CURRENCY CONTEXTS: RECENT RALLIES IN THE DOLLAR AND RENMINBI

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"Seek truth from facts." Mao Zedong and Deng Xiaoping

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CONCLUSION

For marketplaces such as the United States dollar, the US Treasury 10 year note, the S+P 500 and emerging stock playgrounds, and commodities in general, as well as for the interrelations between such financial arenas, observers should remember their 2007-2009 (or even earlier) history. "The past" of course need not repeat itself, either exactly or even in part. However, it should not be forgotten.

Currency marketplace watchers generally concentrate their attention on important cross rate relationships such as the US dollar against the Euro FX, Canadian dollar, Japanese Yen, or Chinese renminbi. However, broad real currency indices (trade-weighted or effective exchange rate) offer greater insight regarding the actual overall strength (or weakness) of any given currency than does a particular cross rate. Thus the broad real trade-weighted dollar is a more comprehensive benchmark for "the dollar in general" and its relationship with debt, stock, commodity, and other arenas.

As the Goldilocks Era faded and the dreadful worldwide economic disaster of 2007-09 unfolded, not only did US Treasury yields collapse alongside massive falls in the S+P 500, emerging marketplace equities, and commodities. During the darkest times of that global financial crisis, the broad real US dollar, Japanese Yen, and Chinese renminbi all appreciated sharply.

Though the renminbi has advanced relative to the dollar since around late April 2014, the broad real (effective exchange rate) yardsticks for both the renminbi and the dollar have rallied together (moved upwards) in recent months (since around mid-2014). In contrast to these bull moves in broad real exchange rates for the renminbi and the dollar, Japan's real effective exchange rate weakened further in recent months. Moreover, despite the Yen's depreciation, this simultaneous recent strength in both the dollar and the renminbi overlaps with (confirms) declines in UST 10 year yields and slumps in emerging marketplace stocks and commodities. In this context, in a world of interrelated marketplace battlefields, and given the increasing importance of China in the international economy, the hand-in-hand (joint) rally in the broad real dollar and renminbi indices also warns that a notable top in the S+P 500 may soon emerge.

The recent declines in the Yen and the Euro FX probably hint that the worldwide economy is weakening, not strengthening. Note too the indications of a slowdown in China's enviable GDP growth rate. In this context, dramatic falls in currencies such as the Russian ruble also can signal or spark potentially more widespread weakness.

The upward trends in the broad real trade-weighted dollar and the renminbi real effective exchange rates probably will continue. For the near term, the Yen's effective exchange rate probably will remain relatively weak. However, if the world economic situation worsens significantly relative to the current scene, since the Yen appreciated very sharply during the 2007-2009 crisis, the Yen may depart from its current bearish path and venture somewhat higher.

HEARING FOOTSTEPS, SEEING FOOTPRINTS

"Chinatown" (Roman Polanski, director): the detective Jake Gittes says: "Let me explain something to you, Walsh. This business requires a certain amount of finesse."

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The 2014 financial landscape of course is not nearly as scary as that of the gloomiest days of the international economic disaster. Central banks have long sustained highly accommodative monetary policies. Deficit spending, though generally reduced, has not disappeared. And the blessed S+P 500 fortunately remains sky-high!

Nevertheless, underline the US Treasury 10 year note's yield decline (and the narrowing of the 10 year less two year UST spread) since 1/2/14's 3.05 percent high, and particularly its slump from 2.65pc on 9/19/14. Recall the MXEF's high 9/4/14 at 1104, and the renewed bear move in the broad GSCI since 6/23/14's 673 interim top. Even the mighty S+P 500 suffered a nearly 10 percent tumble from its 9/19/14 (the day of the UST yield top) 2019 height. Significantly, these assorted marketplace moves overlap with a recent broad real trade-weighted dollar rally. See "Talking the Talk: Marketplace Parallels" (10/19/14), "Walking the Walk: US Stocks and the Dollar" (10/5/14), and other recent essays.

The beloved S+P 500 rebounded after its nerve-racking nearly ten percent tumble to 10/15/14's 1821, achieving new peaks slightly above its mid-September 2014 elevation. Easy money rhetoric from some worried central bankers (in the US and Europe) helped. Moreover, the Bank of Japan's expansion of Quantitative and Qualitative Monetary Easing and the simultaneous policy shift of Japan's Government Pension Investment Fund asset mix toward increased equity holdings propelled both Japanese and American stocks higher (10/31/14).

However, the S+P 500's travels do not tell the whole story. Emerging stock marketplaces have not recovered much ground since mid-October 2014. Use the MSCI Emerging Stock Markets Index (from Morgan Stanley; "MXEF"). The MXEF cratered 12.5 percent from its 9/4/14 height at 1104 to 10/16/14's 966. It rests around 1000 in early November, still distant from its September 2014 top. Although the UST 10 year yield achieved its low of 1.86 percent alongside the S+P 500 on 10/15/14, they remain under their 1/2/14 and 9/19/14 levels. Take the broad Goldman Sachs Commodity Index as a benchmark for commodities in general (the broad GSCI is significantly petroleum-weighted). In early November 2014, after its bloody dive into the 520s the GSCI stands far beneath 6/23/14's 673 interim high drop-off point.

The recent climb in America's broad real trade-weighted dollar index ("TWD") carried it to about 87.7 for October 2014 (Federal Reserve Board, H.10; March 1973=100, monthly average). Its October 2014 elevation not only edges above June 2012's 86.3 high, but also beyond another crucial level neighboring the June 2012 one. Recall August 2008's 86.7, from which the dollar rallied sharply during the worldwide economic disaster that stepped forward in mid-2007 and raced ahead during 2008. As "Walking the Walk: US Stocks and the Dollar" (10/5/14) notes, "A walk in the TWD toward or above September 2008's 88.8 (and especially) October 2008's 93.9 increases the likelihood of a noteworthy S+P 500 peak."

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The US dollar's recent strengthening partly reflects widespread relative optimism regarding the current and future outlook for the American economy in comparison to that of the Eurozone, Japan, and many emerging/developing nations. For example, contrast America and the Eurozone. America provides signs of continued growth, and the Federal Reserve finished shutting down its latest round of money printing. In contrast, the European Central Bank several weeks ago revealed a modest quantitative easing scheme due to deflation fears, mediocre growth, stubbornly high unemployment, and fears of social unrest. Japan, still fearful of deflation and concerned about its economic growth, recently again displayed its allegiance to massive quantitative easing.

However, an increasingly bullish TWD does not necessarily equal sustained strong American (or international) GDP growth, particularly in an interconnected global economy. Relative and even further attractiveness for the dollar do not necessarily translate into beautiful prospects for the US economy.

WALKING BACKWARDS: CURRENCY HISTORY

"I'm a reasonable guy. But I've just experienced some very unreasonable things." A character in the film "Big Trouble in Little China" (John Carpenter, director)

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Let's chronicle the currency adventures of the US dollar, Chinese renminbi, and Japanese Yen for the 2007-09 era as well as in the relatively recent past. The focus will be on the "overall" moves for each currency rather than specific cross rates. The dollar's benchmark is the Fed's broad real trade-weighted dollar index (H.10; March 1973=100, monthly average; "TWD"). For China and Japan, use the Bank for International Settlements real effective exchange rate indices (CPI-based, 2010=100; monthly average). BIS data starts in January 1994.

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Given the dollar's leading role in the world economy and currency trading, start down the road with the broad real TWD. Although the S+P 500 peaked on 10/11/07 at 1576, recall that its final high was 5/19/08 at 1440. Shortly before the final S+P 500 summit in May 2008, the TWD in April 2008 established a crucial floor at 84.2 (prior major bottoms around 84.0 in October 1978 and July 1995). The global financial troubles worsened in late summer/early fall. Alongside this downturn in the US and global economy and the S+P 500, the TWD's rally continued. It stood at about 86.7 in August 2008, hopped to 88.8 in September, and leaped to 93.8 in October. After a 15.1 percent bull ascent, the TWD's summit occurred at 96.9 in March 2009, as did the S+P 500's major bottom (3/6/09 at 667).

The TWD then commenced a significant bear move, with the S+P 500 travelling on a wonderful bull path. The TWD stumbled to a record low 80.5 in July 2011. Until relatively recently, and thus for about three years, it remained rather feeble; this arguably encouraged rallies in the S+P 500 and assisted US (and worldwide) economic recovery. Beginning in September 2011, it edged over 83.0 and stayed in a rather narrow band, promenading around the prior major lows around 84.0, touching a high of 86.3 in June 2012.

The broad real TWD"S 8.9 percent rally from July 2011's record bottom to October 2014's 87.7 has pushed it above the important resistance at 86.3 (June 2012)/86.7 (August 2008).

What are some percentage measurement moves for the broad TWD as it moves along the bull road? Take the July 2011 record low slightly above 80.5 as the starting point. This TWD depth occurred not long after the MXEF's 4/27/11's significant top at 1212 and the S+P 500's 1371 interim high on 5/2/11. A five percent advance is 84.5 (recall the several key lows around 84.0), 7.5pc is 86.6 (June 2012 high 86.3) and 10pc is 88.6 (compare September 2008's average). A 15pc climb gives 92.6, with 20pc appreciation 96.6 (March 2009 high 96.9).

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BIS data for the US currency are consistent with the Fed's TWD statistics. Look at the BIS information in the context of the worldwide financial crisis and the current situation. The US effective exchange rate ("US EER") rallied from 96.4 in April 2008 to a high of 110.6 in March 2009. The US EER attained a July 2011 bottom at 93.0. It trotted up to a June 2012 high of 99.7. However, it stayed under the June 2012 top until it broke above it with September 2014's 100.6. Based upon the Fed's H.10 data, the BIS EER for the dollar for October 2014 probably is about one percent higher than the September 2014 level.

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The Fed provides daily data for the nominal broad TWD (the broad real TWD data is only a monthly average). That nominal TWD information sometimes helps to emphasize timing relationships between the dollar and other financial marketplaces. The nominal broad TWD initial take-off point on its rally road was 7/1/14's 101.7, only about a week after the GSCI's 6/23/14 interim top at 673. In addition, underscore further the nominal TWD's climb from 103.3 on 9/3/14 to 106.7 on 10/31/14 (the most recent data point). The Euro FX cross rate against the US dollar stumbled beneath 1.300 on around 9/4-5/14. The European Central Bank introduced its asset-backed securities quantitative easing (money printing) scheme on 9/4/14. That ECB easing helped to rally the TWD. After all, the Fed's latest round of QE was likely to (and did) cease at end October 2014. But also note that the emerging marketplace stock world (MXEF) also topped on 9/4/14 at 1104.

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China's cross rate against the US dollar captures headlines. After peaking around 6.039 on 1/14/14, the renminbi declined to about 6.267 on 4/30/14 (6.264 on 5/28/14) before rallying to around 6.11 recently.

However, a long run review of BIS statistics for China's real effective exchange rate ("China EER") is more enlightening than individual renminbi cross rates. The China EER reveals the renminbi's overall long run upward march.

According to the BIS, the China EER was 65.6 in January 1994. After a long bull march, it achieved an interim high at 101.6 in January 1998, fell to 90.2 December 1999, and rallied to 101.5 (near the January 1998 wall) in February 2002. Its December 2004 low was 81.9.

China's currency appreciation raced ahead again during the 2007-09 financial crisis. From around an 88.7 take-off point in October/November 2007, the China EER jumped to a pinnacle at 107.4 in February 2009, a 21.1pc rally.

Like the TWD, the China EER then began to retreat. The China EER dipped to a 95.6 low in November 2009. However, the China EER rose steadily up to its 121.2 record high of January 2014, a 26.8pc advance relative to November 2009.

The Chinese EER thereafter fell modestly, to about 114.0 in May 2014. However, by September 2014 (latest month for BIS statistics), it had risen to 119.8. The renminbi edged a bit higher versus the dollar in October 2014 relative to September 2014 (around 6.126 versus 6.139 monthly average) and has been around 6.110 in November. The renminbi has tended to move higher against the Japanese Yen and Euro FX over the past several weeks. According to the BIS, the US represents about 19.0 percent of the weight in China's broad EER, the Euro Area 19.4pc (plus 2.8pc for the United Kingdom), and Japan 15.9pc. Thus China's current EER probably has risen above September 2014's 119.8 and thus is challenging January 2014's 121.2 record high.

Thus in recent months, the China EER has rallied alongside a stronger broad real TWD.

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Examine the path of Japan's real effective exchange rate ("Japan EER") during the financial crisis era. After attaining a low at 79.4 in July 2007, the Japan EER spiked. It appreciated quickly from July and August 2008's 82.1 to January 2009's 106.6 lofty elevation. The leap from July 2007 to January 2009's pinnacle was a monumental 34.3 percent.

The Japan EER depreciated to 94.3 by April 2010. However, by October 2011, it had rallied up to 105.7, very near to its January 2009 level. What happened next for the Japan EER? The TWD meandered sideways for over two years after autumn 2011, and the China EER continued to rally. But in contrast to the dollar and renminbi moves, the Japan EER headed down a different path. Assisted by determined monetary easing, Japan EER began a noteworthy bear move from its October 2011 top.

By January 2014, the Japan EER crashed down to 74.9, a 29.1pc swoon. It moved relatively little for the next several months, inching up to 77.9 in May 2014. It then began to deteriorate again, reaching 74.8 in September 2014. For the October 2014 and current theater (keep in mind Japan's end-October 2014 expanded monetary easing and the Yen's fall against the dollar and the renminbi), Japan's EER probably has sagged beneath its January 2014/September 2014 depth.

Since a strong Yen in 2007-09 was associated with the worsening of the global crisis), does the weak (recent slump in) the Japan EER offer grounds for optimism regarding sustained Japanese and world economic growth? After all, look at the rally (particularly since mid-October 2014) in the Nikkei and S+P 500. Probably not. First, the TWD and the China EER generally have rallied together, as they did during the acceleration of the worldwide economic crisis. Moreover, the dollar and renminbi have advanced alongside continued weakness in emerging marketplace stocks and commodities. Also, the benchmark US Treasury 10 year yield remains under its important 2014 highs.

In addition, and to the extent the travels of other assorted entangled marketplaces confirm this, further rallies in both the real effective exchange rate of the Chinese renminbi and the broad real trade-weighted dollar will warn of (or underline) widespread global economic feebleness.

Moreover, even though Japan is an advanced country with substantial domestic savings, keep in mind Japan's enormous government debt, as well as the fact that its current EER level is around half of its record 150.3 April 1995 pinnacle. Japan may resemble some troubled developed/emerging nations more than many inside and outside Japan would like to admit. The weak Japan EER, not only the rallies in recent 2014 months in the TWD and the China EER, underscores current and warns of future global economic weakness.

OTHER CURRENCY PATHS

The 2007-09 crisis period is not the only one to recall in the current currency context. Remember, for example, the Asian financial crisis of 1997, Russia's 1998 crisis, and various ones in Latin America.

In the present-day global environment, falls in commodity prices (especially petroleum), weaknesses in various emerging marketplace stocks, and a strengthening broad real trade-weighted dollar indicate current or potential challenges for numerous nations around the world.

What if large quantities of "carry trades" involving borrowing in the US dollar and taking positions in emerging marketplace securities are unwound? The Financial Times in the carry trade context headlines "Emerging markets face dollar threat" (9/30/14, p2).

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What does a survey of BIS effective exchange rate statistics (monthly averages) reveal regarding Russia? In January 1998, the Russian EER was 90.6. By August 1998, it was 75.6. By January 1999, it was 43.5, down over fifty percent from its January height. Next, recall the stratospheric petroleum prices of mid-summer 2008 and their subsequent collapse. The Russia EER was 101.0 in August 2008 and 104.0 in November 2008; plummeting alongside a crash in petroleum and other commodity prices, the Russia EER was 84.4 in February 2009.

Russia arguably is in much better economic shape than it was 15 years ago during its 1998 crisis. And 2014 is not 2008. However, the Russian currency has depreciated sharply in recent months. Prices for commodities in general (and notably petroleum) have tumbled since late June 2014. Russia is embroiled in battles with the Ukraine and enduring sanctions imposed by the United States and others.

Russia's EER rallied up to a key high at 110.1 in February 2013. However, it has declined since then. Although it rallied from a low of 96.8 in March 2014 to 104.4 in June 2014, it fell to 99.1 in September 2014. Nowadays, the ruble probably is attacking March 2014's minor low of 96.9. Although the dollar is only about 5.9 percent of the Russian EER, the Ruble has declined significantly in recent weeks against the dollar.

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