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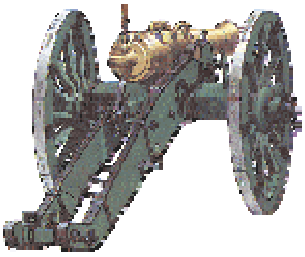
The Currency Wars of 2010

Speaking at an APEC related business forum today, NZ Prime Minister Mr Key said escalating tensions over foreign exchange policies could threaten economic growth. "***If we don't get this right, it's my view that we will see currency wars,*** we'll see retaliatory action taken that will be bad for economic growth, that would have unintended consequences and would be bad for integration in the region."

Our topic for discussion today is “The Best and Worst Currencies of 2010”. That is a wide topic as it has differing meaning to different players, but let’s start with the macro view to put Mr Key’s comments into perspective and see the wars from a Sovereign’s point of view. Later we will shorten our vision to give you the trader’s take.

The Sovereigns’ View

Forex traders and currency speculators had ringside seats as all out currency war flared again in 2010, with this round featuring no less than four Sovereigns, the major mercantile powers of the West, battling each other and at times their own constituents, in a race to the bottom in the mistaken belief that the laws of relativity have been repealed.



So far we have only observed the opening campaigns of what promises to be a long and bloody war of attrition, but already the opposing Generals in the guise of various Central Banks are nervously assessing their reserve battalions and eyeing over extended supply lines with little regard to the dangers on their exposed flanks.

In our search for the best and worst currencies of 2010, we will look at the tactics and resources of our major players and come to a surprising conclusion.

The Protagonists

Our obvious protagonists in this great global misadventure are UK, US, Japan and Europe. As the leading mercantile powers with issuance rights in their own currencies, these were always going to be our key players. Or at least the obvious choices. Strangely, wars are usually the result of differing aspirations and social mores. In the present conflict, aspirations and mores are identical and quite interchangeable. All are driven by the same cause; all are functionally insolvent absent the money printing press, and all dream of mercantile growth as their saviour of last resort.

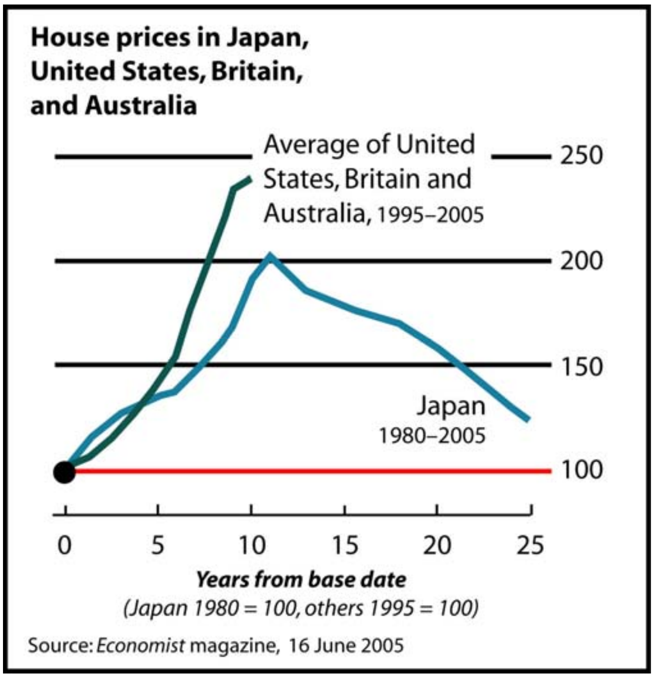
The Sting

Like most major conflicts, the source of the 2010 Currency Wars dates back some years. Despite untold reams of analysis, commentary and opinions from those most unqualified of observers, economists, the cause of our currency wars is simple, unsophisticated and apparent to almost anyone other than those invested in the opposite case.

As the old joke goes, “Complaining about your wife to your mother-in-law is not a productive strategy”. In this case the mother-in-law comprises almost all home owners and all central bankers; a massive constituency. Perhaps that is why this chart, published by The Economist in June 2005, failed to breach the psyche of our redoubtable leaders, for within this simple presentation is past history and a fearsomely accurate foretelling of that which was to come, and for some, that which is still to come.

Simply put, housing and property prices are to a large extent the result of bank lending standards and the optimism (gullibility?) of lenders. There will be many more potential buyers in a zero deposit regime than there will be if a 20% cash deposit is mandated. In similar vein, the ability to enhance ones earning prowess (no doc or low doc loans) mitigates mightily against lenders being repaid in a timely and orderly manner. Or ever!

Who or what is to blame for the scandalous excesses of various property bubbles from Japan to US to UK to large parts of the EU community is outside the scope of this article, but the problems primarily from this outrageous rort are the root cause of bank insolvencies and the scandalous demands by governments of various hues that at whatever the cost to taxpayers, the cosseted darlings of the banking world must be supported.



The other side of the coin is the often understated effects of "building" generically to those vital stats, unemployment and GDP. We have trouble encapsulating these effects particularly in very large economies and over large time frames. The property bubble in Japan popped in 1991. US blew up in 2008, UK and others are just at the start of their fall from lofty heights, so we are seeing a slow motion train crash over many continents. For some, like Australia, the boom is still in place. To give you a potted version of how these same scenarios have played out, let's start with the first of our protagonists, Japan. This from Global Property Guide:

> "Japan's property bubble was a textbook example of how fast economic growth combined with loose monetary conditions can lead to asset price bubbles. Japan had one of the highest economic growth rates in the world from the 60s to the 80s, growing annually by an average of 8%.
> Massive speculation in the commodities and real estate markets emerged as a result of PM Tanaka Kakuei's macroeconomic policies in the 70s, with uncontrolled increases in the money supply. Land prices rose 213.4% (85.3% in real terms) in the six biggest cities, and by 178% (22.7% in real terms) nationally during the decade to 1980. From 1980 to 1990, land prices in the six biggest cities rose by another 251.2% (179.7% in real terms), while national land prices climbed 119% (44.3% in real terms).
> In the late 80s, monetary policy was suddenly tightened, and this led to the biggest financial crash in modern Japanese history. The real estate bubble finally burst in 1991. Three-quarters of local banks' lending was to small businesses, which had properties as collateral. The property crash crippled the banking sector, as the amount of bad loans skyrocketed to almost USD1 trillion. This led to more than a decade of stagnation and deflation, known as Japan's lost decade."

So to highlight the continuity of this theme and the complete inability of Central Bankers and Governments alike to learn anything from others, let's jump to the present where one of Europe's former stars is now faced with exactly the same predicament. This pithy summary from Morgan Kelly, Professor of Economics at University College Dublin, by courtesy of the Irish Times, 8 November 2010:

> "The gathering mortgage crisis puts Ireland on the cusp of a social conflict on the scale of the Land War, but with one crucial difference. Whereas the Land War faced tenant farmers against a relative handful of mostly foreign landlords, the looming Mortgage War will pit recent house

buyers against the majority of families who feel they worked hard and made sacrifices to pay off their mortgages, or else decided not to buy during the bubble, and who think those with mortgages should be made to pay them off. Any relief to struggling mortgage-holders will come not out of bank profits – there is no longer any such thing – but from the pockets of other taxpayers.

The other crumbling dam against mass mortgage default is house prices. House prices are driven by the size of mortgages that banks give out. That is why, even though Irish banks face long-run funding costs of at least 8 per cent (if they could find anyone to lend to them), they are still giving out mortgages at 5 per cent, to maintain an artificial floor on house prices.

While the current priority of Irish banks is to conceal their mortgage losses, which requires them to go easy on borrowers, their new priority will be to get the ECB's money back by whatever means necessary. The resulting wave of foreclosures will cause prices to collapse further.

By next year Ireland will have run out of cash, and the terms of a formal bailout will have to be agreed.

As ordinary people start to realise that this thing is not only happening, it is happening to them, we can see anxiety giving way to the first upwellings of an inchoate rage and despair that will transform Irish politics along the lines of the Tea Party in America.

Ireland faced a painful choice between imposing a resolution on banks that were too big to save or becoming insolvent, and, for whatever reason, chose the latter.

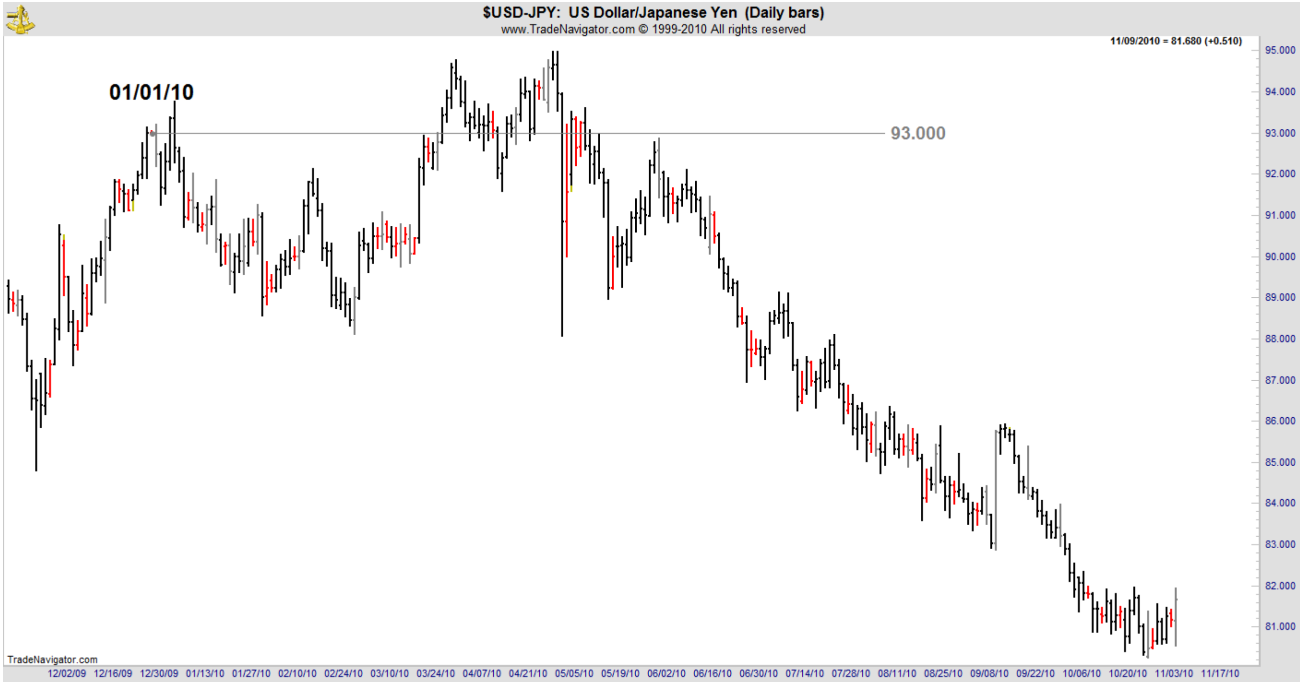
So over a decade, and across continents, we see the same story being played out again and again. Save the banks, the purveyors of mass buffoonery masquerading as sagacity and, kick the can down the road as no pollie worth his salt can face the enormous consequences of letting the cards fall where they may. This is "Extend and Pretend" on a global scale. In effect, the affected Western Governments are having a massive one way bet that "things" will return to normal at some stage before they are required to face the voters again. The ignorance of the masses in this slowly unfolding train wreck is their best hope.

So why, you may ask, is a forex article plumbing the innards of various property markets? Well, that is because currencies, that notionally or otherwise "float" are the shock absorbers of modern economies, or at least those that are Sovereigns, that is those that issue their own currencies. Given the various financial crises that are the aftermath of bank bailouts, all are focused on supporting their export industries, and fighting to maintain competitive pricing in the international market place. That means for the beleaguered Sovereigns that are our main protagonists in this discussion so far, those that win the race to the bottom will be the most successful. Effective devaluation means in relative terms, cheaper exports and more expensive imports, the key metric in those balance of trade figures that measure the casualties in currency wars. In addition, it's always considered a fine idea by treasuries to repay foreign debt in devalued currency. In the long pull, a devalued currency plus some prospects of future growth restoration is the only plan on the table. And right now, there is no plan 'B'.

Of course the relative devaluations of which I speak are only of assistance if they effectively impale ones major trading partners. And of these the US-China nexus is the best known and most prominent example. Unfortunately for US, the wily Chinese long ago were alerted to the enormous power bestowed on US by virtue of the Dollar being the World's reserve currency. The China strategy to block that power by pegging the Yuan to the Dollar pays dividends for Chinese mercantile interests every day. Simply brilliant. That much of this benefit stands to be negated by China financing much of the US foreign debt is another story.

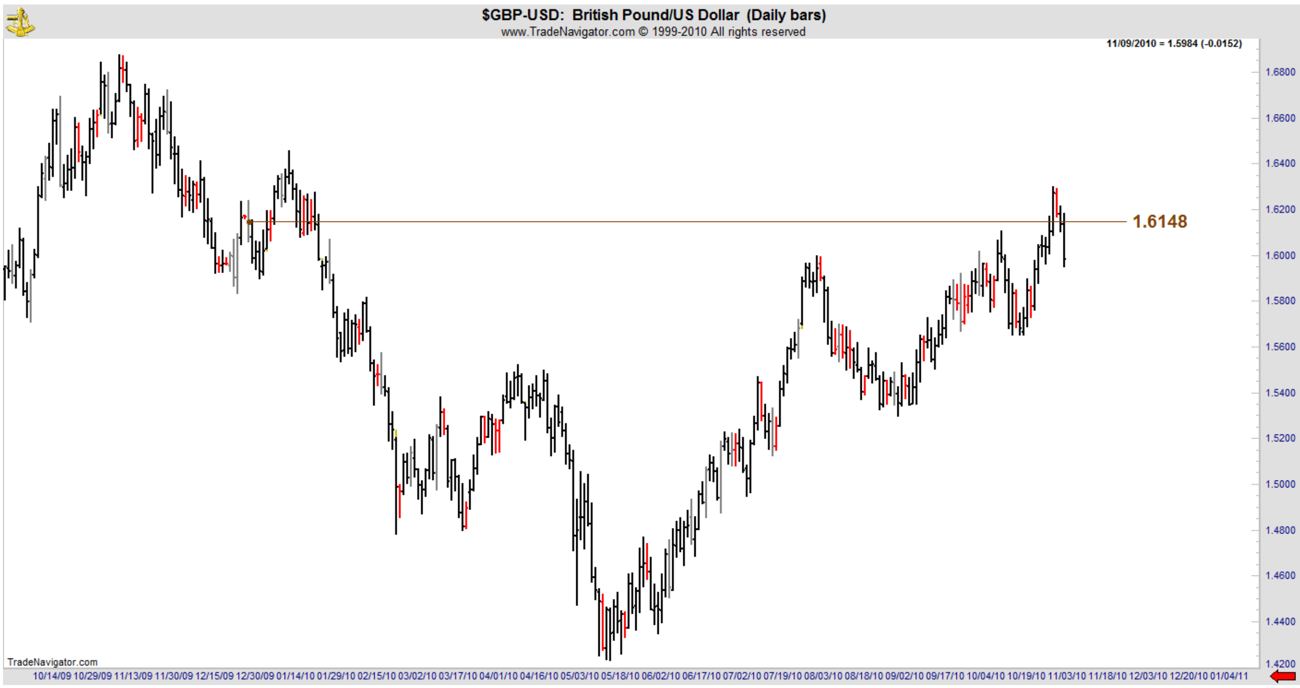
Let's turn now to the charts to see the extent of four Sovereigns all attempting the same strategy at once. We will start by taking USD as our benchmark and finding vis-à-vis the major players, not much has changed other than the USD-Yen cross:

First the Dollar-Yen:

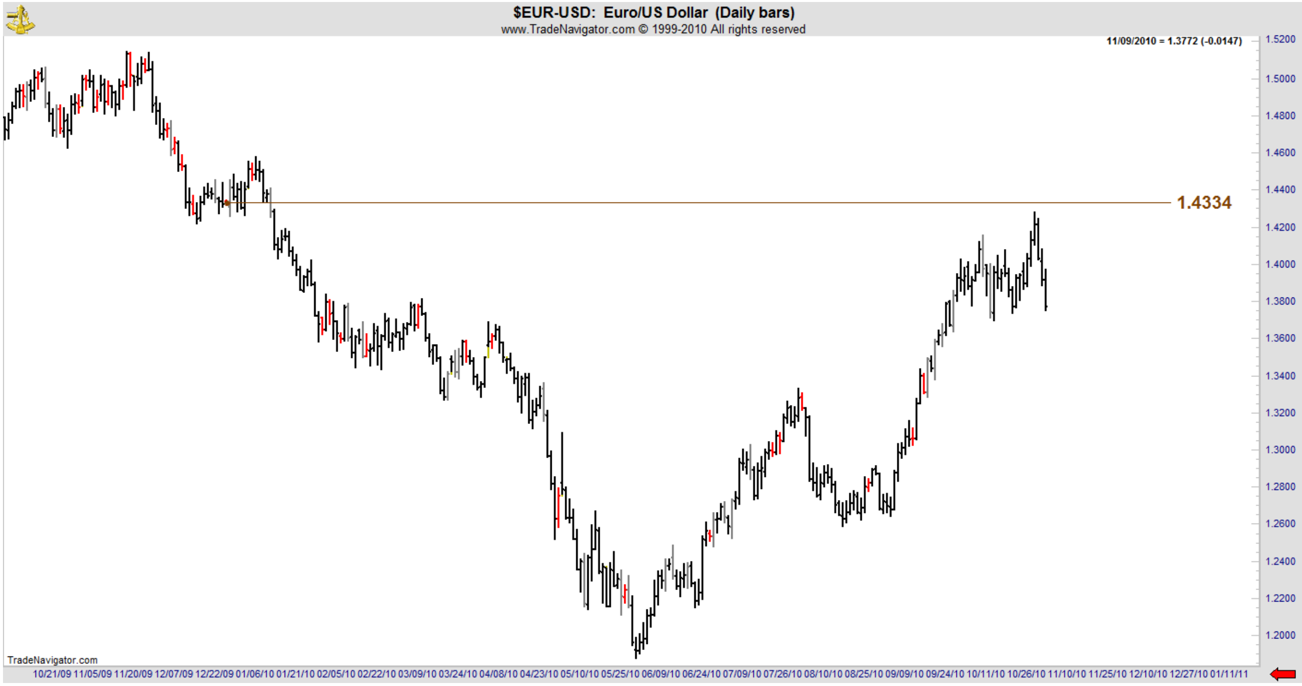


This pair opened 2010 at 93 and is currently at 81.6, a handy devaluation of USD of just over 11%.

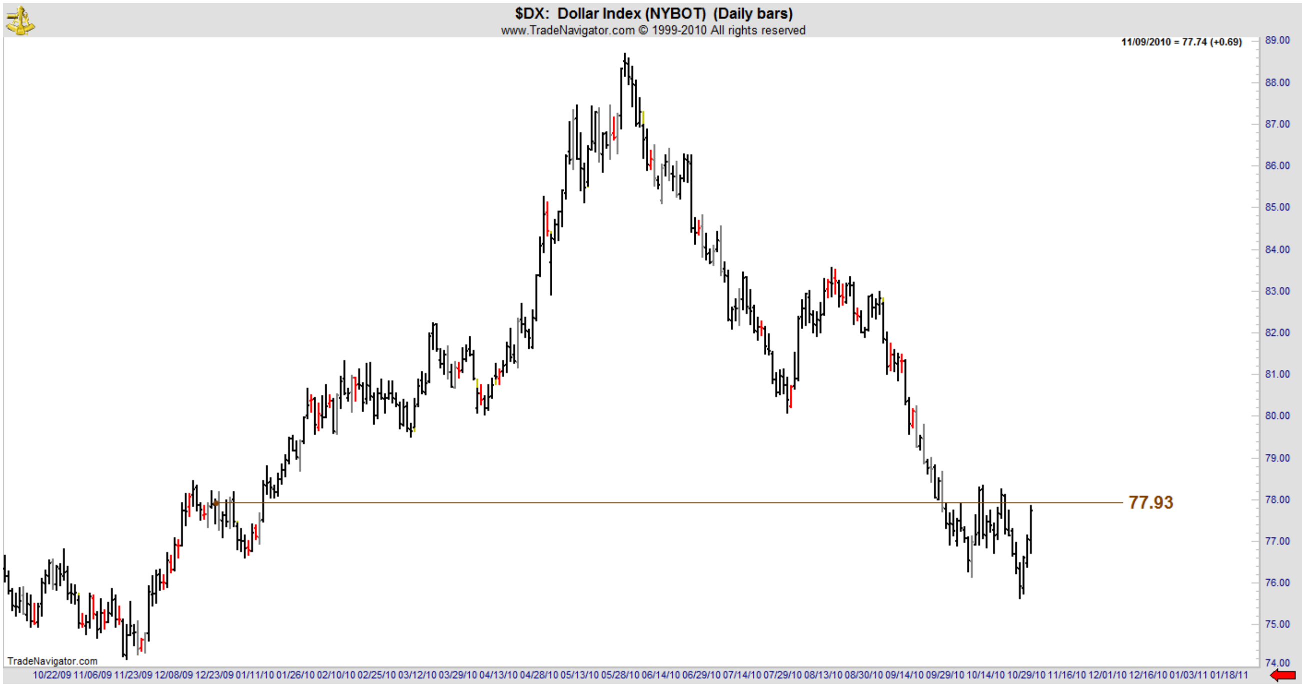
Next on our list is GBP-USD. This pair opened the 2010 innings at 1.6184, and despite some dramatic gyrations is essentially unchanged during this year.



Then the EUR-USD, which exhibits much the same characteristics as the GBP pair, off slightly against its US cousin, but for mercantile purposes, not much net change over this 11 month period.



And finally the DX, the US Dollar Index which measures USD against a weighted basket of the currencies of its major trading partners:



No significant change here. All of our major proponents, despite reams of commentary to the contrary have, with the exception of Japan, maintained their relative positions against the major currency blocs. So where is all the shot and fury from competitive devaluations, currency and trade wars that have been so evident in headlines during much of the year? Not in these pairs, and certainly not in the USD-Yuan cross of America's major trading partner:

Despite this dramatic looking chart, this pair has only moved from 6.8269 to 6.6695, as the Yuan has appreciated by about 2%, much to Tim Geithner's chagrin! This is the munificence of a pegged currency.

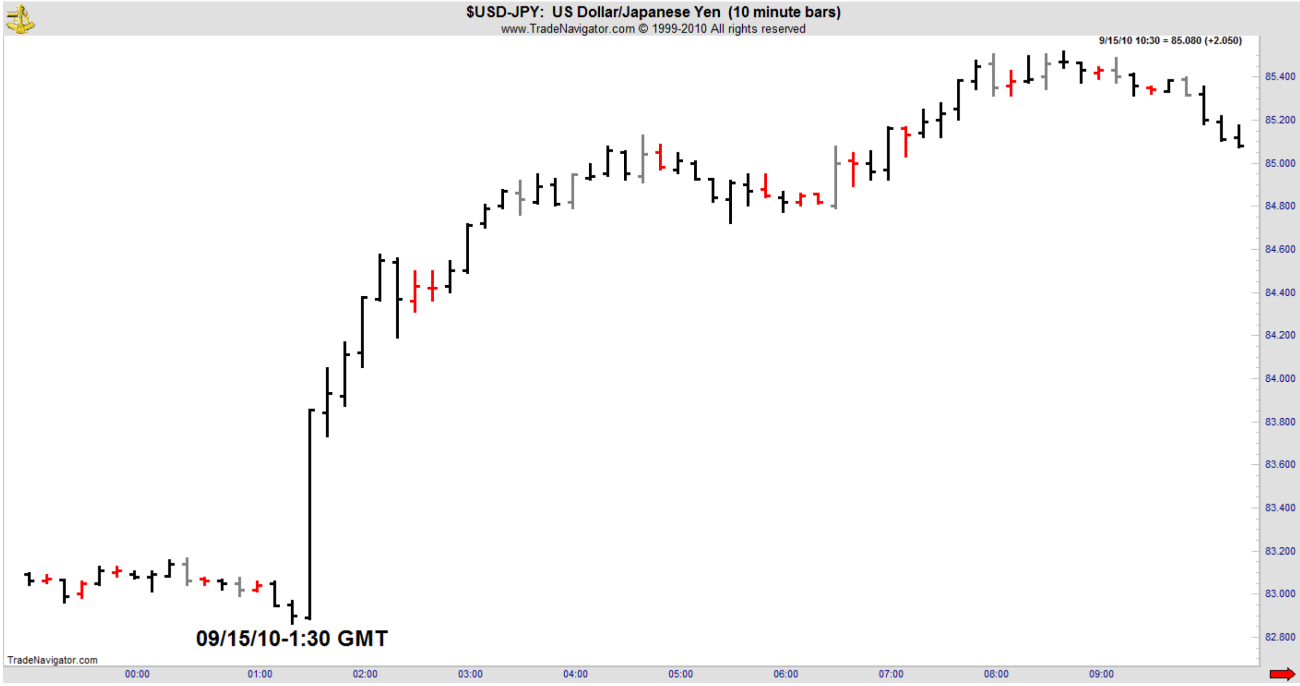
The Victims

Unlike China, Japan and other much more damaged victims have, where they felt they had the ammo, been forced to enter the field of battle to try and prevent their own currencies appreciating on the cross rates and damaging their economies. Two of the most notable have been the Bank of Japan and the Central Bank of Switzerland, the SNB.

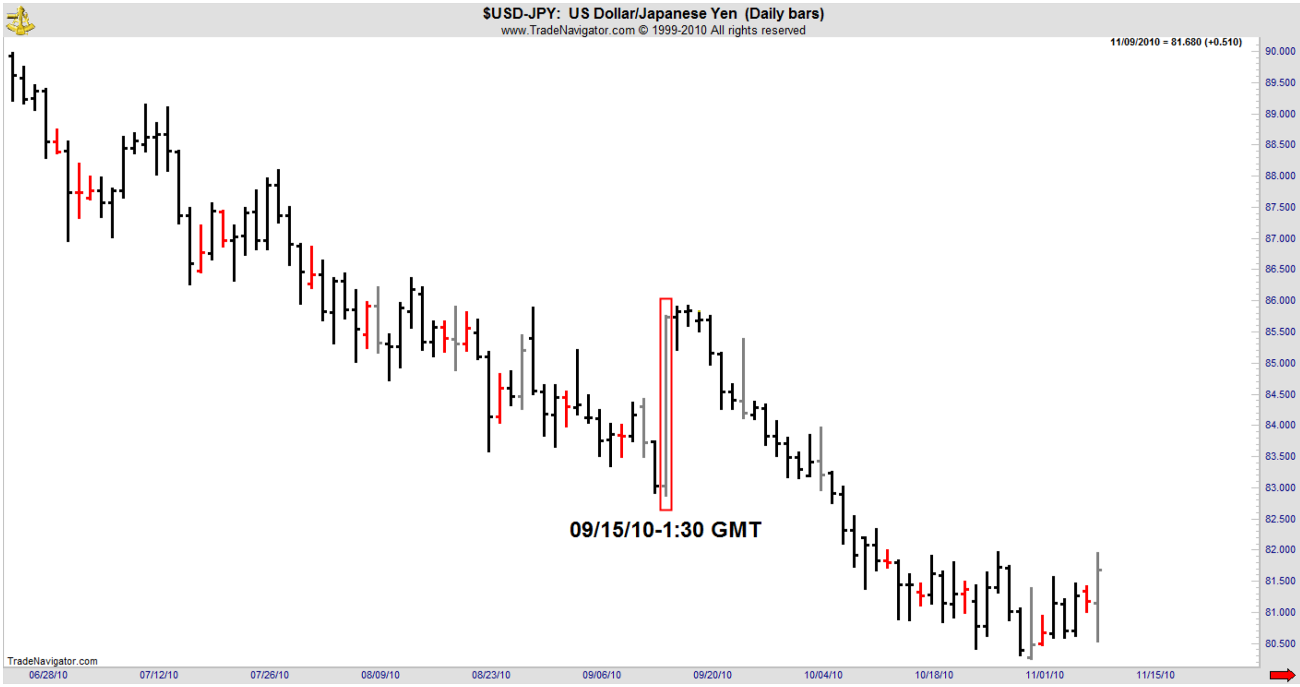
BOJ is legendary for its successful and sudden forays into forex markets always to weaken the Yen as an aid to its major exporters. Strangely, this year's interventions have been damp squibs. Regarding BOJ intervention on 15 September, the Wall Street journal had this to say:

> Round about 10:26 a.m. Wednesday morning, a mere 82.91 yen would have bought you a dollar, leaving the U.S. currency at its lowest since May 31, 1995. And that's apparently when Japan's Ministry of Finance just got a little bit tired of the yen being too strong. Ten minutes later, the yen was trading at 83.72 to the dollar.
> Selling hundreds of billions of yen, according to traders, to weaken the currency against the dollar provided not only a very fetching spike on yen-dollar charts in trading rooms. It also pumped up shares in Japan's household name exporters, who've been hit very hard in recent months by the yen's relentless strength: every auto or TV they sell in the U.S. has been translating into a lot less revenue when the dollar price tag is translated back into Japanese currency.
> The country's central bank "strongly expects that the action taken by the Ministry of Finance in the foreign exchange market will contribute to a stable foreign exchange rate formation", according to a statement from Governor Shirakawa. And Finance Minister Yoshihiko Noda pledged more decisive steps if needed.

A fetching spike indeed as this short term chart shows:



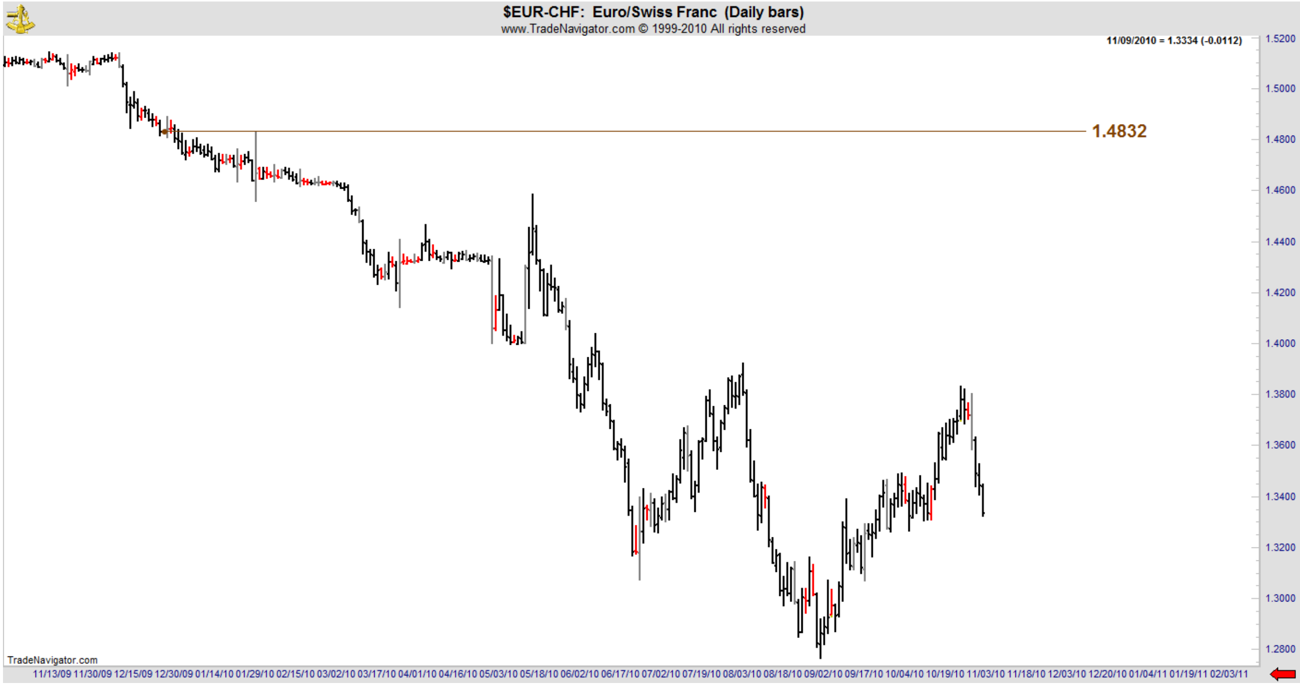
Unusually, BOJ intervention failed to fulfil the Finance Ministers confident rhetoric and this one day marvel, which handily coincided with Danielcode Buy signals for the Yen, was soon eclipsed:



Perhaps the clue to the undoing of the BOJ strategy is contained in a later paragraph of the same WSJ article, which references the failed efforts not only of BOJ, but also the Swiss National Bank

> The problem is that Mr. Noda confirmed Japan intervened unilaterally Wednesday, having informed counterparts in other countries. And without authorities in other countries taking similar action – particularly the U.S. – the conventional logic is that Japan's intervention leaves Messrs. Noda and Shirakawa performing a high-wire balancing act that could yet backfire. If they're in any doubt, Japan's intervention boffins might want to place a another call to the Swiss National Bank: Switzerland's central bank went ahead and did its own thing on intervention earlier this year, but by the time the SNB stepped away from efforts to curb the franc's strength against the single European currency, the euro was at an all-time low against Switzerland's currency.

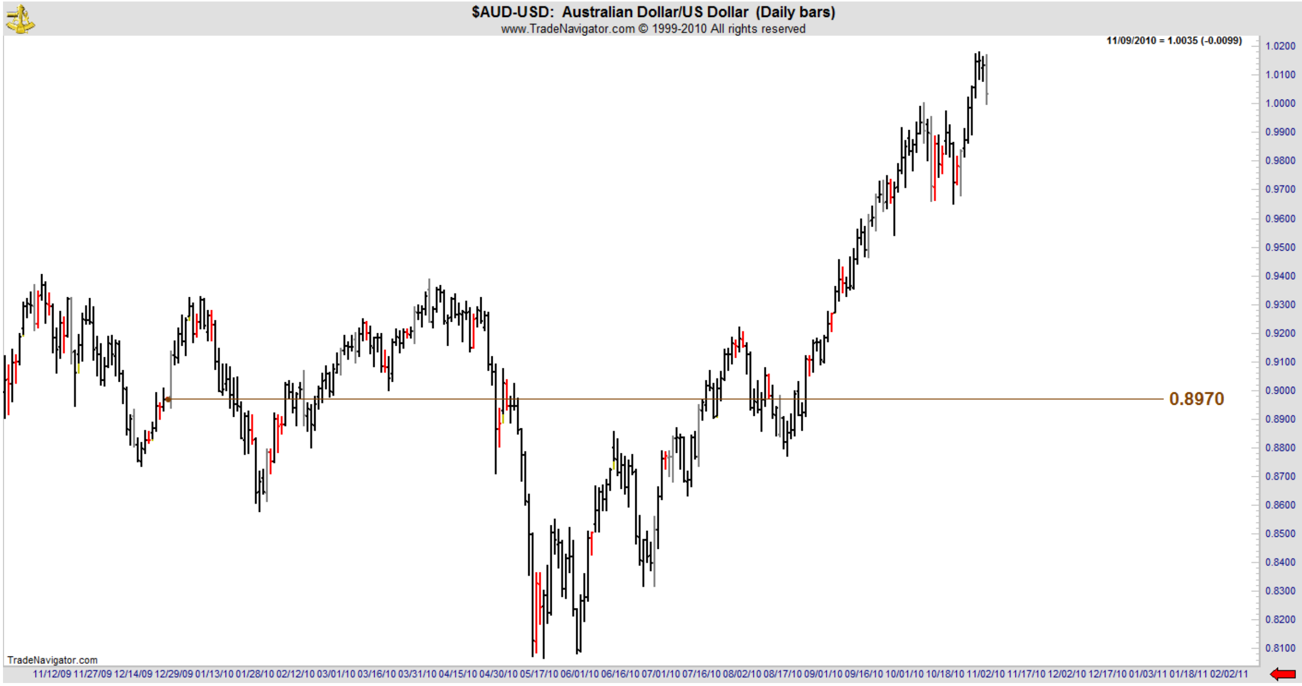
Here is the battle between the Swiss and Europe, its major trading partner:



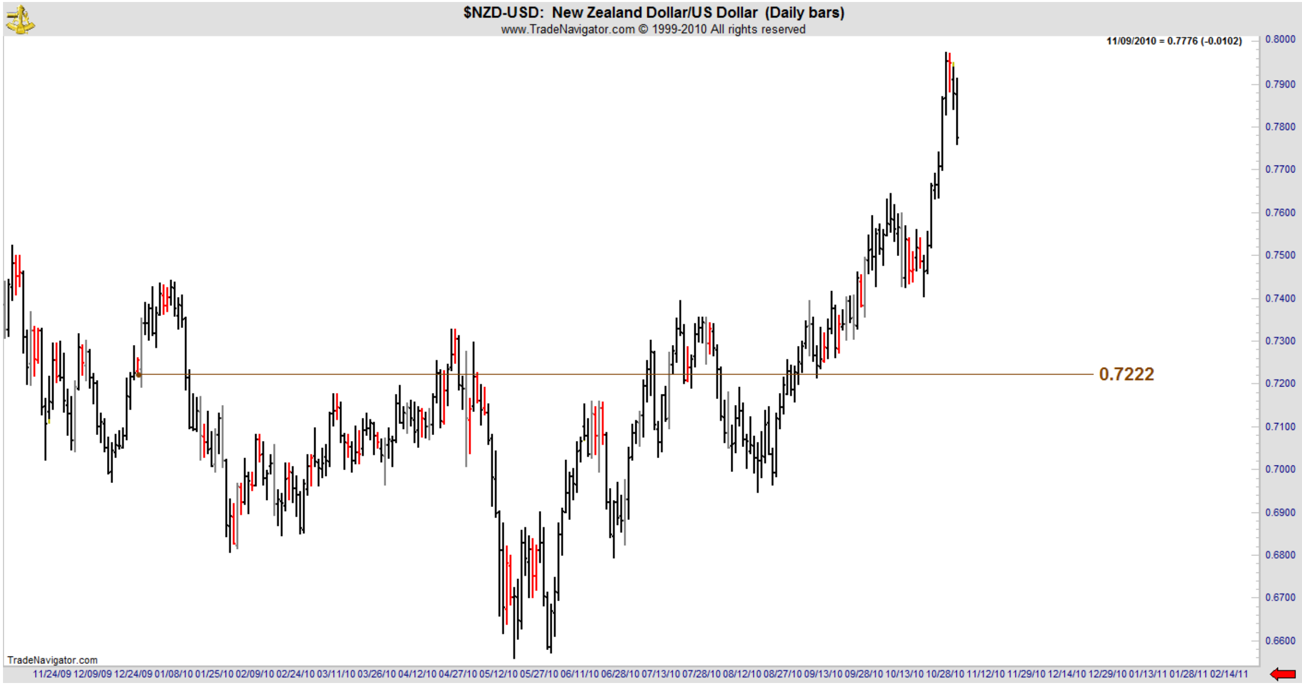
A handy 10% devaluation for the Euro, and some real pain for SNB.

Of the smaller economies, the peripheral damage to allies and friends is immense. Here is the US devaluation against Singapore:

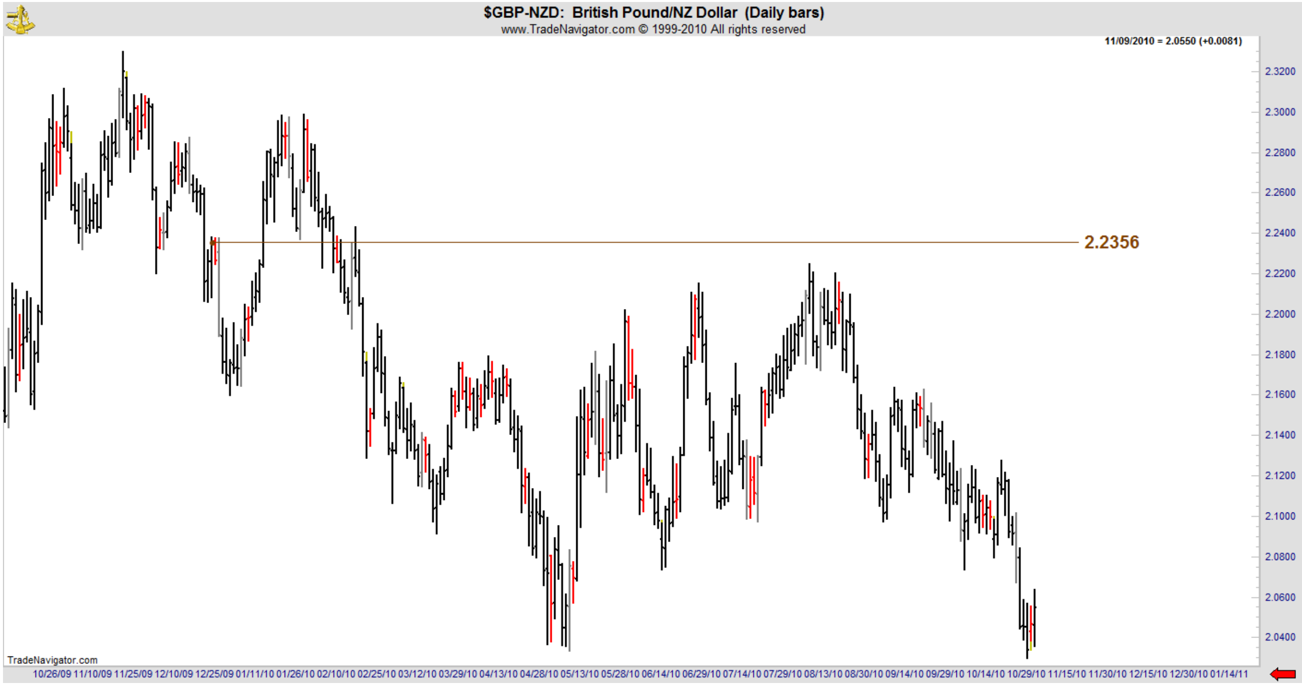
And Australia:



And finally, tiny New Zealand, whose currency in this brave new world of floating exchange rates is being decimated against the majors USA:



And the old 'Mother Country', Britain:



Our review of the stars of 2010 comes against a background of unparalleled Government intervention in major currencies together with the less obvious forms of currency intervention such as pegging of currencies to those of major trading partners.

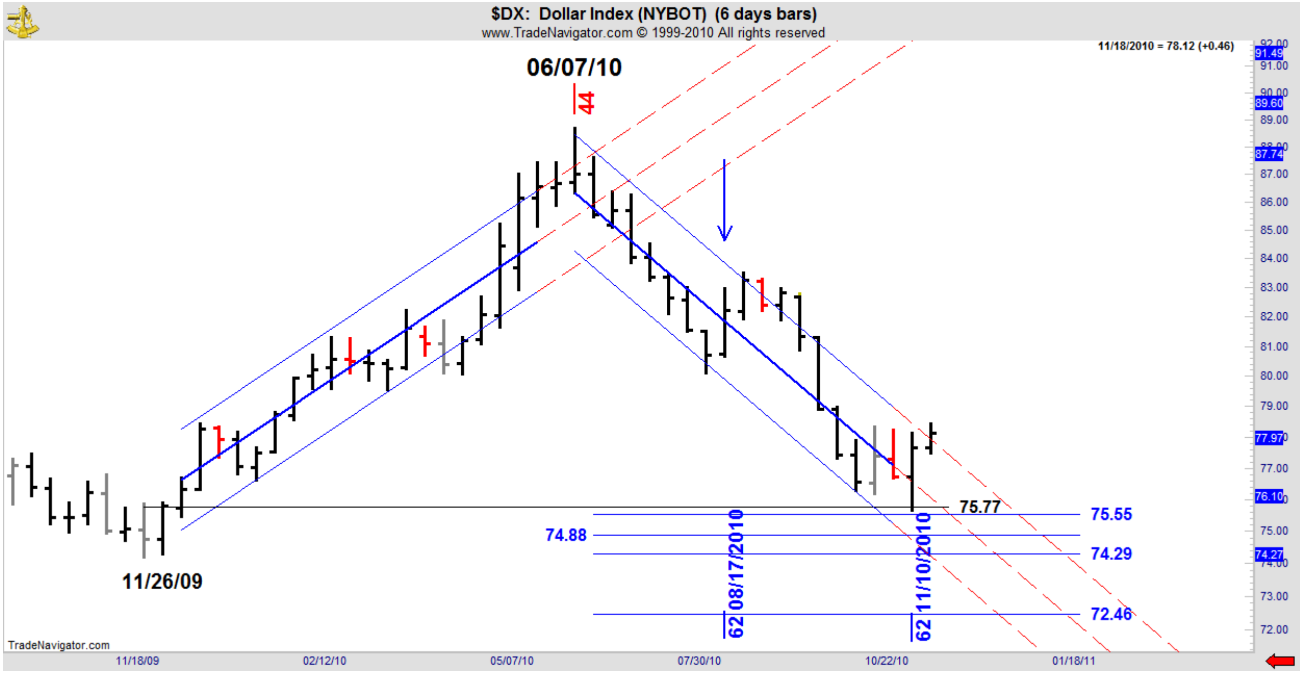
If we define "Best" as that currency which has most successfully implemented its leaders' wishes, then the prize for 2010 undoubtedly goes to the mighty Dollar. US policy, in reality is diametrically opposed to the "US favours a strong Dollar" rhetoric, regularly trotted out by Tim Geithner and a list of US Treasurers before him. In their efforts to devalue the USD against almost all of their trading partners, they have, with the exception of their major partner China, been notoriously successful.
QE2 from the Fed's Governor and reality naysayer "Helicopter" Ben Bernanke, is designed to continue this trajectory.

Traders Take

From the uniquely selfish view that Forex traders take, the "Best" currencies are those that are most predictable. For 2010, the US Dollar index and the Euro win hands down, as they have turned all year at Danielcode price and time targets. The ability to be aware of major market turning points well in advance is a huge benefit to traders, as this sets us up with the correct bias for both swing and shorter term trades.

For some of these markets, the Danielcode publishes its proprietary "Time Turn" charts every week at www.thedanielcode.com . They are free to all and past editions are available under the "Trading Reports" tab.

Here is the latest DX chart showing DX making its low at the end of 2009, a turn that we called almost to the day; its subsequent rally into the 44 DC "week" cycle in June, and it's subsequent two stage fall into the famous DC Black line this month. For those with an interest in the correct application of market "Time", I refer you to the two "Master Class" articles available at the Articles tab at the Danielcode Online. The 44 DC week cycle belongs to Gold, rather than DX, but the inverse correlation inherent in these markets has resulted in Gold following the DX time cycles and vice versa. You can see how these time cycles were posted many weeks and sometimes months in advance from my archived reports.

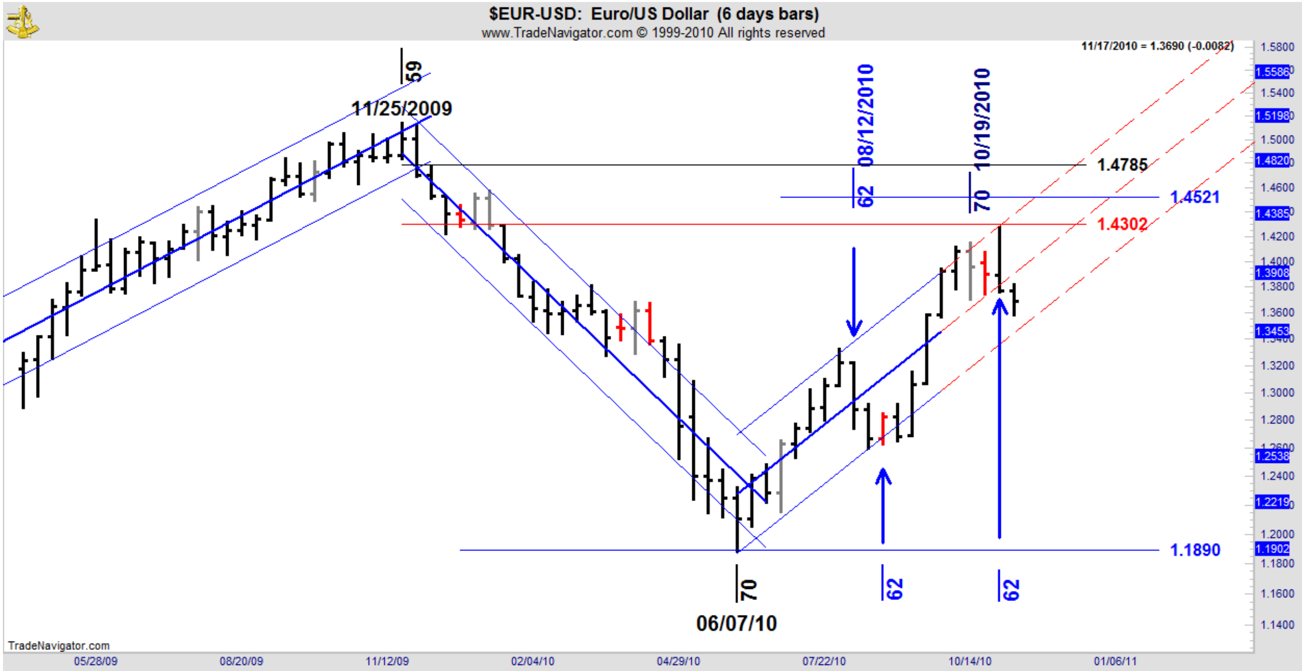


The Euro has been equally impressive as a traders tool. Our picture below captures the British squares at Waterloo as Marshal Ney destroyed the cream of Europe's cavalry in a series of fruitless charges against Wellington's redcoats. Today the might and Empires built by both Wellington, the Iron Duke and France's Napoleon are long gone. Today's battlefield is currency and forex markets as both UK and France strive for mercantile survival rather than the long lost dreams of Empire.

As one of the founders of the EU, France shares its economic fate with Germany and a host of assorted European countries, a peculiar definition which includes Ireland and shortly may include Turkey. The uneasy grouping of such disparate states is a thing of rare wonder as Germany continues its manufacturing ascendancy, whilst the Mediterranean fringe ponders the decade of profligacy that now faces the butchers bill. By the time this is published, Ireland will have become the fourth EU country to seek a bailout, as its affair with over loved and over leveraged property reaps its toll.

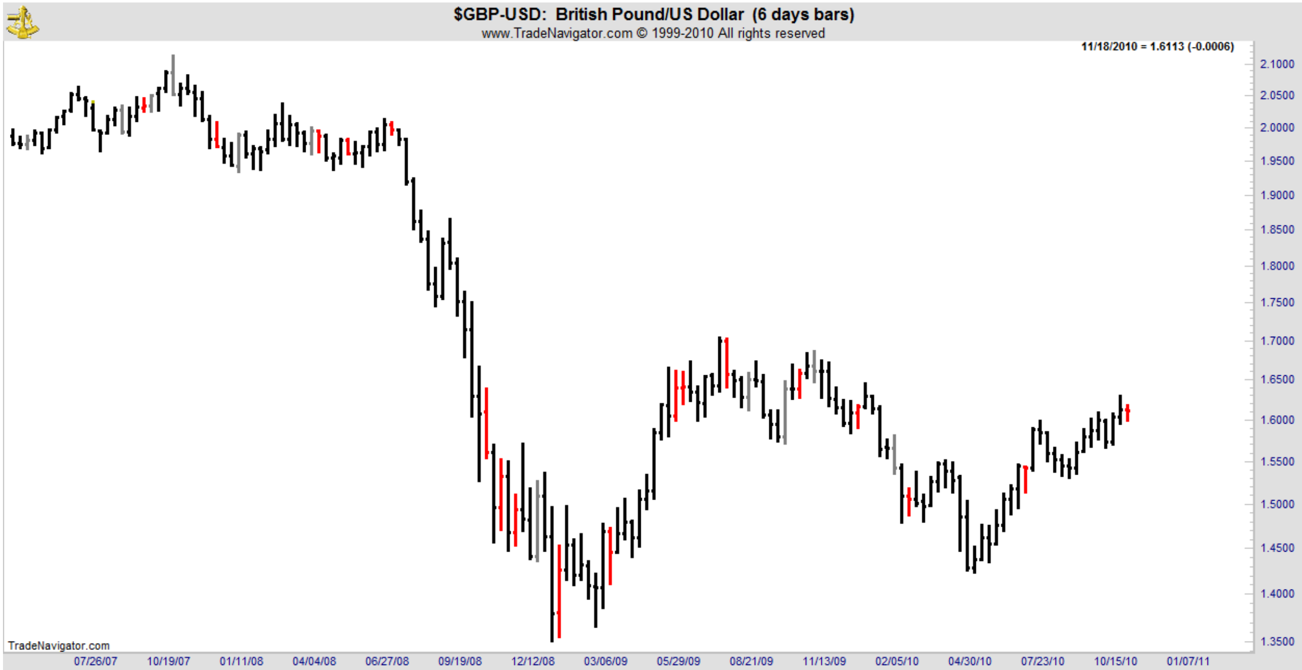
The Euro was the first currency to show the 70 week DC time cycle at its June low. This is one of the Danielcode "Heathen" or non-compliant cycles. A comparative rarity which has been showing up more frequently in distressed markets.

Below is the EUR-USD chart. Note the precision of its turns at the DC time cycles, its obedience to the DC retracement ratios and its high observance of the DC regression channels.



With precision such as this, you can well understand how this pair has qualified as one of the "Best" of 2010. Knowing the trend and the high probability turning points for any market makes it a trader's favourite.

The "Worst" for 2010 was undoubtedly the British Pound:



It's fall from grace is mute testimony to the Brown years, first as Chancellor of the Exchequer (UK Treasurer), and then as unelected Prime Minister. Despite the current weak rally, Britain's travails still lie ahead.

15 November 2010
John Needham
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