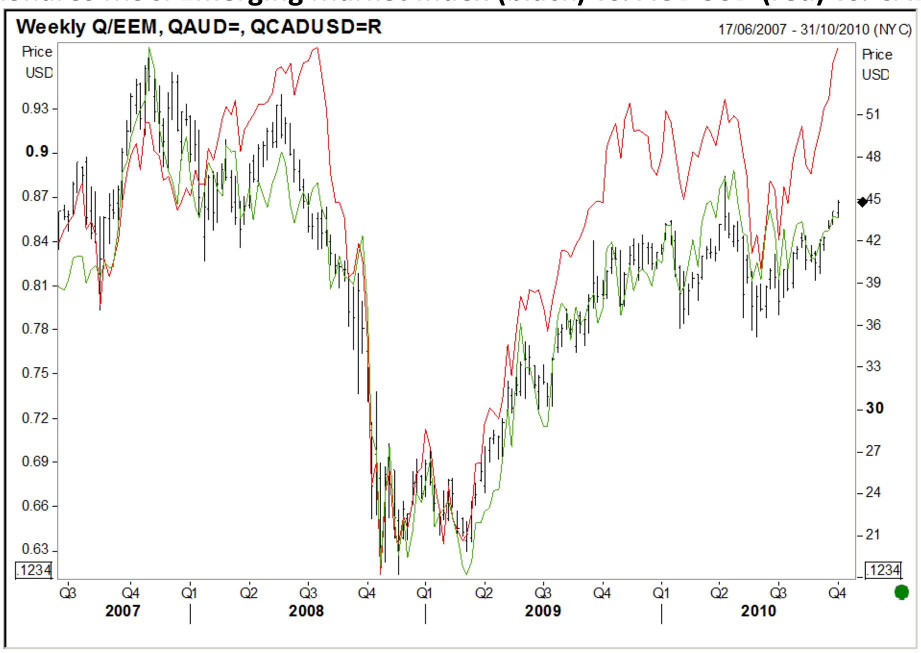
As fast as the emerging markets are moving, the relative movement of the key major risk asset currency -- Australian dollar -- is moving even faster. <u>No matter again that Australia's housing market is a gigantic bubble (40% overvalued by some estimates) or that its manufacturing numbers cooled for first time in 2010, as reported this morning, or that on measures of purchasing power parity the Aussie is about 30% overvalued</u>

relative to the US dollar; none of that matters when it comes to Australia. Why? Their boy China!

All things China drag along all things Australia.

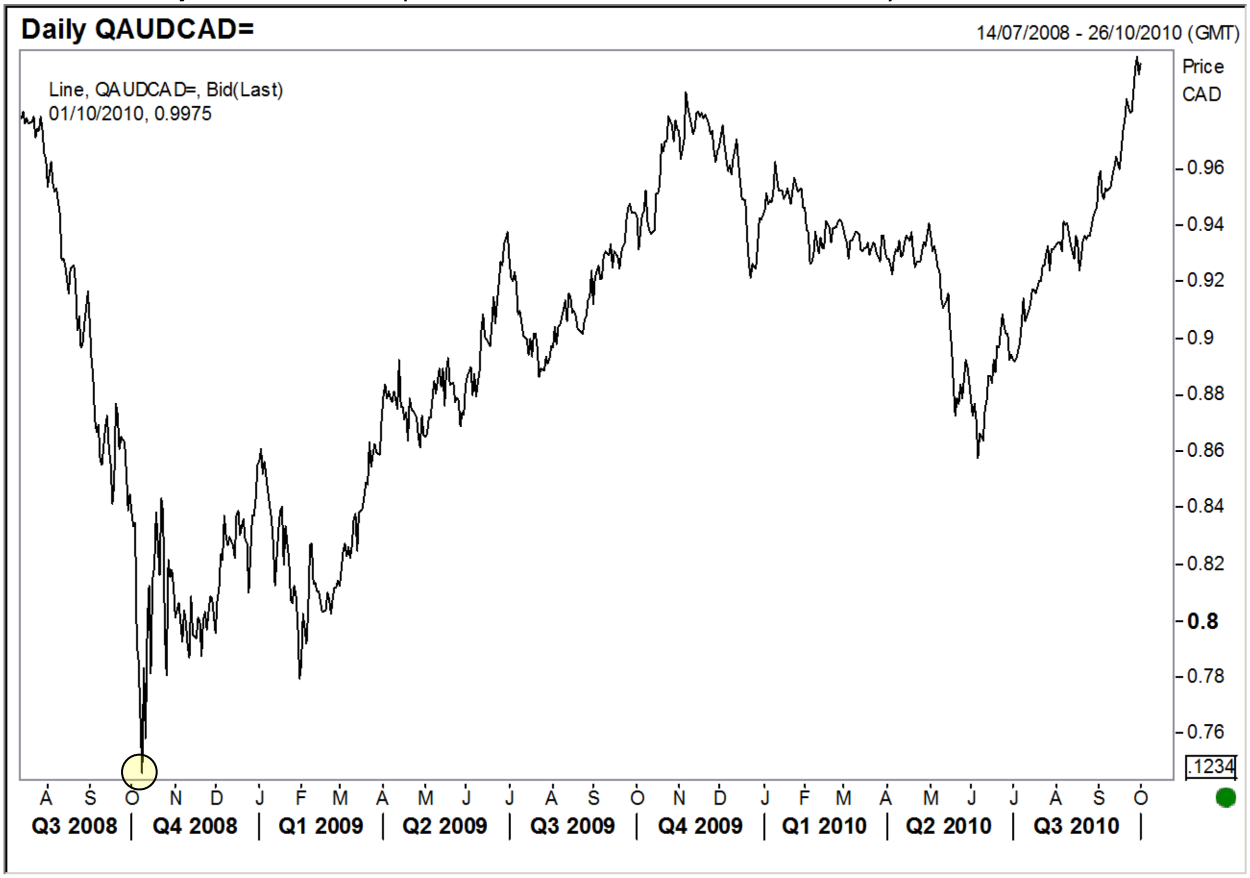
The point being: Aussie-USD is running well ahead of even the Emerging stock markets thanks to the dismal view on the dollar and the cheerful view on the Chinese economy. The Canadian dollar, by comparison, which also benefits from the Chinese, unfortunately has the ball and chain of the US economy locked around its leg. Thus the Aussie is the star player with a whole bunch of growth premium factored into the trend. I think you can see this in the comparison chart showing:

iShares MSCI Emerging Market Index (black) vs. AUDUSD (red) vs. CADUSD (green):



The questions: Is it time for CAD to play some catch-up to the Aussie? Is it time for the Aussie to play some pull-back to the CAD? Or does this trend continue to diverge? All depends on you know who: China.

AUDCAD Daily: Talk about outperformance between the commodity currencies. Yikes!

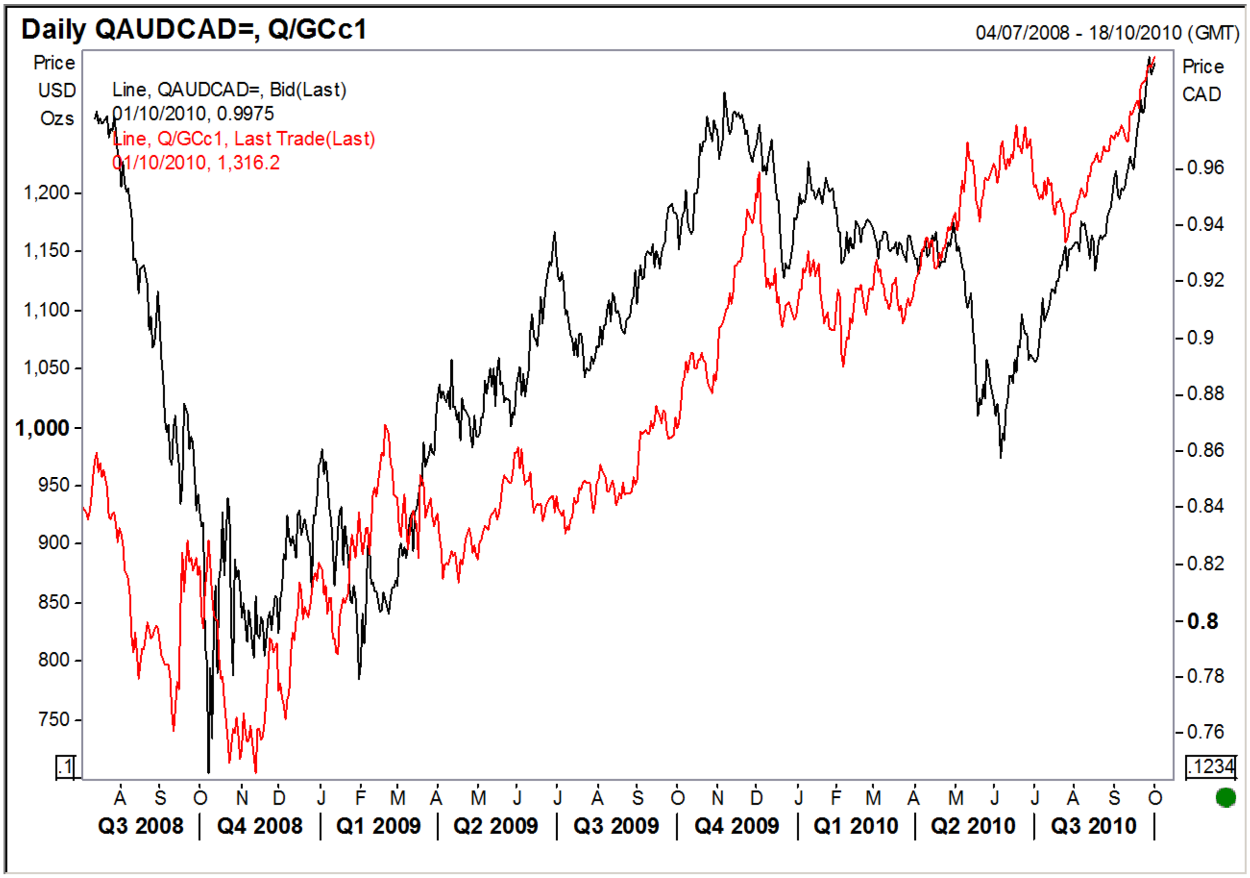


This chart shows that CAD plays a safe-haven role on risk aversion, evidenced by the low back in late 2008; but the Aussie plays the growth role on risk appetite as the spread widens on growth expectations, hitting new intermediate-term high in this spread.

And as much as we keep harping on the fact that maybe gold is moving on rising risk, when we overlay gold here we see it is moving tightly correlated with this spread. Which might, key word is *might*, as I don't want to stir up the gold bug crowd's hornet's nest ... or the ire of my father in law now that his net worth has jumped considerably; he a man who seems to be taking his gold inventory more frequently than usual for some reason these days. In fact, he emailed me yesterday in the middle of the night, 1:29 a.m. to comment on a recent *Currency Currents* -- I suspect is was yet another sleepless night finding new hiding places for his bricks in the wall.

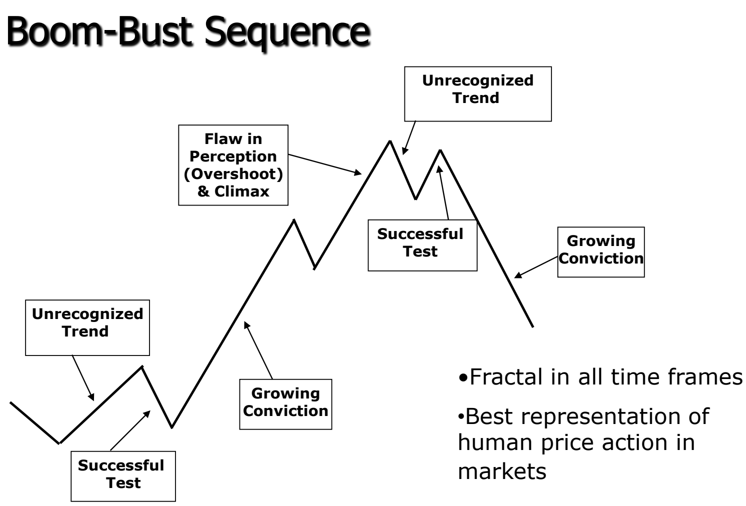
Anyway ... sorry about that tangent ... I was going to say that gold is following tightly on the AUDCAD spread, suggesting the move in gold might be more of a liquidity/growth-driven move than we have been suspecting; or it might be just another spurious correlation. Anyway, worth a look I think ...

AUDCAD (black) versus Gold (red) Daily:



So, maybe our culprit for the gold move might just be, you know who: China.

It is the nature of self-reinforcing trends that it leads to overshoot, i.e. asset prices overshoot their fundamental values because the trend becomes primarily price-led at the end whereas the beginning was driven by solid fundamental rationales which no longer apply at the end. <u>Of course we all know the problem here. Even if you know the fundamentals no longer support the rationales, it can take a long time for the trend to change to reflect the new reality.</u> It is why the simple boom-bust does such a good job explaining this human-driven price action.



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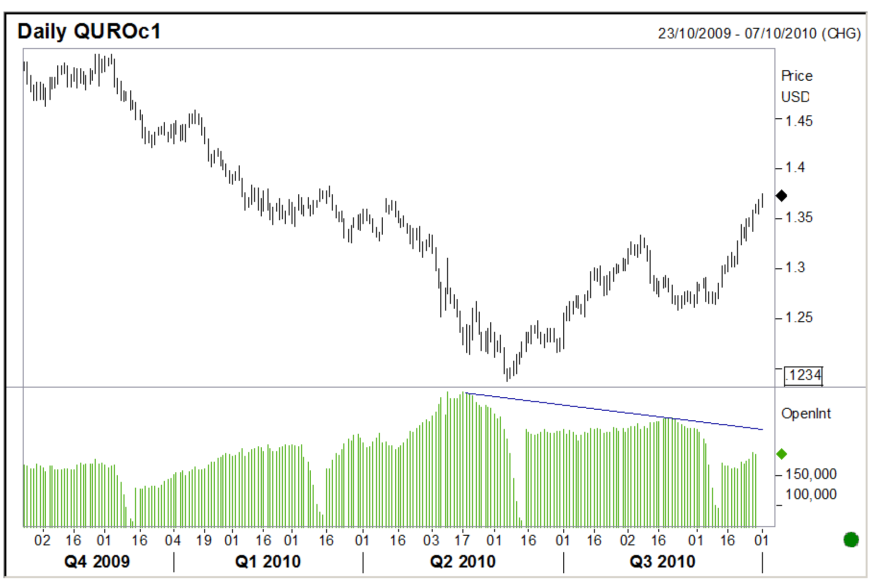
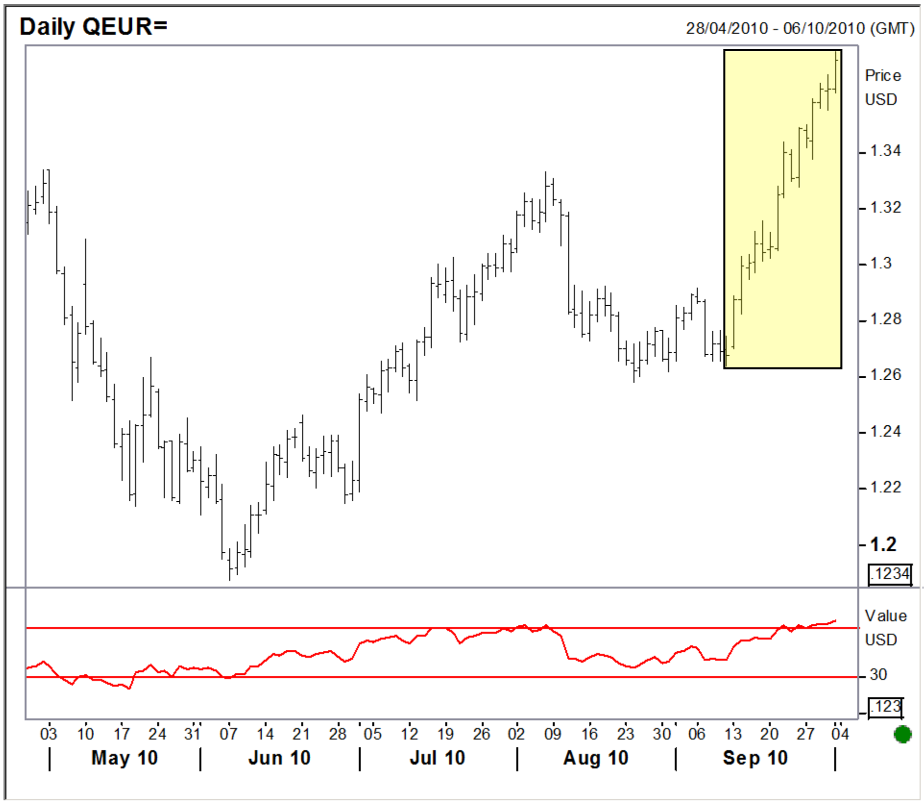
This is why sentiment is such an important part of the currency game. The problem of course is that sentiment can be hard to get a handle on at times. We do our surveys and watch comments and price action, but there is rarely an "a ha" moment without the gift of hindsight.

In real time, one indicator that can be helpful, though far from perfect, is the open interest levels in the currency futures listed on the CME. (Unfortunately we don't get accurate volume or OI numbers for spot forex.) If we take a look at the Open Interest in the euro contract (the key dollar alternative), it shows we are far from an extreme. That might suggest there is still plenty more buying power on the sidelines yet to capitulate.

Euro Futures Daily: Green bars at the bottom of the chart represent open interest levels



If we circle back to the human action perspective of this, notice there has yet to be any correction to the latest leg of the trend since it began back on September 10th, as seen more clearly in the EURUSD daily chart below (red line at bottom is Relative Strength Index) ...



Let's call that yellow box on the chart the "QE2 power surge". Makes sense for the reasons discussed above.

Okay. Our job is to try to help you make money from these trends. And unfortunately we have been woefully negligent in helping you catch this EURUSD move. Maybe it was the euro-going-to-par bias, admittedly. No matter. But it is also our job to help you realize there are other scenarios outside of the mainstream so that you can know when to reduce risk or take some profits when fortunate enough to be riding a trend. Again, this has no bearing on whether or not the trend is about to end.

Here are two plausible alternative scenarios that could change the current dynamics of this trend (for all the ignorant "dollar is going to zero crowd" out there -- and you know who you are -- do not write to us to tell us the dollar is going to zero; we will not respond):

1) **A relative US growth surprise.** Shocking as that is. And precisely because it would be a big surprise it would move prices dramatically -- surprise is always a powerful motivator to get real people to act. Why do we say relative? We say that because it is relative to the Eurozone that just may experience the growth crushing power of austerity. And because we have already seen warnings from

the UK central bank that forward-growth looks very tenuous at best and calls for more UK quantitative easing are on the front burner.

Think of the rapid expectation quantitative easing juxtaposition traders would have to make in their minds (a mouthful I know). A US growth surprise would mean our Nanny Fed would move the helicopter back into the hanger. A crushing blow from austerity (they ain't rioting in the streets of Europe for nothing) may lead the European Central Bank to do more stealth or covert QE of its own. And if the Bank of England hints it is going down the QE trail ... bada-bing bada-boom for the US dollar.

Maybe scenario stretch, but I think something that needs to be considered. Even the hint of that might be enough to finally lead to a decent and overdue correction in the EURUSD pair -- currently watching for that trade to develop as dollar sentiment sinks lower and lower.

2) **You know who reacts *negatively*** to US talking trash about its incredibly manipulative currency and trade policy: our boy China.

   No need to go through the scenarios here. Growing real concern of a trade war will be seen in the commodities markets and ripple through the commodity currencies very fast. That entire Aussie currency premium now displayed would shrink faster than you can say "bring me another fortune cookie."

3) **You know who reacts *positively*** to US talking trash about its incredibly manipulative currency and trade policy: our boy China.

   Reacting positively means letting its currency find higher ground relative to the buck. It would mean fewer currency reserves sloshing about in China in particular and Asia in general, reserves that have been reallocated to a large degree into euro, Aussie, pound and, dare we mention this, maybe even gold.

   This from a story by Jeremy Boulton of Reuters yesterday: "Let China be and reap the rewards"...

   > "Most notable in this respect is China's ever growing FX reserve, the build-up of which will be pared by any managed yuan appreciation. However, other Asian central banks may also step back from the plate.
   >
   > "Already running current account surpluses with China, both Japan and Korea stand to gain from a stronger yuan so will have less cause to intervene.

> "Other central banks in the region are also actively intervening on a near daily basis to offset the weaker dollar, and more often than not redirect the proceeds not euros, sterling, or Australian dollars.
>
> "If China leads and others follow, this near daily bid for G-4 currencies will ebb, or perhaps stop entirely. At the very least Asian central banks will have more time to pick and choose how they diversify.
>
> "If they do a key prop for EUR/USD will be withdrawn.
>
> "With bulk of currency trade in the majors, this would partially alleviate the trend to a weaker dollar that is prompting so much intervention in the emerging market currencies."

So, there are reasons out there that could change this trend. This morning, the rationale that has driven asset markets so far is still clearly in play. The trend is your friend until it's not any more. Once you realize that, it's a layup (just kidding).

Happy Friday.

Jack Crooks
Black Swan Capital LLC
www.blackswantrading.com