<u>CURRENCIES: THE WAITING GAME</u>

© Leo Haviland, 646-295-8385 November 4, 2013

"I'm so tired
Tired of waiting
Tired of waiting for you". The Kinks, "Tired of Waiting for You"

****

<u>OVERVIEW</u>

Many academic, financial, and political circles have long been married to "free market" ideologies. Nevertheless, the manipulation, maneuvering, or managing of a nation's currency level and trends often occupies the deliberations and behavior of that territory's central bankers, finance ministers, and many politicians. As in their efforts to control or at least influence interest rates (or stock marketplace trends), sometimes their reasoning, actions, and targets are explicit, often they are implicit.

Of course even within a country, these leaders do not always agree. And the assorted other relevant national economic (political) players (importers and exporters; producers, manufacturers, consumers) obviously do not necessarily share the same views regarding appropriate or desirable currency levels. What is a "too strong" or "overly weak" United States dollar, anyway? Also, although embraced currency policies generally remain in place for some time, they change. After all, viewpoints and financial marketplace conditions (not just in the currency arena) frequently evolve, sometimes dramatically.

Moreover, in today's globalized and competitive economy (with related intertwined complex international political dealings), currency-related opinions, outlooks, policies, and actions of a given country entangle in numerous ways with those of other nations. Currency levels and appreciation and depreciation travels are important variables affecting economic output. Hence some nations occasionally complain about the currency levels and programs of other realms. People talk about the outbreak, duration, and consequences of currency wars. However, not everyone can devalue together.

Currency considerations are not islands apart from interest rate, stock, real estate, commodity and other marketplaces. So policy makers enamored of free market propaganda do not necessarily restrict their efforts to affect economic results to their home currency (or that currency's cross rate relationship to one or more key trading partners). For example, picture the Federal Reserve Board's longstanding yield repression policy, which has pinned the Federal Funds rate close to the ground. Thus much of the US government yield curve has long rested below or around the inflation rate. Borrowers and debtors and stock marketplace bulls especially adore the Fed's repressive interest rate scheme. The European Central Bank and many other central banks embrace similar rate policies. In recent years, the Fed, like many other leading central banks, has embarked on a massive money printing enterprise. The Fed's highly accommodative interest rate and money printing strategies aim to spark and sustain economic growth, create what it views as sufficient inflation, and reduce unemployment (and rally real estate and stock marketplace prices).

****

Although the majority of currency observers and strategists focus their attention on crucial cross rates such as the US dollar against the Euro FX, broad real trade-weighted (effective) exchange rates influence important national policymakers. Analysis of these trade-weighted measures can unveil signs as to important (even if implicit) levels watched by central bank, finance ministry, and political guardians. Such trade-weighted foreign exchange measures consequently provide instruction as to potential strategy responses or changes by these often-vigilant sentinels. National and international policymakers of course are not the only ones looking and waiting around in marketplace games; Wall Street and Main Street likewise wait, watch, and act. Because these broad foreign exchange indicators (and the underlying cross rates) interrelate with perspectives on and decisions relating to current and potential elevations of and movements in numerous interest rate, stock, and other marketplaces, they offer insight into past, present, and future levels and trends of these arenas.

****

Given the great importance of the United States in today's international marketplaces, and as the greenback remains the most important reserve currency, and since US Treasury debt and American stocks are widely-watched benchmarks partly affected by dollar levels and fluctuations, why not concentrate on America's broad real trade-weighted dollar? Japan and China likewise are major players on the global stage. Japan (despite its enormous government debt) and China are creditor countries, America is a debtor nation. Since Japan and China not only are key trading partners of the United States, but also far and away the largest owners holders of US Treasury debt, scan their currencies in this context as well.

AMERICA: TRADE-WEIGHTED DOLLAR

Iggy and the Stooges sing in "Gun": "Money is a waste of time, course I made sure I got mine".

****

China's current trade weight in the broad index of the foreign exchange value of the dollar is 20.8 percent. It was 7.9pc in 2000, 3.0pc in 1990. Japan constitutes about 7.6pc, down from 2000's 12.8pc and 1990's 18.7pc. (Federal Reserve Board, H.10 statistics).

As of August 2013, major foreign holders owned about $5.58 trillion US Treasury securities (US Treasury International Capital System "TIC" data, 10/22/13). This is a decline of about $133 billion from March 2013's peak. With this net foreign UST selling in recent months, isn't it wonderful that the Federal Reserve has been such a devoted acquirer of UST (and mortgage-backed securities) via its money printing venture? Assume little progress is made on America's near term deficit or its massive long term one. Based on the Washington's political divisions and debates and recent government shutdown, why should there be noteworthy progress anytime soon? The deficit ceiling quarrel was postponed, not solved, by Democrats, Republicans, and the President singing loudly while huddling around their various campfires. What happens to US interest rates if the Fed tapers its securities acquisition scheme?

Mainland China held about $1.27 trillion UST at end August, about 22.7 percent of the total foreign holdings. Japan owned almost as much as China. Its $1.15 trillion equals 20.6pc of the foreign UST possession. China's current level is a decline from the May 2013 peak around $1.98tr; Japan's holdings, have risen only slightly, about $28.2bb, since August 2012.

How happy will China, Japan, and other foreign holders of UST be if the dollar depreciates from current levels (or if US inflation creeps up), especially given the Fed's steadfast determination and promise to keep repressing interest rates? All else equal, both resolute US interest rate repression and gigantic money printing tend to encourage dollar deterioration.

****

The widespread relative silence of American leaders over the past couple of years regarding the dollar in general (broad real trade-weighted dollar, "TWD"; monthly average, Federal Reserve H.10 data, 1973=100) over the past couple of years coincides with the TWD being confined within a range during that span. That range runs from July 2011's record bottom at 80.5 to its subsequent high at 86.3 in June 2012. The 80.5 to 86.3 band is well under the March 1973=100 benchmark level and stands far beneath February 2002's 112.8 pinnacle. In addition, it rests considerably below March 2009's peak at 96.9 (reached at the depths of the worldwide economic crisis; recall the 3/6/09 timing of the S+P 500's major bottom at 667). At 84.2 in October 2013, the TWD remains mired near its former major lows around 84.0: October 1978's 84.1, July 1995's 84.0, April 2008 at 84.2.

The relatively depressed TWD range over the past couple of years strongly suggests that many American policymakers, including the Federal Reserve, generally are content with (and promote) a rather feeble TWD, even if they do not want one that is allegedly too weak (or too robust). The joyous hymn "weak (or at least a moderately weak) dollar equals strong US stocks" may not hold true forever, but this faith continues to encourage the congregation of US stock owners and their allies.

Although the TWD has not retested its July 2011 trough, a sustained challenge to it (and especially a break under 80.0) probably will excite significant attention across numerous marketplaces.

****

"I'm waiting for my man Got twenty-six dollars in my hand". "I'm Waiting for the Man", The Velvet Underground (Lou Reed)

****

What consequences for the dollar will ensue (and US and other interest rates and equities) if foreigners remain grudging buyers or consistent net sellers of US assets? What does studying the wide vista of foreign ownership activity in relation to US assets indicate? It hints that foreigners have become increasingly uneasy regarding additions to their portfolio of dollar assets. All else equal, this represents a bearish warning for the dollar.

The monthly average of net foreign buying (by official and private sectors combined) over the first eight months of calendar 2013 of UST notes and bonds (not including Treasury Bills), agency bonds, and corporate bonds plus US equities (these four securities marketplaces combined) averaged merely $1.1bb per month. Over that period, UST actually displayed net selling, an average of $2.8bb/month. Compare this with full year 2012 monthly average net buying of UST at $34.7bb/month, with the three debt categories and stocks combined averaging net purchases of $52.8bb/mo. The 2013 sum of $1.1bb/mo represents a precipitous collapse from net foreign acquisition of debt and stocks together of $95.3bb in 2006 and $83.8bb in 2007. (US Treasury, TIC data).

Underline that foreigners were net sellers of US stocks each month from May through August 2013. Their net selling total of $61.8bb may be relatively modest, and of course TIC data does not cover the past two months. However, this net foreign selling of US stocks over the May-August span probably indicates that recent buying enthusiasm for American equities is primarily a domestic phenomenon (including vigorous corporate share buyback programs). Leverage (encouraged by the rock-bottom Federal Funds rate) arguably has encouraged this quest for equities. New York Stock Exchange margin debt of over $401 billion in September 2013 represents a new summit (recall July 2007's $381.4bb).

In addition, a trend of falling direct foreign investment in America has emerged. This hints that foreigners are not in a big hurry to grab such assets. Calendar 2000's level was $321.3bb, with 2008 at about $310.1bb rivaling this. However, that investment fell to $150.4bb in 2009. Although foreign direct investment ascended to $205.9bb in 2010 and $230.2bb in 2011, it slipped to $166.4bb in 2012 with first half 2013 (annualized) edging lower to $133.0bb.

Pundits may label American current account deficits as manageable, but sustained ones are not a bullish factor for the dollar. In any event, the United States probably will run a current account deficit of 2.7 percent of GDP in 2013 and 2.8pc in 2014, with 2018's at about 3.0pc. In contrast, China will have a current account surplus of 2.5pc of GDP in 2013, with 2014's at 2.7pc; 2018 rises to 4.1pc. Japan, also unlike the US, generates a surplus. For 2013, it will be about 1.2pc of GDP, rising to 1.7pc in 2014, with 2018's estimate also at 1.7pc. (International Monetary Fund, "World Economic Outlook", October 2013).

****

The Euro FX (16.2 percent), Canadian Dollar (12.6pc), Mexican peso (11.7pc), and British Pound (3.4pc) are important parts of the TWD. The Euro FX, Canadian Dollar, Mexican peso, and British Pound trade actively against the dollar. Their levels and trends are relevant to US and other international policymakers. But let's look at Asia and focus on the Japanese Yen and Chinese renminbi.

LOOKING EAST: JAPANESE YEN

The gunfighter Joe says: "Crazy bell ringer was right, there's money to be made in a place like this." From the movie, "A Fistful of Dollars" (Sergio Leone, director)

****

The Japanese Yen versus US dollar cross rate level and trend are watched closely by Japanese and other international authorities. Many marketplace players in other currencies, debt arenas, and stock fields also monitor this important currency cross rate. However, the Yen's broad real trade-weighted level and motions (effective exchange rate, "EER", monthly average, 1990=100; Bank of England statistics) are a more comprehensive guide to the Yen "in general" and Japanese official policy in regard to it. Analysis of the EER Yen also offers a helpful perspective regarding trends in related currency, interest rate, and stock marketplaces.

****

Japanese authorities in recent months engaged in a concerted effort to weaken the Yen. What are some key EER Yen levels to recall and pay attention to as time passes?

Remember the July 2007 EER Yen bottom at 114.4 at the end of the blessed Goldilocks Era and the dawn of the dreadful worldwide economic crisis. As the disaster emerged and worsened, as world stock marketplaces crashed, the Yen generally rallied. It paused at an interim high at 131.7 in March 2008. After slipping to 123.8 in July 2008, it jumped to a high of 161.4 in January 2009.

Despite the economic recovery, this lofty height was broken with June 2010's 162.2. The Yen attained its all-time EER pinnacle in January 2012 at 185.6, building final tops in July/August 2012 at 183.7/183.4. After substantial central bank easing and new government policies/"Abenomics" aimed at stimulating growth and creating inflation, the Yen plummeted. Its 141.4 low in May 2013 stumbled 23.8 percent from January 2012's lofty peak. However, the Yen slump has stalled, with its October 2013 average 143.2.

The Japanese government and its central bank remain wedded to their current program, including the proposition that the Yen should not be too strong. Many Japanese industrialists applaud these policies.

Nevertheless, the Nikkei stock marketplace established a noteworthy top in May 2013 (5/23/13 at 15943) alongside the low in the EER Yen that month. The Nikkei (and many emerging stock marketplaces) rapidly declined, falling 22.1pc to its 6/13/13 low at 12416. The Nikkei's May 2013 level stands substantially beneath February/June 2007 plateaus around 18300. Note also the quick fall in the S+P 500 from its 5/22/13 level at 1687 to its 6/24/13 low at 1560, although it since climbed to make a new peak. So a sustained rally in the Yen EER toward its January 2009 top (even if it does not touch it) probably would warn of noteworthy trouble for the world economy. A Yen EER march over its January 2009 plateau and toward the 2012 pinnacles would indicate very severe international economic problems.

The June 2012 high in the TWD occurred around the same time as the final high in the EER Yen in July/August 2012. On balance since mid-2012, the TWD has weakened slightly, whereas the Yen EER has slumped significantly.

Japan and America do not have the same trading partner percentage breakdowns for their currencies, and their economic and political positions obviously are not identical. Admittedly Japan has a large and growing government debt, but its pool of domestic savings available to finance that debt arguably is greater than America's. Moreover, Japan's social consensus currently probably is greater than America's (evidence Washington DC's vicious battles between Republicans and Democrats). So if the world economy displays even more signs of weakness or if the American political situation (deficit debates) worsens (or both), perhaps a sharp rally in the EER Yen would coincide with renewed weakness in the broad real TWD.

****

Note the following various percentage falls in the Yen EER from its 185.6 peak in January 2012 alongside several other key historical levels for that index.

**5 percent decline gives Yen EER of 176.3; about 171.0 was April 1995's major high.
**10pc: 167.0 168.6 is three times November 1979's major low of 56.2.
**Recall January 2009's high at 161.4 and remember June 2010's breakout level of 162.2. The Japanese economic (political leadership) probably will be dismayed if the Yen EER advanced close to the January 2009 height. Compare 158.8 (September 2000 peak; December 1999's top 155.2).
**A 20 percent fall in the Yen EER from its January 2012 high gives 148.5. Many gurus define a bear trend as s downturn of 20 percent or more from an important top. Watch the May 2013 low at 141.4.
**25pc: 139.2 (139.4 is a 50pc move from the April 1990 trough at 93.0.
**33pc: 123.6; the November 1988 high was 120.2; 114.4 was the significant low attained in July 2007.
**107.4 was the August 1998 low.
**50pc collapse gives 92.8; 93.0 bottom April 1990.

****

In the cross rate context, the Yen weakened sharply against the US dollar from its tops under Y80 (Y75.4 on 10/31/11, Y77.1 on 9/13/12). From jump-off points of Y79.1 on 11/9/12 and Y90.9 on 2/25/13, it swooned, falling to its 5/22/13 low slightly under Y103.7. A five percent rally in the Yen cross against the dollar from its May 2013 bottom gives about Y98.6. A ten pc bull move from its May 2013 low gives Y93.4 (the high in the Yen versus the dollar since its 5/22/13 low is 6/13/13's Y93.8; 4/2/13 interim high at Y92.6). A twenty pc rally makes Y83.0.

LOOKING EAST: CHINESE RENMINBI

The US dollar gradually has weakened against the Chinese renminbi for the past few years. The renminbi has steadily rallied from its 9/2/10 low at about 6.818 versus the dollar. Another key low for the renminbi was 7/25/12's 6.396. By the way, the US government 10 year note made a major bottom that day at 1.38 percent. Also, the Euro FX made a major low against the US dollar on 7/24/13 around 1.204. Anyway, the Chinese currency advanced further from its lows around 6.250 (12/12/12's 6.257 and 2/20/13's 6.249) as well as 6/27/13's 6.152. The renminbi's high against the dollar to date is about 6.077 (10/24/13), about a 10.9 percent rally relative to its 9/2/10 level.

A five percent fall in the dollar against the renminbi from its 9/2/10 high is about 6.477, a ten pc drop 6.136. A 15pc slide gives 5.795, with 20pc depreciation equaling 5.454.

Given the substantial share of China within the broad real trade-weighted US dollar, further significant declines in the dollar relative to the renminbi from current levels may put substantial overall pressure on the TWD, including a test of the major TWD support around 80.5.

Dollar weakness does not necessarily (inevitably; forever) encourage or reflect a strong American economy or continue to help propelling US equities upward. Suppose a significant run against the "dollar in general" (TWD) occurs, whether via Chinese renminbi, Japanese Yen, or Euro FX (or other currency) strength against the dollar. A TWD dollar dive (especially under the July 2011 low) could force the Fed to significantly reduce or even abandon its interest rate repression and quantitative easing (money printing) policies. Consequently the effort by many American leaders and businesses promoting further weakness in the dollar relative to the renminbi may have some enthralling consequences not only for the dollar in general, but also for American (and other international) interest rate and equity marketplaces.

****

Most observers focus on the Chinese renminbi's various cross rates, especially against the US dollar. However, the growing international strength of China's economy manifests itself in a review of its currency trend on a trade-weighted basis.

The Bank for International Settlements ("BIS") provides broad real Effective Exchange Rate indices for many currencies (monthly averages, 2010=100), including China. For China, this data extends back to January 1994. The current weights for key nations in the BIS's China EER index include the US at 19.0 percent, Japan's 15.9pc, Korea's 7.9pc, with 19.4pc for the Euro area, and Chinese Taipei (Taiwan) at 5.8pc. Compare weights for the BIS's Japanese Yen EER; China comprises 29.5pc, the US 16.6pc, the Euro area 14.0pc, and Korea 5.9pc.

In addition to the China EER low at 73.7 in April 1995 (65.6 in January 1994), see the one at 81.9 in December 2004. The China EER then rallied strongly to a key high of 107.4 in February 2009 (shortly before the S+P 500's March 2009 major low). Although the renminbi EER slipped to a trough of 95.6 in November 2009, it thereafter charged to a new high of 117.4 in September 2013 (which also is the most current BIS data month). The long run rally from December 2004's 81.9 bottom to September 2013's height is huge, about 43.3 percent. The 22.8pc advance from April 2011's 95.6 floor to the September 2013 elevation is rather rapid as well as substantial.

****