The Words that Dare Not be Spoke Down Under!-The Best Currency Trades for 2013

*"**Central banks can provide liquidity to shore up financial stability and they can buy time for borrowers to adjust, but they cannot, in the end, put government finances on a sustainable course. They cannot shield people from the implications of having mis-assessed their own lifetime budget constraints and therefore having consumed too much.**"* Glen Stevens, Governor of the Reserve Bank of Australia"

For those of you who are neither of, or have ever visited the lands Down Under, Australia and New Zealand, let me welcome you to a different world. A world with a land mass as big as the United States, roaring into adolescence with unsurpassed gifts of Iron Ore, Coal, Gold, Copper, Uranium, Diamonds and vast pastoral tracts, deep sea Oil and unlimited Gas reserves. Lands of awesome and abiding natural beauty and contrasts. From the tropics of Darwin in Australia's Northern Territory (all is upside down in the lands Down Under…the North is hot and the South is cold), to the unending Inland Desert, the Pilbara and the Hamersley Ranges, hunting grounds of the mining giants BHP-Billiton, Hancock Mining and Rio Tinto et al, in the West to the icy waters South where the Great White Sharks breed in the Great Australian Gulf, thence East across the Tasman Sea locally referred to as "the ditch" and onto the Land of the Great White Cloud, New Zealand, home to grand lakes, massive glaciers and crystal clear fjords and abode to the Lord of the Rings, Hobbits and associated elves.

Note how many times the word "great" appears in the previous paragraph. Everything is great and mostly massive Down Under. And lucky. Australia is often called the lucky country due to its abundance of all things "rich and rare" as its National Anthem declares. With a population of just 18 Million concentrated in its costal belt near the never ending white sand beaches that fringe this giant isle, Australia is a burgeoning growth engine as its premiere hordes of minerals are torn from the ground to feed the gaping maws of China and Japan, the raison d'être of Australia's Iron Ore and Coal mines, the highly visible and entirely dominant story of that country's economic growth.

Australia has:

- the world's largest reserves of brown coal, mineral sands (rutile and zircon), nickel, lead, silver, uranium, iron ore and zinc
- the world's second largest reserves of bauxite and tantalum
- the world's third largest reserves of copper, and

- the world's fourth largest reserves of silver ..data from Austrade

Across the ditch in New Zealand we find a softer clime and almost a whole country dedicated to farming where the once despised dairy farmers have, with the help of the most beautiful landscape imaginable and a wonderfully effective government approved (yea nurtured) monopoly, turned themselves into the lords of a vast green manor. This gem Fonterra is one of the largest milk processor in the world with dynamic expansion plans across the ditch and North to China, the giving mother of consumption, from whose pendulous teats the fortunes of the Down Under economies gratefully hang.

And cows. soft eyed Friesians with a scattering of the cream producing Jerseys to thicken the mix. 4.5 million of them in fact, grazing on lush green pastures. Clients of mine visiting for a trading tutorial recently commented "New Zealand is one great park with some animals". True enough. Mining and pastoral in Oz; cows and timber in the home of the Kiwi.

So there's the travelogue. Now onto business.

The good news (and it's mainly good news) is that Australia and New Zealand rank in the top of all OECD rankings. They are semi socialist states where universal health care and education are a given and largely of a very high standard, social divisions are much less obvious and very rarely on display; business is encouraged and supported and generally these lands are regarded as being most desirable places to live.

The growth of Australia's mining and New Zealand's Dairy industries over the past two decades are hard to describe to an outsider. Simply saying immense does no credit to the size and further growth potential of these industries, which of course carry a huge tail of service industries with them. Prosperity from Australia's BHP to every tradesman Down Under is uber apparent. Wages are staggeringly high and with that has come a property boom that makes the US sub-prime boom and Spain's "build and the Poms will buy it" booms, now about 37% and 60% underwater respectively, look like calm and rational moments in history. Add historic immigrant intake and urban growth is simply breath taking. To put this in context consider that the *average* house price in Sydney, one of Australia's two premiere cities is $642,000 Ozzie Dollars (AUD), each now worth $1.05 US. Auckland, New Zealand's only really major city is more expensive still and continuing its rip roaring ride. This from Bloomberg today:

> "The Real Estate Institute of New Zealand said house prices climbed 7.3 percent in November from a year earlier, the fastest annual pace since November 2007"

House prices as a multiple of earnings are a moot discussion as the figures vary so widely, but by my estimates from the 2010 census figures, most of these major cities are running house prices at North of 10 times earnings. And the merry populace as is inevitable in great booms think that better things are in store as property prices can only go up, joining their US and European cousins in their deluded belief system!

So let's try to put this in some context. For the future of Australia's mining boom we can look at the CRB charts that measure a basket of commodities almost all of which are Ozzie staples:

For a country blessed with massive resources of Iron Ore and Coal, the feed stocks for Steel, and a near neutral foreign policy, the explosion of China as a great mercantile power and more importantly its historic growth in usage of building materials, mainly steel is a match made in heaven for Ozzie miners. Western Australia's Iron and Queensland's open cut coal mines are of extraordinary quality and scope and all importantly they have inherent cost advantages over the competition. To many in this field, scope is an unattainable luxury and government fees and taxation impositions an ever present burden. For Australia's mining giants this has never been a problem as successive State Governments (Australia is a Federation where States and the Federal Government have separate and overlapping areas of responsibility) have been no match for the savvy of big business, and the promise of job creation in regional areas that are of immense political importance. Hence at the State level where miners are usually important contributors to political parties, relationships are cosy but recompense to the State as consideration for the value of its resources being extracted is minimal at best and laughable to most.

With the above backdrop of massive wealth creation, the infrastructure requirements to bring these huge but remote mines on-stream including rolling stock, harbours and ships (did I mention Australia's North-West Shelf Oil and liquefied gas industries?) the demand for Aussie Dollars has been and continues to be immense as its mining investment pipeline reaches in excess of $430 billion with future projects estimated at double this figure.

The Joys of Public Service (Yes Minister)

But this is OK. The lands Down Under are notoriously apathetic about politics per se and more so when faced with the usual barrage of municipal, State and Federal layers of bureaucracy and pollies (politicians). Indeed it is a standard article of faith for both of these countries that at the Federal level, voting is compulsory with significant financial penalties for failing to attend a polling booth. Were it not so, I doubt if the polling places would get a big enough roll up for a chook raffle.

At the Federal level, Australia is currently saddled with a government of dubious legitimacy (hung vote, shoddy deals etc) and stunning incompetence. After an acrimonious three year battle between Canberra (the Nation's Capital) and big mining in the shape of BHP, Rio Tinto and hangers on, as government attempted to belatedly introduce a Mining tax to enable the country to share in just a miniscule part of the record profits being torn from the landscape by these miners, predictable the miners out muscled Canberra with ease in the advertising war and eventually negotiated the Federal Labour (Democrat type) government into its longed for piece of legislation, that last month, near the peak of this historic boom raised zero. That's right. Nothing. Roll on all those expensive pollies, bureaucrats and assorted camp followers whose demonstration of incompetence is beyond breath taking.

The reaction?

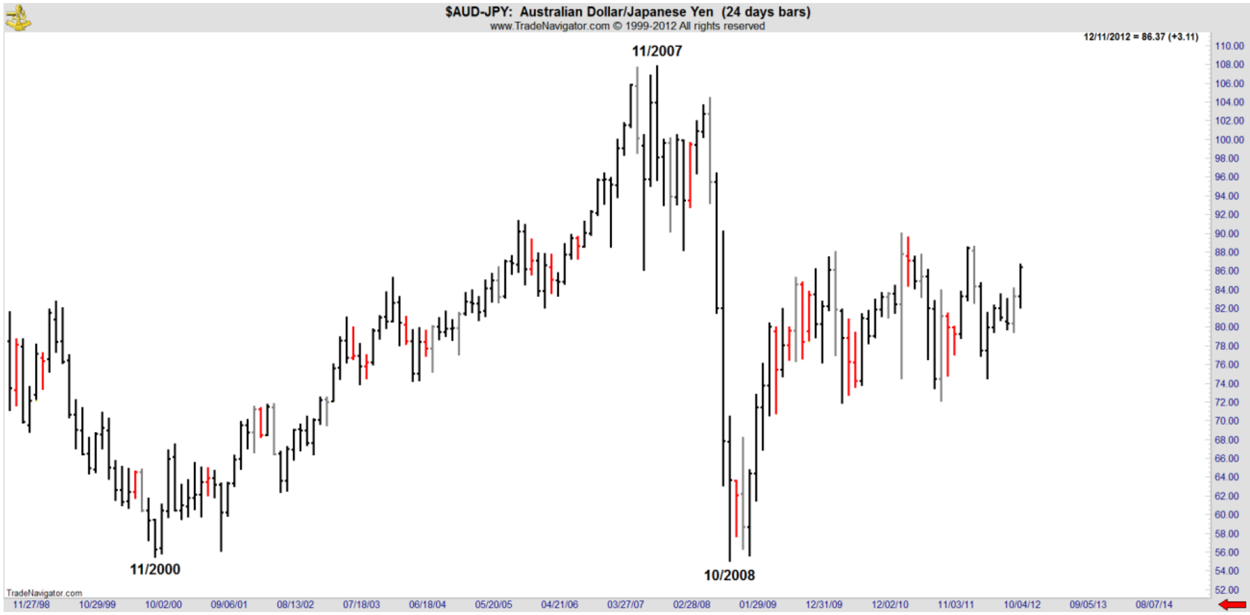
Apathy. Nobody cares.

So miners at least are happy with government and have plenty of reasons to be so.

Currencies

Below is the AUD-USD chart:

And on the cross rates, the AUD-JPY chart both of which show the extraordinary volatility during the fun run down from the 2007 highs.



This extreme potential for volatility is a function of the Aussies importance in the carry trade. As the highest earning currency in a stable and secure region with a long settled Democracy and rated in the top 3 (New Zealand and Norway first with Australia third) rankings of fiscal transparency and all other good metrics, both of the Down Under currencies are magnets for those institutions that can borrow cheaply in USD or Yen, both of which currencies are at the Zero bound thanks to political infection of both US Fed and Bank of Japan. The disease takes the form of too many staff at these institutions, who like their cousins the bureaucrats become alarmed that the populace may someday wake to this reality, and hence they resort to that well established tradition of "make work". This is a severe and chronic affliction shared by their masters the pollies. You may think this comment unduly harsh, but after a lifetime of considering the foolishness of the ideas emanating from these groups, I am forced to the conclusion that these ideas cannot be the result of mere incompetence, and the only alternative is that they are deliberate.

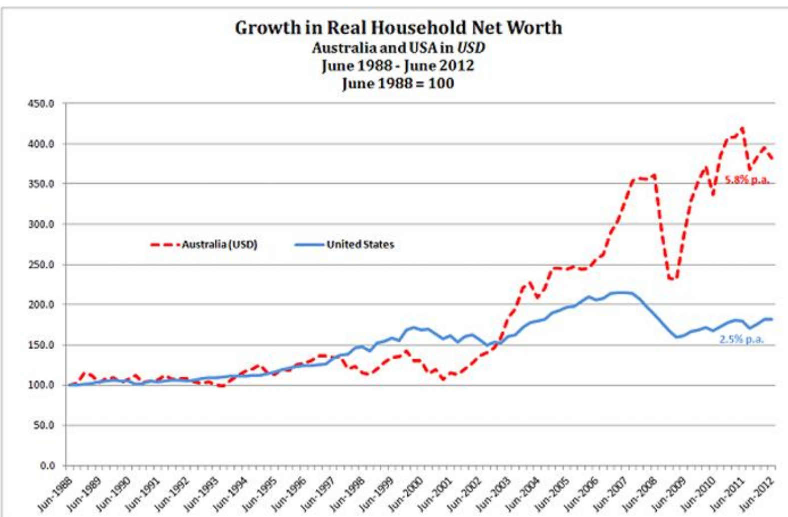
And that of itself is a self-reinforcing paradigm. Instead of lapping up vast sums for bloated salaries, insidious perks, scandalous expenses and wholly immoral pensions, a better idea for sustaining this cancer is to pretend that they are creating new and beneficial policies that serve the populace. Of course this is mere pretence and the comments above about the efficacy of these groups are not far from the mark despite my jaundiced views. Part of the propaganda battle constantly waged by our rulers the pollies and their civil servants is to use the big trumpet of friendly press to ensure that their actions are always seen in the best light, and given the media's well deserved reputation for serving powerful interests (the News of the World fiasco in UK was not a one off), we rarely get to see the light shined on this nexus of power, but the European experiment aka Eurozone which is a giant pantomime transferring power from elected elites to tenured elites (civil servants) is showing, to those who wish to see, how easily resources, rent and rewards can be transferred when natural enemies (pollies and civil servants) can find a

common cause. For background to this battle you can do no better than view a multi decade oldie the BBCs "Yes Minister"

But I digress, so let us return to our currency observations.

It's the Principal Risk

For the past decade, the growth in wealth of Australians has been phenomenal. What is not generally appreciated is as the "Australian Financial Review" of 10 October 2012 reported, Australia's median wealth per adult at USD194,000 is the highest in the world, according to the Credit Suisse Global Wealth Report 2012. Average wealth per adult, at USD355,000, is second only to Switzerland. And most of that wealth has come from housing. Australians have less than half the average liquid assets of US citizens and for Aussies, dwellings comprise over 71% of that wealth. It's all in the house sport! This from Wealth Foundation: "An implication may be that there will be growing pressure to convert "excessive" housing wealth to a more liquid form. The question is who will be able to afford to buy at current valuations. Our analysis suggests certainly not Americans, nor younger Australians."



Whist valuations of mining stocks in Oz are well off their highs, they remain at nosebleed levels with many still being valued at potential. This month Sydney siders are chuckling at a regulatory post mortem of a mining deal with sinister political connections gone wrong. The plot involves a number of Sydney's leading business men, who having obtained a mining prospect from the New South Wales State Government for the fee of $1 Million, promptly agreed to on sell it to a listed entity they controlled for $500 Million. And apparently valuers and auditors were OK with that!

But other than miners, that other great purported wealth creator the stock market shows that even the 30% that Australians retain as liquid or non property assets has not prospered. The chart below is the Australian Stock Exchange's SPI 200 Index, a broad measure of Australia's biggest listed companies. It is trading at 2005 levels. No wealth creation there!

The paths of financial institutions are mapped by government and Central Banks. New Zealand and more so Australia are asset rich but capital poor. That is their infrastructure and housing is financed largely by foreign borrowings. Other than the virtues listed above, foreign appetite for government debt is vital, and this is why the rates for government bonds Down Under are consistently 3% or so above other comparable countries. The Reserve Banks of Australia and New Zealand set the official or "cash" rate and the banks add their margin to this figure to create the mortgage rates. Hence we have relatively high but historically very low mortgage rates.

Few understand the importance of the housing industry to governments. It provides a vast source of jobs for both skilled and relatively unskilled labour and due to its physical nature it is a prime employer of younger people. Spain, provider of a memorable house/condominium boom over the past years is a classic example of what happens after a house building boom is abruptly terminated. Unemployment in the under 25s of 50.5%. It also finances a host of associated services, many in clerical and financial jobs, and is a primary source of income for States and Municipal bodies. And endless repetition of the home ownership mantra has long ago made home owning the collective Aussie and Kiwi dream. And that demand is fed by policies instituted by Australia's central bank.

You see, all great crimes require a cover story to sell it to the great unwashed. The perennial standby well swallowed by our US and Iberian friends is that property values will always go up. The whole US sub-prime lending debacle and now Spain's very popped property bubble swayed the populace, banks, institutions and regulators alike into believing that this market sector in particular is immune to mean reversion and that the only way is up. Although subsequent history has shown the fallacy of this assumption, the reality has not filtered to the lands Down Under. And what is crystal clear but strangely seems to get little coverage and less comment is the reality that interest rate risk, although the dominant part of any mortgage discourse is not the real issue. A 0.25% changes as the Reserve Banks habitually twiddle is insignificant on average mortgages.

What eventually brings the house of cards down is principal risk, and despite the GFC (which down Under was neither Financial or Crisis) Aussie and Kiwi banks continue to roll out 90-100% loan to value mortgage financing on demand. This level of risk is definitely an issue for Reserve supervision, but it has become the status quo. It is implicit in this level of lending that there is an underlying assumption that markets will never correct more than 10%. How has that worked out in US and Spain?

This is a case of "He who rides the Tiger" a favourite Eastern aphorism. What happens if that norm is wound back? Certainly first home buyers are already stressed at financing homes at huge salary multiples, and saving the present deposit requirements is a challenge. Their reduction as new market players cascades ever upward and destabilises an already stretched market. And politically this is revolution material as the undoubted right of citizens to own their own home is dogma Down Under.

I do not suggest that we are likely to see a housing crash of US or Spanish dimensions. There are relatively few foreign buyers who can walk away from contracts (Spain) or jingle mail as available in US, where in most States, underwater borrowers can return their keys to the lender and walk away with nothing more serious than a temporarily distressed credit score. Down here, mortgages are all personally guaranteed and lenders will garnishee wages, pursue bankruptcy and whatever else it takes to recover their funds, so dénouement will be slow and steady, but in my view inevitable.

Across the ditch in New Zealand, where farming is the major industry, these are the latest Property figures for the vital farm sector:

> REINZ's All Farm Price Index rose from 2,852.46 to 3,069.52 (+7.6 per cent) in the three months. The index was 5.4 per cent higher compared to November last year
>
> The median price per hectare for all farms was $22,885, up 15.2 per cent on the previous three months and 11.9 per cent on November last year.

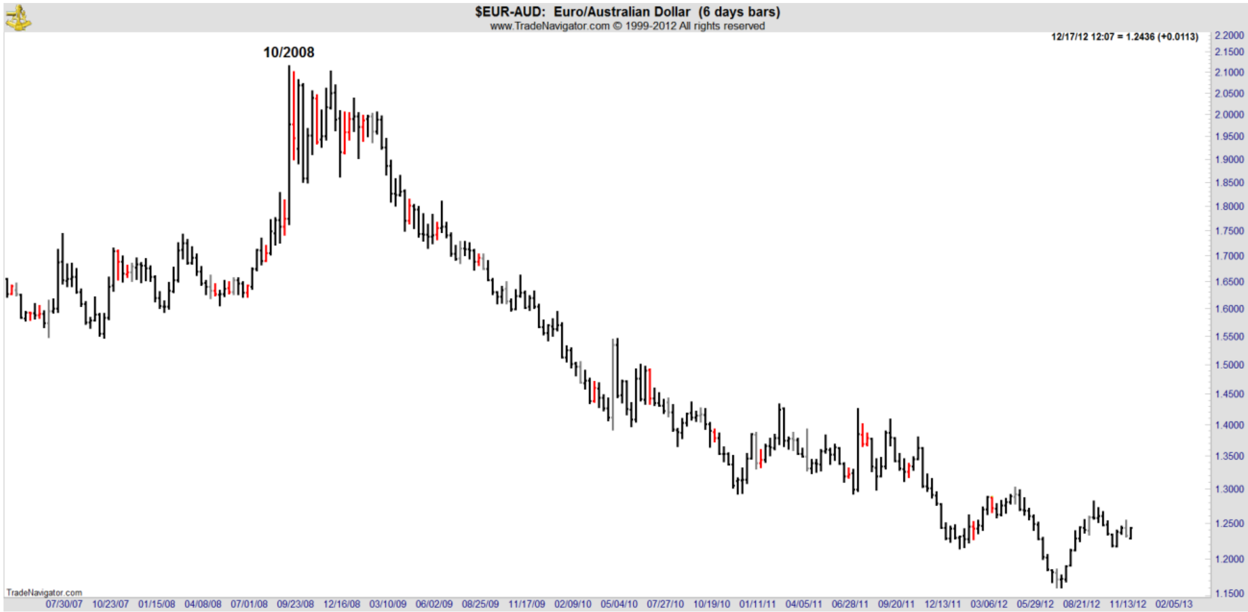
I don't know whether this particular boom is sustainable. Science is creating huge boosts to farm productivity in the dairy industry in particular, and the young are always optimistic. But it seems very rich to me.

The Words that Dare Not be Said

Glen Stevens, the Governor of Australia's Reserve Bank is an experienced and wily player. He has been in the job since 2006 and like all serious bankers he is cautious what he says, so these recent comments are of special interest:

> I would have thought that by this point we have to conclude that simply expecting to clean up after the credit boom is not sufficient anymore, Mr Stevens said. "The mess might be so large that monetary policy ends up not being able to do the job when the time comes."
>
> Property assets were especially significant because they tended to be leveraged, meaning booms and busts were felt across the financial system and economy, he said. Mr Stevens also stressed that interest rates could not do all the work on asset price bubbles - it was also incumbent on governments to supervise banks and collect accurate information on house prices. The issue is the potential for damaging financial instability when an economic expansion is accompanied by a cocktail of rising asset values, rising leverage and declining lending standards. The Age. Melbourne

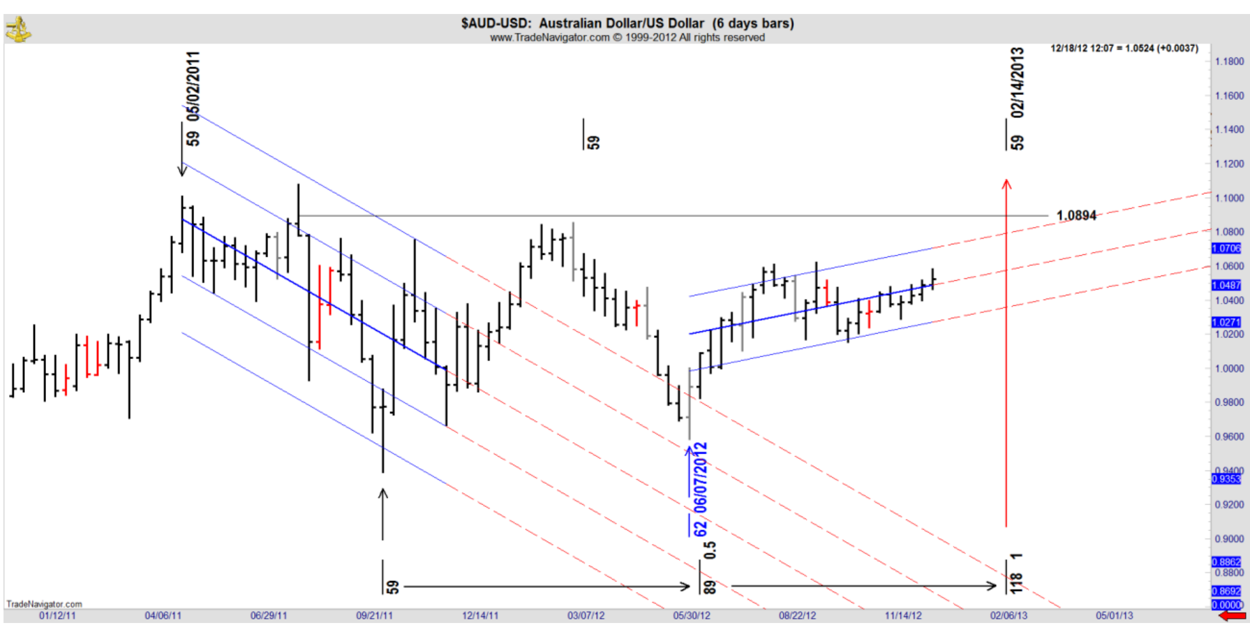
More on the cross rates. This is the Euro:



Obviously the strength of the Aussie and Kiwi currencies is also a function of active devaluation by other major Central Banks and governments, and to complete your view of the biggies, below is the GBP-AUD cross which shows that the Brits have been in the devaluation business for the past decade. But these are no longer the days of Empire and Aussie foreign currency exposure is primarily to USD and EUR. What fun these foreign lenders are having with superior interest rate differentials, the basis of the ubiquitous carry trade being boosted year on year by their effective devaluations.

This is another looming cross for the Aussie balance sheet to bear as somewhere, sometime, these exchange losses needs be recognised. But not yet.

Markets make significant turns when time and price are squared, that is when a recognised Danielcode cycle in time coincides with a recognised Danielcode ratio of price. For those of you interested in the methodology of market time, you can read a detailed explanation at www.thedanielcode.com under the "Articles" tab. There are two important articles entitled "Master Class" I and II.



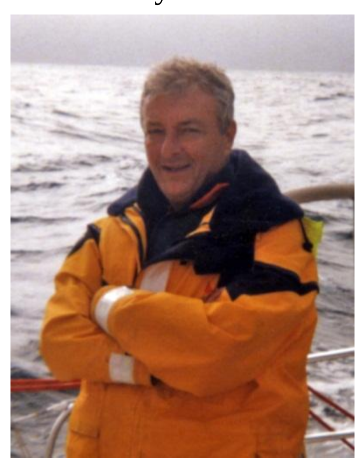
AUD-USD has been sensitive to the more common Danielcode time cycles which we typically see as resistance at the 59 and support at the 62 DC week cycle where a DC week is 6 trading days. Financial markets including currencies have strong fractal patterns with the time cycles repeating as Daniel recorded, "It is for time, times and an half", and on the 6 day timing chart above we see an interesting overlap of different time fractals in mid February 2013. I fancy that may be an opportune time for chaos in US or European financial affairs and it's a likely time for a significant change in trend for the Aussie and Kiwi.

As a firm believer in mean reversion I think that AUD-USD and AUD-EUR are likely to present the outstanding trading opportunities of 2013, with the Aussie Dollar on the short side. Australia is New Zealand's dominant trading partner and historically these two currencies have traded in a well defined range, so the same thoughts apply. The likely trigger for this reversion is financial drama in US or Europe or even Japan. Aussie is dependent on all of them for funding. And of course Australia's Iron and Coal boom is directly levered against China, and any significant slowdown in China's infrastructure (Steel) plans will impact mightily on Aussie miners as the recent correction of the Ore price from $187 to $90 and bounce back to $120 has demonstrated with both BHP and Rio Tinto mothballing major projects.

So there is an interesting proposition. A host of countries with well publicised problems supporting the most leveraged property markets on earth; largely through a currency with a propensity for high volatility as it reacts to events elsewhere.

What could possibly go wrong?

I invite you to visit us at www.thedanielcode.com where you will find a plethora of my published articles, videos and Power Points on trading Forex and Futures. I trust you had a Merry Christmas and I wish you great trading in the New Year. Get that right and the prosperity part is guaranteed.



Ecc 9:11 I returned, and saw under the sun, that the race is not to the swift, nor the battle to the strong, neither yet bread to the wise, nor yet riches to men of understanding, nor yet favour to men of skill; but time and chance happeneth to them all.

John Needham, Sydney, Australia

www.thedanielcode.com

10 December 2012

John Needham is a Sydney Attorney who has traded futures and forex for over 20 years. He invented the Danielcode, a unique understanding of the DNA of markets and shares much of that knowledge through his website and writing.