



Black Swan Capital
Currency Currents

Friday 17 July 2009

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Currency Newsletters

Managed Money

Key News

- [The euro zone recorded a trade surplus in May](#) because imports contracted at a faster pace than exports, data showed on Friday, pointing to continued weakness in internal demand. (Reuters)
- [China's government failed to sell as much debt as it planned](#) for the third time in two weeks on speculation the central bank will push up money-market rates. (Bloomberg)

Key Reports Due (WSJ):

8:30 a.m. ET- Housing Starts

Quotable

"All is not hopeless. Markets are turbulent, deceptive, prone to bubbles, infested with false trends. It may well be that you cannot forecast prices. But evaluating risk is another matter entirely."

Benoit Mandelbrot

FX Trading – Aussie angst and some feedback loops!

Given that Australia has effectively become a satellite country of China—a country we are told is “booming” with growth--does the news item from Bloomberg this morning strike anyone else as a bit odd? [Our emphasis]

July 17 (Bloomberg) -- The **value of Australian exports plunged in the second quarter by the most in almost 25 years** as coal prices tumbled 36.8 percent and the nation's currency rose.

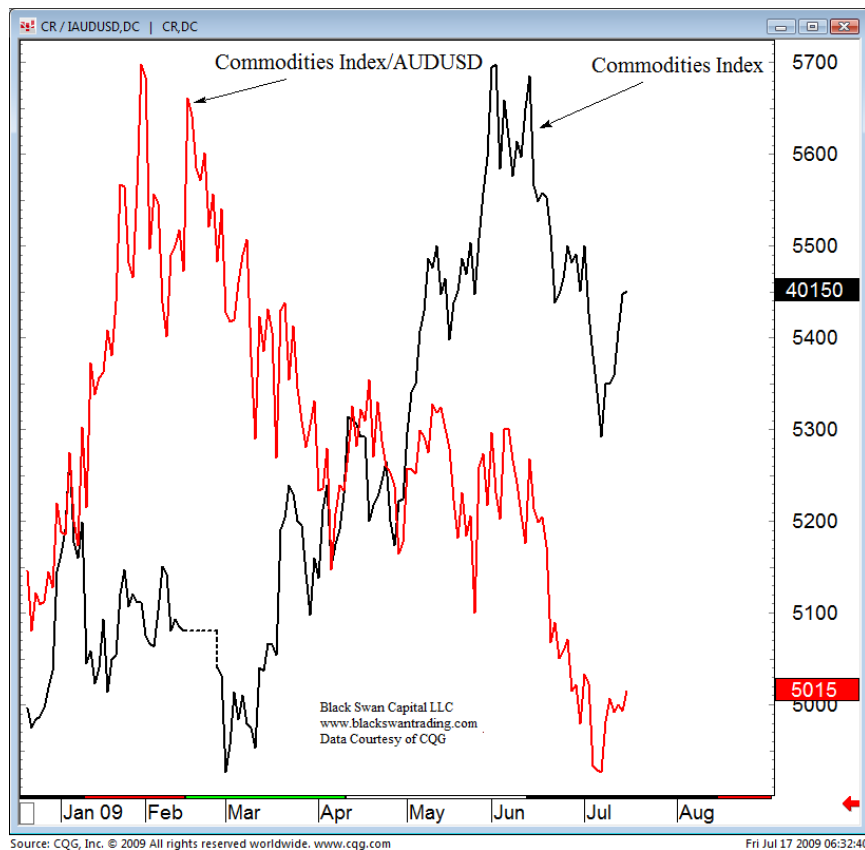
The export price index slumped 20.6 percent from the first quarter, the biggest decline since the index began in 1974, the Bureau of Statistics said in Sydney today. Imports fell a record 6.4 percent. Economists forecast declines of 6 percent and 16 percent for import prices and export prices respectively. Lower prices for exports threaten to erode Australia's economy, which was one of the few including China and India to expand in the first quarter. Australia's terms of trade, a measure of income from exports, tumbled 15 percent in the second quarter, said Helen Kevans, an economist at JPMorgan Chase & Co. in Sydney.

“The terms of trade will fall at least 30 percent from peak to trough, draining national income, although it now appears the squeeze will be worse than we currently forecast,” Kevans said.

Australia’s trade deficit widened in May as **a drop in coal shipments pushed exports to the lowest level in 14 months**, a report showed on July 2.

Yikes! Outside of the beloved BRICs, Australia was supposed to be everyone’s hero economy being pulled kicking and screaming along the path of Chinese growth. It goes back to a point I mused over earlier in the week: maybe 8% quarterly GDP growth in China isn’t all it’s cracked up to be. If China isn’t importing much, possibly evidenced by Australia’s trouble (and angst rising among other Asia-block nations), then how can it carry the rest of the globe out of recession?

Another question: Given the big run in commodities prices this year, why is Australia not benefiting? Maybe the chart below of the **Commodities Index compared to the same index in Australian dollar-USD terms** can help explain:



As you can see, from the Australian’s perspective, thanks to the big run up in the Australian dollar (or big fall in the US dollar since Jan ’09), the price of commodities to them has fallen!

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So how might the Australians help alleviate this situation? Possibly through the pressure valve of the currency, which goes hand and glove with economic prescription when growth is slowing and there is no fear of rising prices—cut interest rates. This is a prime example of the powerful feedback loop between currencies and the real economy.

Fundamentals influence currency prices and currency prices influence the fundamentals.

In a free-floating currency world the currency can be the pressure valve. But in a hermetically sealed financial world (cap controls and pegged currency), that is China, domestic asset market speculation can become a pressure valve. Thus, you get major pricing dislocations and non-market allocations—a 75% increase in the stock market year to date might be an example.

Back to the Aussie in attempt to close the loop of this missive...It's likely the Reserve Bank of Australia will cut interest rates given the change of fortunes in the Australian economy. The 3%+ Australian short-term rate already seems low, but it towers over other major currency competitors that seem to be seeking ZIRP (zero interest rate policy). We know that growth and yield are, and have been, a powerful driver for the Australian dollar's rapid run up in price.

Here's the point (sorry for these very long sentence): If investors start lurching to the conclusion that a five-fold increase in bank lending from China is part and parcel to the 75% increase in the stock market (a pressure value since there is no currency pressure valve), what may follow is the thought valuations of mostly state owned (or state controlled) companies there listed, whose shares are held mostly by the government, just might be artificially propped up given that the massive infrastructure build (fixed asset investment up 33.5% in the first half) in China in a world where demand is not rebounding will only lead to even more overcapacity and thinner profit margins for companies whose shares have been bid up 75% year to date. Thus, hot money may then flow back out of China, further dampening the prospects for more demand for Australian raw materials, thus further impacting expectations Australian interest rates will play catch up on the downside to its industrialized competitors and therefore pulling the prop of growth and yield viciously out from under what is now the much loved Australian dollar.

Australian \$ - USD vs. Shanghai Stock Index Daily:



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Are they in nosebleed territory yet?

Have a great weekend.

Jack Crooks

Black Swan Capital LLC

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