

Strategies, analysis, and news for FX traders

CURRENCY TRADER

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U.S. dollar bracing for a bumpy ride

The European situation and politics in the U.S. could put pressure on the buck for the rest of the year.

BY CURRENCY TRADER STAFF

From May 2011 into late July 2012, the U.S. dollar index (DXY) surged a smart 15.69 percent (Figure 1). The Euro currency is heavily weighted in the DXY — more than 50 percent, in fact — so the dollar rally represents a broad strengthening trend of the greenback vs. the Euro.

Ongoing European sovereign debt woes and a flight to the perceived safety of U.S. Treasury securities has been a

large part of that year-plus long rally. Citigroup commodity analyst Sterling Smith notes the rally isn't so much a matter of the dollar being so intrinsically attractive as it is the Euro being clearly out of favor.

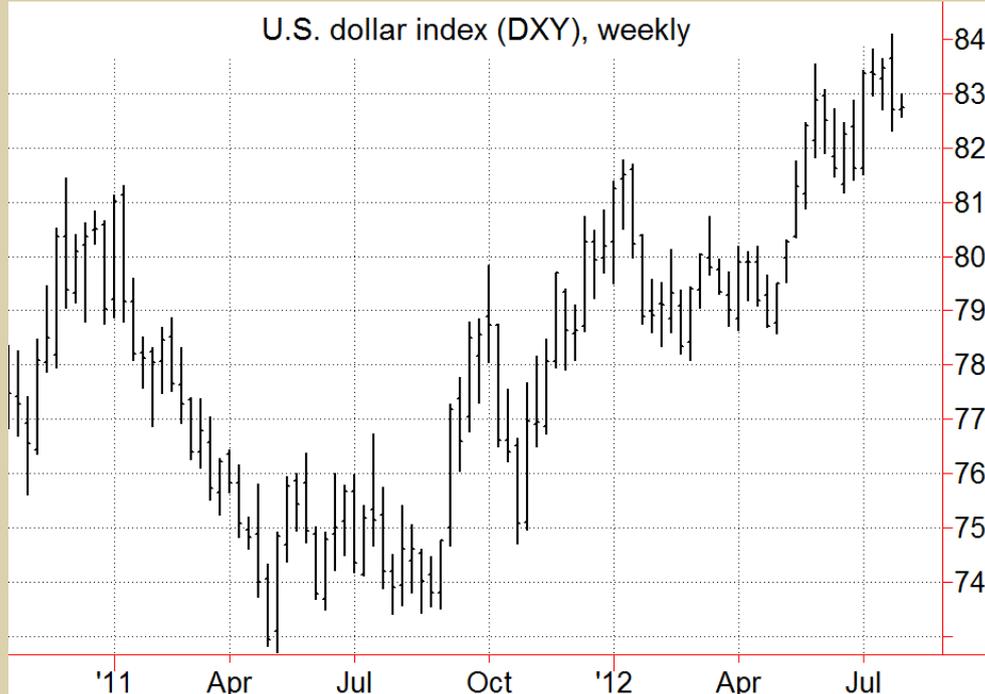
"[Treasuries] are up on the roof, and people are willing to be paid very little to be in the dollar," he says.

However, in late July European Central Bank (ECB)

president Mario Draghi lifted market hopes by loudly proclaiming the bank would do whatever it takes within its mandate to preserve the Euro. The Euro/U.S. dollar pair (EUR/USD) responded with a two-day rally on July 26-27 that brought the Euro to its highest level in around three weeks and put a little air between it and the two-year low it hit on July 24 (Figure 2). However, the July 27 rally fizzled intraday, and the pair closed toward the middle of the day's range.

Could this be a turning point for the dollar index and the Euro? Or, can the greenback continue its impressive bull run? What other issues are lurking in the background that could raise their ugly heads and spark a definitive reversal for the greenback this fall?

FIGURE 1: THE DOLLAR BULL



The U.S. dollar has been in an uptrend for more than a year, but it may be coming under increasing pressure.

FIGURE 2: EURO/DOLLAR PAIR



The beleaguered Euro, which dropped to more than a two-year low on July 24, got a bump on July 26 and 27 when ECB chief Mario Draghi stated his commitment to saving the currency.

The still-struggling U.S. economy and QE3

With renewed signs of slowing in the U.S. economy, more currency watchers are betting on a reversal in the dollar's bull trend vs. the Euro — or at least very volatile trading — in the second half of the year. Among the potential triggers for a reversal is a third round of quantitative easing, which has historically been negative for the dollar. Other triggers include stabilization of the European sovereign debt crisis, U.S. presidential election volatility, and U.S. political wrangling over “fiscal cliff” issues.

The timing of a reversal in the U.S. dollar index to a great degree revolves around any announcement regarding quantitative easing — something few analysts seem to agree upon. Some market watchers see potential for a QE3 announcement as early as the Fed's confab in Jackson Hole, Wyo., in August or at the Sept. 12-13 FOMC meeting.

However, more analysts — though not all — seem to be taking the view that QE3 is a matter of when, not if.

“We hold a very bearish view on the U.S. dollar, predominantly because we think the Fed is moving toward QE3, which will result in substantial weakness for the dollar,” says Michael Sneyd, FX strategist at BNP Paribas. Sneyd's firm forecasts a \$600 to \$900 billion balance sheet expansion over the next six to nine months, split between Treasuries and mortgage-backed securities.

“We expect the dollar to react very similarly to past QE and sell off aggressively as investors seek opportunities outside the U.S.,” he says.

Recent economic data, Sneyd says, makes the case for QE3 becoming a reality. “The Fed is focusing on labor mar-

ket performance,” he notes. “There's not strong enough employment growth to meet the Fed's mandate of growth and inflation. You need non-farm payrolls running above 125,000 to have an impact on unemployment.” (Sneyd describes a 125,000 gain in non-farm payrolls as a “neutral” reading.)

After posting stronger numbers earlier in the year, the pace of non-farm payroll job growth slowed in the spring and summer. Specifically, in February and March, payrolls grew by 259,000 and 143,000, respectively. In April, May, and June, growth slipped to 68,000, 77,000, and 80,000, respectively.

While forecasts remain mixed about quantitative easing, economists are uniformly concerned about the recent loss of momentum in economic growth in the U.S.

“With all the uncertainty that businesses and households are facing, we are seeing businesses pulling back on hiring needs,” says Beth Ann Bovino, deputy chief economist at Standard & Poor's. “We are seeing a slowdown in the second quarter in job growth to one-third of what we saw in the first quarter. Momentum is slowing, and it adds to the risk of a recession.”

Combined with uncertainty about how Congress and the president will deal with the upcoming automatic spending cuts set to go into effect in 2013, as well as the potential repeal of the Bush-era tax cuts and the end of the payroll tax holiday also set for early 2013 (dubbed the “fiscal cliff”), the potential for renewed U.S. recession looms large if those issues aren't addressed. These factors could prove to be bearish for the U.S. dollar, regardless of whether

another round of quantitative easing occurs.

"People are getting nervous about what to expect from the fiscal cliff," Bovino says. "What will taxes be next year, what will spending be next year? It's causing people to pull back."

A negative resolution to these issues, she explains, "could push the government budget to contract by 3 percent relative to its share of GDP — it could shave about 1 percent from GDP in the first half of 2013."

It's already weighing on the economy and the markets. "There's a lot of concern, and people start to save more and spend less, so we could see the impact before the end of the year," Bovino says.

Charles St-Arnaud, FX strategist at Nomura, sounds a similar note.

"More people are becoming pessimistic, they are thinking all these spending cuts and tax increases will come into play," he says.

David Resler, chief economic advisor to Nomura Securities, highlights the spillover impact from the slowdown in Europe. "We're seeing clearer evidence the slump in Europe is taking a toll on the U.S.," he says. Conditions are deteriorating in the direction of a Fed policy move. I'm not convinced the Fed is ready to act yet. I think the Fed would like to be armed with a little more evidence on how weak the U.S. economy is."

One of the brighter spots for the U.S. economy had been the manufacturing sector, but recent data revealed that sector is slipping, too. In June, the ISM manufacturing index fell below 50 for the first time since July 2009, dropping to 49.7 from 53.5 in May.

"The part of the economy we had been encouraged by has been the manufacturing sector," Resler says. "But there are hints manufacturers are being forced to take a step back. Manufacturing is the thing that has changed at the margin."

Resler does add, however, consistent improvement in the housing sector has been a plus.

QE impact

With much criticism already swirling around the U.S. Federal Reserve in the wake of QE2, it begs the question of whether QE3 can even make a difference to the economy.

Resler admits if QE3 is implemented he would expect it to focus primarily on mortgage-backed securities.

"There is a bit of an exhaustion effect in Treasuries," he says. "It's not clear you will do much by pushing Treasury yields down a few more points. There's a belief that buy-

ing in the mortgage space would deliver the most bang for the buck."

Resler offers the following analogy for the Fed's predicament: "Let's say a brush fire starts in your yard and all you have is a worn-out broom; you have no water. Are you just going to sit there and watch it, or are you going to go at it with your tired, old broom? The Fed feels they don't have the option of doing nothing. The real issue is the Fed feels the economy needs some help. It knows fiscal policy has been put on the sidelines until the election. [QE3] may not work, but it won't be harmful," he says.

Pressure on the dollar

There are more bearish voices emerging in the currency world, claiming the dollar's bull run may be getting tired.

"We've got [the dollar] heading lower later this year," says Bob Lynch, head of G10 FX strategy Americas at HSBC. "We are still cognizant of the risks associated with Europe, but there ought to be renewed focus on the U.S. fiscal backdrop. It's reasonable the U.S. election will be a catalyst for that."

Vassili Serebriakov, currency strategist at Wells Fargo, downplays the significance of U.S. economic data and argues the likelihood of improved conditions in Europe will put pressure on the dollar vis-a-vis the Euro.

"We see the dollar gains reversing in the second half of the year," he says. "With or without further easing from the Fed, the U.S. economy has been weakening in the first half of 2012. The U.S. dollar strength has had little to do with U.S. economic fundamentals and everything to do with the next round of European debt crises and ongoing market volatility. We feel the European situation is more likely to get better rather than worse in the second half of the year."

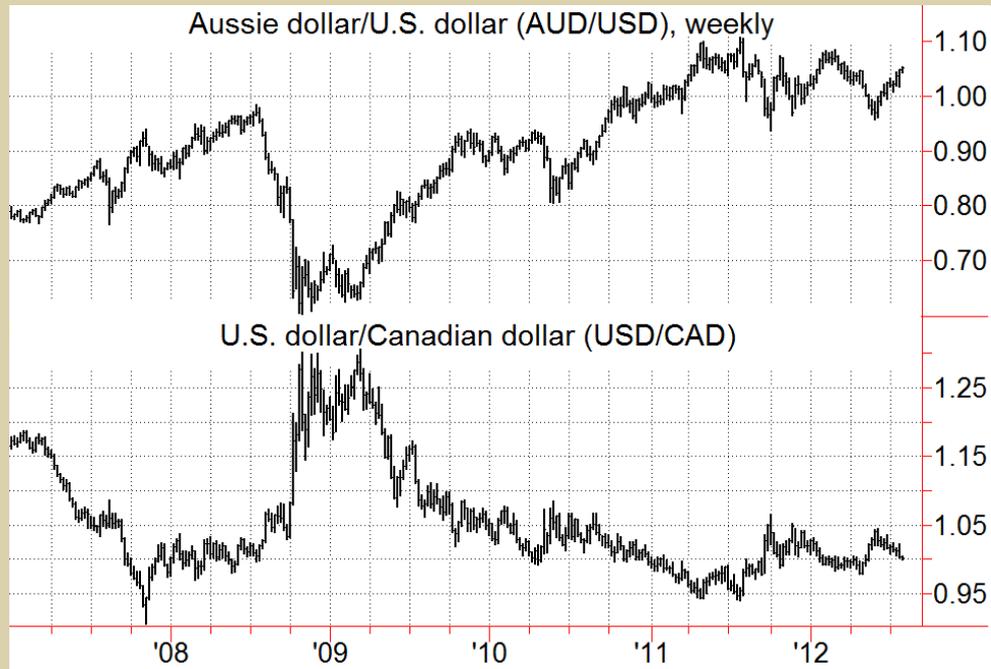
If QE3 is announced in the late summer or fall, market watchers virtually uniformly agree it will be a negative for the dollar. "Once QE becomes a near-certainty, you will start to see the dollar depreciate against almost every currency," St-Arnaud says.

Of course action by Congress and the president in November and December will be critical for the U.S. dollar and the economy. Most market analysts expect the politicians to deliver some relief from the looming fiscal cliff.

"My expectation is that no politician wants to be known as the one who ruined the recovery," Bovino says. "I think they will come to some kind of compromise to deal with the spending and revenue issues."

Some currency watchers see the potential for significant

FIGURE 3: COMMODITY CURRENCIES



So-called "commodity currencies," such as the Australian dollar (top) and Canadian dollar (bottom), may be especially poised to benefit from U.S. dollar weakness.

currency moves over the next several months. Lynch gives \$1.35 as a potential upside target for the Euro, approximately 10 percent above the pair's July 27 closing price and explains how several outcomes from the fiscal cliff scenario could ultimately prove bearish for the dollar and bullish for Euro/dollar.

"If it's not addressed and Congress and the White House don't prevent the substantial constraints [on the economy], there is the potential to throw the economy back into recession, which could generate a response from the Fed in the form of QE, which is bearish for the dollar," he says. "Additional QE is likely to support risk assets, and the dollar and risk assets are negatively correlated, so it should put pressure on the [dollar]."

Lynch describes an alternative scenario that could also have bearish implications for the dollar. "If they do address the fiscal cliff in a way that limits the extent of tax and budget cuts and alleviates the downturn, the deficit grows, which is a further problem for the dollar in the long term, and in the short term might be a problem for the rating agencies," he says.

Serebriakov says he still believes the Euro is a weak currency in the long run, although he sees room for a correction in the short run. He also says there are other currencies to keep an eye on.

"We still like commodity currencies, such as the Aussie

dollar and Canadian dollar, and we still see them strong in the second half of the year," he says (Figure 3).

Sneyd agrees those currencies bear watching. If the Federal Reserve delivers a QE3, "the extra liquidity provided by the Fed will end up in foreign assets, particularly commodity currencies like Australia, New Zealand, and Canada," he says.

Sneyd outlined some of his firm's longer-term targets (into next year): 1.10 for Aussie/U.S. dollar, .9500 for Canada/U.S. dollar, 1.35 for the Euro/U.S. dollar, and 1.78 for the British pound/U.S. dollar.

Regarding the U.S. dollar, he says simply, "We recommend selling it. There are a lot of investors long the dollar and short Europe, which leaves plenty of scope for investors to sell existing dollar exposure."

Serebriakov, who also notes the market is very long the dollar and very short the Euro, adds short-term interest rates between the U.S. and the ECB have converged between very low and near zero. Can Europe fix Spain and Italy? "It's all about headline risk and what's going to happen to Italian and Spanish bonds," he says.

St-Arnaud stresses the importance of the upcoming political battles in the U.S.

"The election will have a lot of headlines, as will negotiations around the fiscal cliff," he says. "The dollar is in for a very bumpy ride." ☒



Recession favors the dollar

The threat of an economic downturn, ironically, appears to be a bullish factor for the U.S. dollar.

BY BARBARA ROCKEFELLER

In December 2011, the Economic Cycle Research Institute (ECRI) predicted a U.S. recession would start in the first half of 2012. So far, GDP has not delivered the two quarters of contraction that traditionally constitute an official recession, but the ECRI points out that recession is a process, not a number. In mid-July, the ECRI reiterated that by the end of 2012, job growth and GDP will almost certainly be negative.

We usually expect a country in recession or entering recession to see its currency fall. The 2011 floods in Australia caused the AUD to dip. When Spain announced its Q1 contraction in April 2012 and the Q2 contraction in July, the Euro dipped both times, although to be fair, plenty of other things were going on at the same time. The March 2011 tsunami and nuclear meltdown in Japan was a special case — repatriation pushed up the yen.

If the ECRI is right and the U.S. is now entering a recession, conventional analysis would call for negative dollar sentiment. But our experience since the European sovereign-debt crisis began in 2009 gives pause for thought. First, there's the "ugly contest," or whose conditions are worse, Europe's or the United States'? With unemployment rates above 20 percent in Greece and Spain, Europe wins that one. Recession already appears to be forming in most Eurozone countries (even Germany), judging from purchasing managers' indices. In fact, the Eurozone will probably enter recession before the U.S.

A second reason to expect the dollar will not fall on news of recession is that it takes good U.S. data to make the world safe for investors in risky assets. When U.S. data is wonky, as in recent nonfarm payroll reports, the initial reaction is the usual spiky dollar sell-off, followed by a rising dollar as risk aversion grabs markets by the throat and safe-haven flows to the dollar ensue. This is one of the many seemingly perverse outcomes of the FX market: that bad U.S. economic data can be dollar-favorable. Risk aversion doesn't have to be present in the first place — bad U.S. data can promote risk aversion all by itself.

Limits of government stimulus

When recession looms, central banks typically pull up

their socks and lower their interest rates to goose lending and business activity. Governments may increase spending, including deficit spending, for the same effect. This time it's different. Interest rates are already at or near zero in Japan, the UK, and the U.S., and the European Central Bank (ECB) cut lending rates in July to 0.75 percent and bank deposit rates to zero.

In classic finance, lower interest rates incentivize consumers and borrowers (including businesses), while punishing savers. Once rates are as low as they can go and central banks see diminishing returns from unconventional monetary policy tools, namely quantitative easing, we are really in the soup. What will inspire business investment that will create jobs to inspire higher consumer spending and pay off the mountain of debt? As Japan discovered, companies preferred to use earnings to pay down debt rather than to borrow from banks, and consumers could not be induced to raise spending, even with government free-money vouchers. Japan has been in a deflationary recession for more than two decades.

Japan is said to be in the dreaded "Keynesian liquidity trap," where massive injections of liquidity to the banking system fail to boost borrowing and activity. Policy initiatives such as QE are like pushing on string. We used to say a deflationary recession can't happen here because the U.S. has an increasing population instead of a declining one, less of a demographic time bomb, endless materialism, and greater inventiveness.

But it can happen here. The U.S. still has some core advantages over Japan, but the key one — inventiveness — has today delivered not the railroad, the interstate highway system, or the Internet, as in past decades, but ... Facebook.

Housing

As for endless materialism, the burst housing bubble impoverished a critical mass of consumers. Zillow.com estimates 31.4 percent of homeowners are under water — i.e., their house is worth less than their mortgage. The amount owed beyond current sale price is a stunning \$1.2 trillion. If we take the 2010 Census Bureau estimate



of the number of households in the U.S., that means 36 million households are feeling financial distress. Of the 31.4 percent underwater homeowners, only 10.1 percent are actually delinquent, and thus only 3.1 percent are at risk of foreclosure. But according to realtytrac.com, there were 2.8 million foreclosures in 2009, 3.8 million in 2010, and 2.7 million in 2011 — 9.3 million in three years. More than 1.5 million of the people who lost their homes were 50 or older. To summarize, 36 million in distress, 9.3 million already lost their homes and their key asset, and 1.5 million are older and not likely to be able to get a job or be able to buy another house.

These are not people eager to run out and buy a new pair of shoes. The housing-bust data is in the headlines nearly all the time, and perhaps we are becoming a bit numb to it. That would be a mistake. We can't see to the end to the coming recession unless we can imagine a scenario in which the U.S. consumer becomes more vibrant. According to Case-Shiller, realtytrac.com, and Zillow, home prices are starting to inch up in many regions and so are sales. The consensus is forming that for U.S. real estate, the bottom is in. But the burst housing bubble leaves behind tens of millions of households with utterly destroyed balance sheets. These homeowners are also the consumers on whose spending the U.S. economy relies for two-thirds of GDP.

The savings quandary

To make matters worse, it's hardly worth saving up for a new pair of shoes or a new house. The return on regular bank savings accounts is 1 percent or less. The household savings rate is higher than during the buildup to the real estate bubble — 3.9 percent as of May 2012 vs. the lowest low of 1 percent in April 2005 — but not really very impressive and lower than the greater-than-5-percent rate from the first half of 2011.

People cannot be blamed for paying down debt rather than saving. Household balance sheets improved in recent years, but the debt-to-income ratio is still a high 114 percent — better than 130 percent at the peak (Q1 2007) but more than double the 1965-1985 average of 60 percent. Deleveraging is a critical part of recovering from a burst bubble, but the current process is taking a long time. People got comfortable with high levels of debt and it's a hard lesson to unlearn. As credit card debt has gone up in recent months, we don't know whether it's because of improved household conditions or desperation.

Real returns

Besides, the rate of return on government bills, notes, and bonds is hardly more impressive than savings bank rates. You receive only about 0.20 percent for a 2-year note, 0.53 percent for a 5-year note, 1.42 percent for a 10-year and 2.53 percent for a 30-year bond. If you expect inflation to be around 2 percent, that means a real return of only 0.53 percent for 30 years.

Note two things about this state of affairs. First, the yield curve is not inverted. An inverted yield curve is thought to be a prerequisite for a recession. But as economist Paul Samuelson used to joke, an inverted yield curve has forecast 37 of the past 10 recessions. It's just not a reliable indicator, and this time, because the Fed has been fiddling with the yield curve with Operation Twist, we lack a clear picture of what true free-market prices would have been, although we can be pretty sure the yield curve would not have inverted, because inflation is not present or expected.

This is the second and more important point. Yield curves normally slope upward as a function of inflation. The farther out you go in time, the more uncertainty there is about how high inflation will be. Investors demand a premium to place funds in longer-term paper. But these days, the real return is considered negative out to at least

the 10-year maturity, and it has been since July 2009.

Most people are having a hard time wrapping their minds around negative real returns, even though they are not all that uncommon. Real returns were negative in the 1930s, for example, and even as recently as the 2000s. Still, real returns have been falling for around 15 years, and if we consider inflation to be about 2 percent today, the yield on the 5-year note is -1.47 percent.

In July the U.S. Treasury issued \$15 billion of 10-year inflation-protected TIPS at a negative yield of -0.637 percent, the largest negative yield and the fourth consecutive negative-yield issue. That means inflation has to rise by 0.637 percent just to get 100-percent of the principal back. If instead we get deflation, the bond holder is paying 0.637 percent for the privilege of parking his money in a safe place, because the Treasury will not be adding any yield at maturity. The investor wants a return of capital, even at a small discount, and is willing to forego a return on capital. Of all the sentiment indicators in the world, acceptance of negative real return on inflation-protected U.S. government notes has to be at or near the top.

No wonder those who must generate some income from a pool of capital are willing to venture into equities and emerging markets — to get any return at all, you must take risk. How is this different from the standard sliding scale of risk and return? Well, it may not be. Equities may rally like a banshee when the Fed cuts or increases QE, but equities do not always benefit from a low-yield environment when low rates are the result of recession. There is a big difference between an event-driven spike and prices based on a cold-eyed evaluation of the business cycle.

As for the business cycle, U.S. companies have been hoarding cash for several years now, possibly as much as \$2 trillion, if we are to believe the White House. This is exactly what Japanese companies did, and it was only massive government spending that made up for it. Over the course of all that government spending, Japan developed the highest debt-to-GDP ratio in the developed world — nearly 200 percent. Fortunately, Japan has sufficient domestic buyers of government paper, so the resulting downgrade by the ratings agencies failed to have the usual curative effect. While this was going on, Japanese companies cut corporate investment by 22 percent of GDP between 1990 and 2003. This failed to have the expected effect on employment because of the country's aging population. The U.S., in contrast, needs to create some 150,000 jobs per month just to keep up with population growth.

What is the solution for the U.S.? Because deleveraging is a big part of the problem, the most obvious is to erase consumer debt, including underwater mortgages. Legally and institutionally, this is ridiculous and impossible to do. A second option is to subsidize or otherwise stimulate exports. This may unlock some of the corporate cash hoard, although it can be hard to figure out who is going to do the importing, with so many other countries also in recession.

Other measures might include incentives to companies to create jobs, although government meddling is open to misallocation of resources and worse outcomes, such as corruption. Job-creating and job-saving initiatives have worked in places like Germany, but there the unions work well with management. When the U.S. sponsored an ultra-low tax on U.S. multinational repatriation during the Bush administration, purportedly to promote domestic job creation, the final judgment was that no jobs were created. To put it charitably, U.S. companies are very, very tax savvy.

As things now stand, the Fed is expected to continue to provide “stimulus” in the form of QE3, either at the July 31-Aug. 1 FOMC meeting or in September. On the fiscal side, congressional gridlock will probably prevent anything getting done, despite the U.S. facing automatic tax increases and spending cuts on Jan. 1, 2013 — the so-called fiscal cliff. In the absence of realistic policy remedies, it's looking increasingly like the ECRI forecast of a long-lasting recession by year-end is accurate. Recessions following burst bubbles can last a decade — the Great Depression lasted 10 years and a month. We are less than 50 percent of the way through this one if we count from mid-2008. Granted, it's more a Great Slowdown than a Great Depression, since GDP is positive, if modest.

Japan (again)

The biggest worry is that the recession becomes deflationary, as in Japan. This has the weird effect of making tiny nominal yields actually positive in real terms. Until recently, for example, the nominal yield on a Japanese 10-year note was about 1 percent, so with deflation of approximately 2 percent, the real return was 3 percent — higher than in the U.S. As Japanese yields fell in July 2012 on the further ripening of the European sovereign-debt crisis, in late July the 10-year was yielding 0.725 percent and inflation was being reported as a positive number for the first time in years (if only 0.20 percent in June, or a real return of 0.575 percent). Remember, U.S. 10-year returns are negative by about 0.56 percent (1.44 percent nominal yields minus 2 percent inflation).

A too-strong dollar contributes to recession and deflation instead of fighting them.

Normally we would expect capital to flow to the country with the higher real return, and that's Japan at +0.575 percent vs. -0.560 percent in the U.S. If what international investors really want is a positive real return, why isn't capital flooding to Japan?

It is, but only to a limited extent. Overseas investors owned 8.3 percent of Japanese Government Bonds (JGBs) as of the end of the fiscal year in March, from less than 5 percent 10 years ago. It's the highest foreign participation in the Japanese bond market since 1979. Still, it's no match for the U.S., where foreigners owned \$5.264 trillion of U.S. government securities as of the end of May 2012, or 33 percent of the total (\$15.9 trillion as of the end of June).

Another way of putting it is to ask whether a positive real return, however small and even one arising from something as awful as deflation, is better than a negative real return. Judging from Japanese enthusiasm for foreign investment, the answer is no. Cash is king. In addition, to the Japanese the yen is the home currency and riskless,

but to non-Japanese, the yen always confers an extra risk. This is why we should probably assume that as U.S. yields wither away to nearly zero (and negative when inflation is factored in), U.S. investors will only reluctantly seek positive returns elsewhere — and probably only among triple-A names. Real rate calculations don't count for much evidently.

Triple-A shortage

There's a distinct shortage of triple-A names — only about 19 if you include all of those on the three big agency lists (Table 1), but many of the bond markets in these countries are small and offer low liquidity. All the same, U.S. investors will likely discover new interest in foreign bonds, as the Japanese did, while non-U.S. investors continue their own flight-to-safety in U.S. paper.

Because the number of adventurous U.S. investors is probably lower than the number of scared foreign investors, the capital flow can continue to favor the dollar. This is not really a good thing. The U.S. would be wise to prefer a falling dollar to promote exports (and secretly, without saying it out loud, to promote a little inflation via higher-priced imports). A too-strong dollar contributes to recession and deflation instead of fighting them.

Ironically, the breakup of the European Monetary Union (EMU) would be a good thing for the dollar — by causing it to fall. This is not to say we expect the EMU to break up, just that more normal rates of return reflecting actual conditions and more normal capital flows could be one of the outcomes. Instead of looking at the bifurcated bond yield tables of the strong set and the weak set in Europe, global investors would have much more choice. Some countries would have inflation (yippee!) and the nominal vs. real rate of return would normalize, instead of the cockamamie setup we have now whereby capital is flowing to a negative real rate of return because it's a safe-haven. At some point, investors would move into Greece, Spain, and Italy if they had drachmas, pesetas, and lira that actually reflected true economic conditions, including the inflation that follows from devaluation. It may seem crazy to want to go backwards — after all, the EMU offers tremendous efficiencies and a single currency removes a great deal of friction — but it would give investors an escape hatch from deflationary recession. It might not be a very big escape hatch, but one that restores the capital-flow equilibrating function of currencies. When capital is perversely flowing to a negative real return, it creates a very big global imbalance.

Because the Eurozone is unlikely to break up, at least not in the next six months, the current situation will persist: a stronger dollar as recession, and acknowledgement of recession, arrives. ☒

For information on the author, see p. 4.

TABLE 1: TRIPLE-A RATED COUNTRIES

Standard & Poor's
Australia
Canada
Denmark
Finland
Germany
Hong Kong (AA+ at Fitch)
Lichtenstein
Luxembourg
Netherlands
Norway
Singapore
Sweden
Switzerland
United Kingdom
Fitch
Austria (AA+ at S&P)
France (AA+ at S&P)
USA (AA+ at S&P)
Moody's
Isle of Man
New Zealand (AA at Moody's and Fitch)
<i>Investors looking for blue-chip economies don't have many choices these days.</i>



The year of the yen

Europe's woe has been Japan's gain.

Are the Japanese economy and currency poised for a much-delayed rebound?

BY PETER PHAM

A recent report by Business Insider made the point the EUR/USD cross, which has been supported for years by many of the emerging markets, keeping their currencies relatively stable vs. both the Euro and the U.S. dollar, is in decline. The argument from Citibank's Greg Anderson is that countries such as Russia, Mexico, and South Korea have stopped cycling U.S. dollars received in trade into the Euro to prop it up.

With trade between the Eurozone and the emerging markets imploding there is little incentive to continue as they have up to this point. Even if the Germans get their way and wind up with stronger financial and political

control over the rest of Europe (which is one very likely outcome), the Eurozone's economic problems will not be repaired overnight. There may be a short-term bounce in the Euro, and the currency may well stabilize, but it won't necessarily be in the \$1.30 to \$1.35 range.

The yen's rally has not been solely in terms of the dollar or the Euro; it has gained ground against a wide range of currencies. Table 1 shows the changes in several emerging-market yen pairs. (March 12 was chosen as the start date for the analysis because it was around that time that many of the pairs peaked and were trading at something close to fair value relative to the range they had carved out during the first quarter of 2012.) The yen appreciated 11.8 percent vs. the Euro since March 12, with the Euro/yen (EUR/JPY) rate dropping from 108.5 to 97.01 in just 11 weeks.

Although this data does not support Anderson's argument per se, it does make it clear that the yen is a possible destination for those funds the emerging markets are no longer interested in.

The question is, why Japan? Conventional wisdom would state Japan is in even worse shape than Europe and should be avoided at all costs. But if that's the case, why is capital flowing there now?

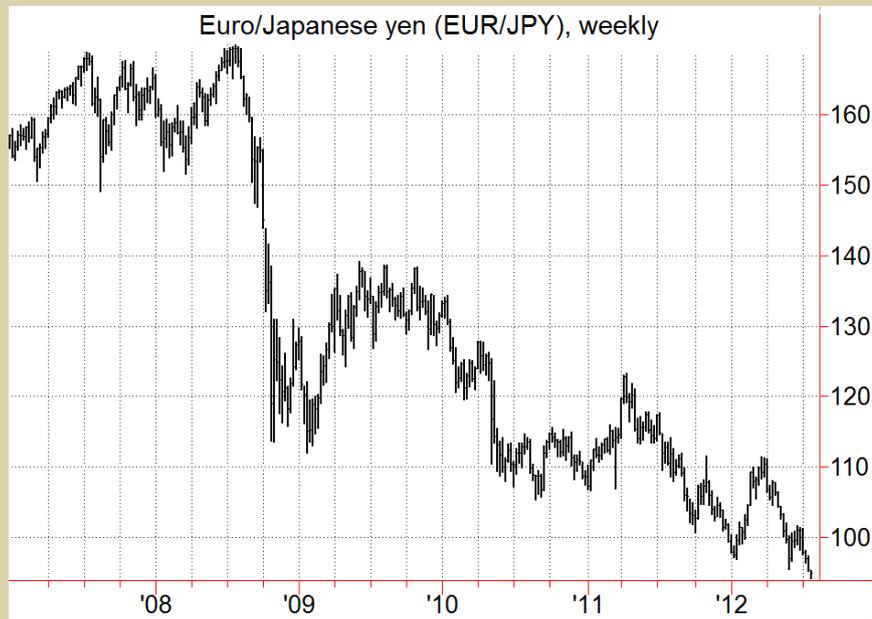
Since the beginning of May when the Greek elections sent the market into panic mode, Japan and the U.S. have seen disorderly buying of their government securities. Yields on the 10-year U.S. T-note hit a record low of 1.45 percent, while the Japanese equivalent dropped below the 1-percent barrier, closing at 0.816 percent on Friday, June 1.

TABLE 1: JPY CROSS RATES, MARCH 12-JUNE 1

JPY cross	3/12/2012	6/1/2012	% change
MXN	6.607	5.450	17.51%
HKD	10.691	10.053	5.97%
RUB	2.814	2.319	17.59%
SGD	65.900	60.334	8.45%
INR	1.662	1.407	15.36%
KRW	0.0738	0.0660	10.67%
CNY	13.113	12.237	6.68%
AUD	87.440	75.690	13.44%
BRL	46.300	38.220	17.45%

The yen appreciated against a wide range of currencies in the second quarter.

FIGURE 1: EURO/YEN



The Euro has been in decline vs. the yen since 2008.

Yields for both countries' five-year debt have been halved. The market for Japanese Government Bonds (JGBs) is nearly 70 percent the size of the U.S. bond market. Who else has markets deep and liquid enough to handle the capital flight from Europe?

Panic station or seismic shift?

The markets are rumbling with fear not seen since 2008. If you look at the stress of the bond market, however, something interesting emerges. The rise in default premium for Japanese government debt has been very low, especially relative to the U.S. and Germany (Table 2). As this crisis has extended, the cost of insuring U.S. debt against default has continued to rise, hitting its highest level on June 1, while that of JGB's has traded in a range. A default risk

premium above 100 basis points is a danger signal. As of Aug. 1, however, there was no panic in the credit markets over the potential for default by Japan on their debts.

The knee-jerk reaction is to blame the market for not "getting it" with respect to Japan, which has disappointed so many people for so long that they are reflexively bearish, while the market continues to make it clear it prefers the yen to the Euro. Since the beginning of the U.S. financial crisis in 2008 the Euro declined more than 70 percent vs. the yen. This is a trade that keeps on paying for those who defy conventional wisdom.

Is this trend sustainable? The uncertainty surrounding the Euro is political in nature, not economic. The economic realities of Europe are now reaching their crisis points, but this has always been baked into the Euro pie. The lack of common European debt would eventually crush the weaker countries that rode the overly strong Euro to unforeseeable heights. In a way, Figure 1 should be viewed as the proverbial canary in the coal mine, highlighting just how flimsy the current political structure underneath the Euro really is.

If the political resistance to a supranational bond and financial oversight solution crumbles and the European Union is given greater control over its members, creating a structure far more like the U.S., the market will likely reward the Euro and capital that has flowed into both the U.S. and Japan will begin to flow out.

In May, the consensus view of 44 financial institutions

TABLE 2: CDS SPREAD CHANGES FOR 5-YEAR GOVERNMENT BONDS

Country	April 18	June 1	% Change
U.S.	30.02	49.22	64.0%
Japan	96.3	107.67	11.8%
Germany	78.57	102.44	30.4%
France	200.01	214.78	7.4%

The increase in the cost of insuring against default for Japanese government debt has been very low, especially relative to the U.S. and Germany.

was for the Euro to strengthen vs. the yen. The median call was for the EUR/JPY pair to strengthen to trade around 104 for the rest of the year. But among those who have changed their opinions since May 23, the consensus estimate has dropped to 100.6. Clearly those following the markets are handicapping a political fix and a bounce from these levels. Are they correct?

Japanese investment boom

There is more to this story than just the short-term resolution of Greece and the European Union. On June 1 the Chinese yuan and the yen began trading without restrictions, and China also announced both countries would hold each other’s currencies as part of their foreign exchange reserves.

Remember the yen is appreciating not only vs. the Euro but vs. the dollar as well, having rallied 5.9 percent since March 12, meaning the flow of funds into the yen is even greater than the demand for dollars. What is not known is who (in terms of central banks) is selling dollars and who is buying yen. China and the rest of the BRICs (Brazil, Russia, and India) have been very vocal about diversifying the world away from U.S. dollars. The

yen rally can be seen not just as a fear trade, but as the first major step away from the dollar by the emerging markets that have been preparing to make this move for months.

The strong yen is a boon to Japanese companies, which have been accelerating their investments in places such as China, Vietnam, India, and Thailand. For example, foreign direct investment (FDI) into Thai equities is up 573 percent year-over-year to \$2.2 billion, while FDI into Indian equities has reached \$8.5 billion this year, an increase of more than 16,000 percent. FDI into South Korea’s equity market

has increased 795 percent from 2011 to \$6.17 billion.

In all these countries the official direct investment by Japanese companies has increased substantially. In 2011, Japan pushed \$6.3 billion into China, up 50 percent from 2010. In Vietnam the numbers are staggering: \$1.8 billion in 2011 and \$3.7 billion so far in 2012, which is 70 percent of the FDI flowing into the country.

Whither the dollar reserve?

A political resolution in Europe will create a bid for it vs. the U.S. dollar, but not necessarily against the yen. Asian capital is flowing out of Europe because of fundamental and short-term issues. The bid for the Euro will come in the form of repatriation, the same way many of the funds

flowing into Japan are repatriated Japanese funds. There is no guarantee much, if any, of that capital will flow back to Europe immediately on a Eurozone reboot.

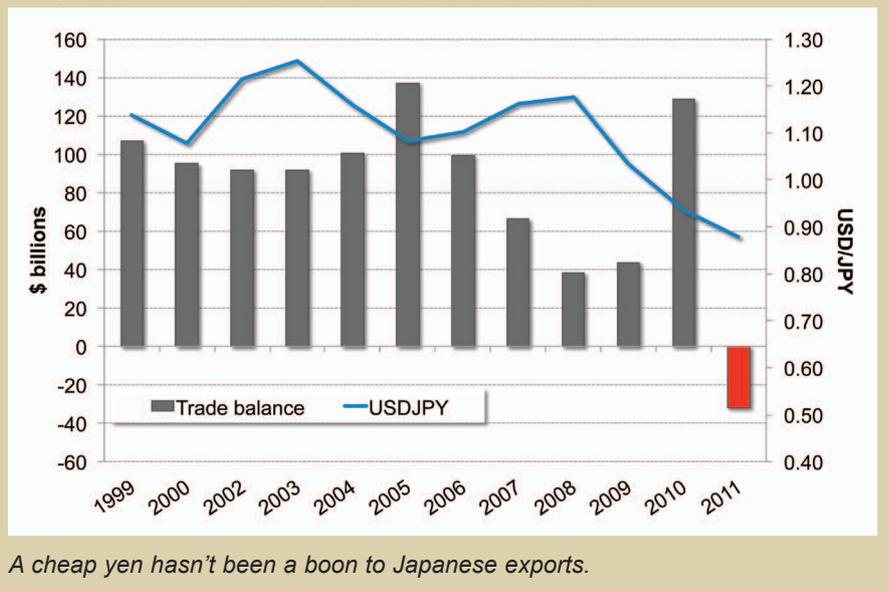
At that point the U.S. fiscal and budgetary situation will take center stage. All the potential policy responses available to the U.S. are not bullish for the U.S. dollar. Maintaining near-zero interest rates will require another massive expansion of the Federal Reserve’s balance sheet. Of

course, the Bank of Japan (BOJ) will intervene at times to keep the yen from appreciating too far, but its recent interventions have succeeded only in slowing down the yen’s appreciation, not stopping it.

The U.S. is in year four of its plan to repair the country’s corporate and financial balance sheets the same way the Japanese have been doing for the past 20-plus years — i.e., financial repression, bank bailouts, and near-zero interest rates. Given Japanese corporate and household debt is at 1988 levels, this would suggest Japan’s economy is ready



FIGURE 2: JAPAN'S ANNUAL TRADE BALANCE



to begin creating return on invested capital — which is exactly what is starting to happen.

The BOJ is similar to the Federal Reserve in its ability to create the funds necessary to maintain a near-zero risk default premium on its bonds. This is unique in the Pacific Rim and it has the power and value to decouple the region from the U.S. dollar. The yen market is deep and liquid enough to act as the default currency of trade — a parallel reserve currency for Asia while the U.S. and Europe work through their issues. With 60 percent of Japan's debt needing to be rolled over in the next five years and bond prices at record highs, right now it looks like Japan will be able to maintain its debt servicing level at the current 21 percent of its fiscal budget.

In 2011 Japan invited foreign investment into the country in the wake of Fukushima and has carried the policy into 2012 because of high oil prices. That trend will begin to abate with the very strong yen and the collapse in Brent crude oil. Expect Japan to soon be posting positive trade balances; their energy costs have dropped by nearly 30 percent in the past two months, and they will turn a few of their nuclear power generators back online.

One of the great economic myths of our age is the supposed relationship between exports and cheap currency.

Figure 2 shows the past 13 years of Japan's balance of trade along with the average USD/JPY exchange rate for each year. There's a temporary boost to export markets via a weak currency, but it only briefly helps those that are uncompetitive in the greater market. Japan has been dealing with a falling exchange rate with its biggest trade partner for nearly a decade. This has removed the marginal subsidy created by a cheapening yen, and yet Japan still ran a trade surplus up until 2011, when a once-in-a-lifetime natural disaster nearly destroyed an entire province.

With the Chinese looking to expand their futures exchange in Shanghai by offering oil contracts denominated in both the yuan (now freely convertible to yen) and the dollar, this further cuts the dollar out of the Pacific Rim trade loop. Yen-yuan convertibility also gives the Japanese a new customer for the bonds that need to be rolled over.

In inflation-adjusted terms the Nikkei 225 stock index is trading at an historic low price-to-book value, as well as its lowest multiples in 13 years. Combine that with the foreign investment being paid for on the cheap and it makes for a very powerful argument for investing in Japan. ☒

For information on the author, see p. 4.



Finding the bull in the dollar index

The U.S. dollar's modern history is one dominated mostly by downtrends.
A weekly pattern can help identify when the odds favor an up move.

BY CURRENCY TRADER STAFF

Traders interested in finding advantageous buy points for the U.S. dollar might justifiably be asked, "Why?" All jokes aside, the dollar has made only limited forays into bullish pastures in the past 35 years, as evidenced by Figure 1. Despite the huge 1981-1985 run-up, the U.S. dollar index (DXY) has spent most of its time going lower or going nowhere; most traders younger than 32 or so have likely never experienced an extended dollar bull market, the last one having occurred in 1995-2001.

Despite some rallies lasting more than a year, Figure 1 is dominated by two massive downtrends. The DXY fell 52 percent, high to low, between 1985 and 1992, and another 41 percent from its 2001 high to its 2008 low.

Even so, short-side strategies must have exit rules, and year-long bull markets should be capitalized on from the long side when possible. We are currently in one of those rallies — the dollar has been moving mostly higher since spring 2011 — although analysts seem to be forecasting a correction (see "[U.S. dollar bracing for a bumpy ride](#)"). Figure 2 highlights several potential long-entry points on a weekly chart of the DXY, based on a price pattern with the following rules:

1. Last week's close is below last week's open.
2. Last week's low is below the lowest low of the preceding four weeks.
3. This week's close is in the top third of the week's range.
4. This week's close is above this week's open.
5. This week's close is above the midpoint of last week's range.

As formulas, the pattern rules are:

1. $\text{Close}[1] < \text{Open}[1]$.
2. $\text{Low}[1] < \min(\text{Low}[2]:\text{Low}[5])$.
3. $((\text{Close}[0] - \text{Low}[0]) / (\text{High}[0] - \text{Low}[0])) \geq 0.67$
4. $\text{Close}[0] > \text{Open}[0]$.
5. $\text{Close}[0] > (\text{High}[1] + \text{Low}[1]) / 2$.

where 0, 1, 2 represent this week, last week, two weeks ago, etc.

The first two rules establish a certain degree of bearishness in the week before the current week: That week must have traded below the lowest price of the preceding four weeks, and it must have closed lower than it opened. Given the DXY's bearish bias, these criteria would have no significance whatsoever, having likely occurred hundreds of times in the past 35 years.

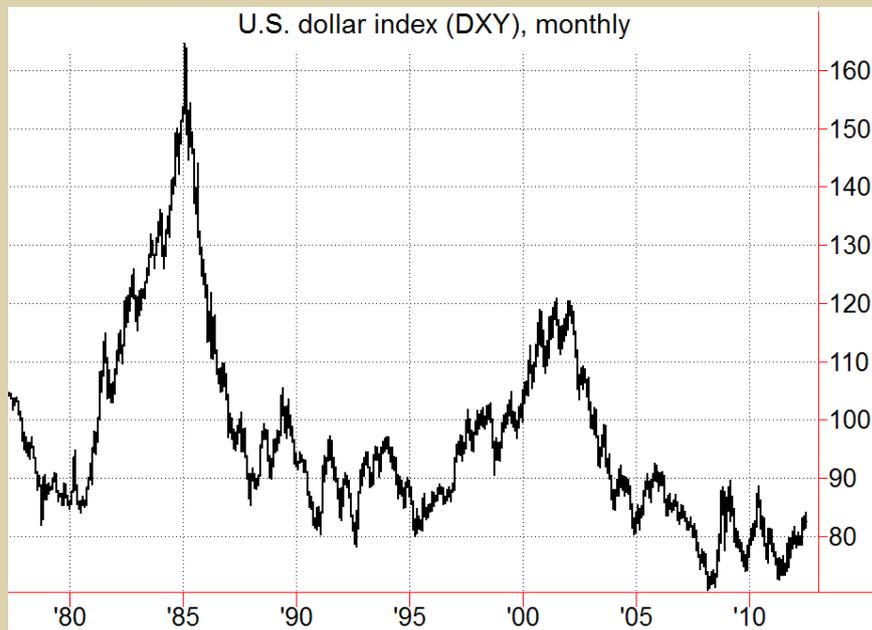
Whatever value the pattern might have comes in combining this down-week definition with the three final rules, which ensures the current week is exhibiting bullish characteristics, both internally and relative to the preceding week: It must close toward the top of its range, above the open, and above last week's midpoint. This final criterion might appear relatively superfluous, but it is a key component that filters out weeks that trade much lower than the previous week but close high within their ranges; such weeks are not indicating bearish momentum is being reversed.

The trade-off with any reversal pattern that includes "confirming" price action, such as the bullish current week

in this formation, is that it is susceptible to (at best) signaling an entry after a market has already made some of its move in the anticipated direction, or (at worst, when the signal is wrong) entering at a relative short-term extreme that is about to be reversed as the previous trend reasserts itself. That was the case with the first signal (February 2011) in Figure 2, when the DXY opened the week after the signal near the signal week's close, traded marginally higher, and then resumed the downtrend. In the other instances price did, in fact, stage solid rallies after each pattern, but each entry would have occurred at the weekly closing price, which in every case was much higher than the corresponding low.

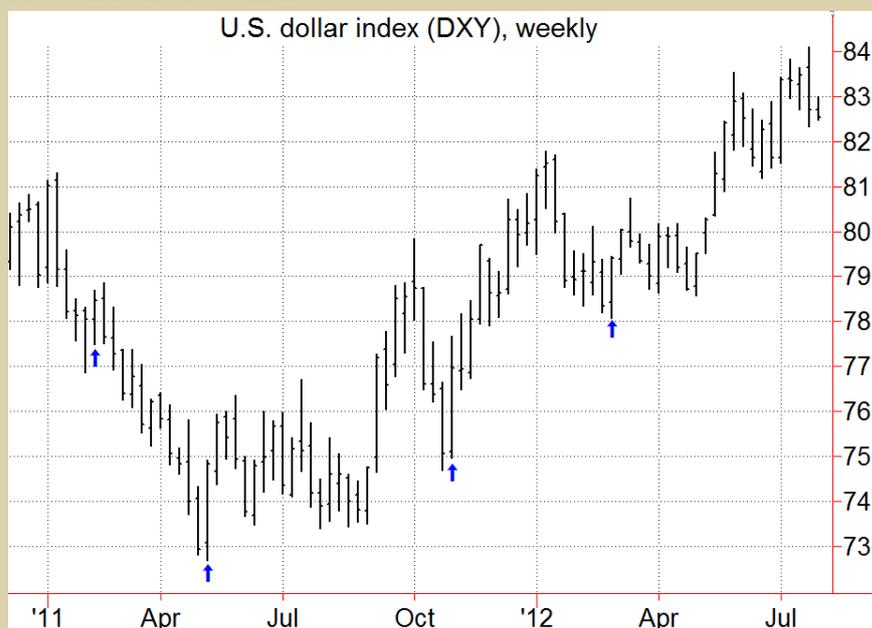
One of the advantages of the pattern is that it's not particularly susceptible to over-optimization or "curve-fitting." Other than the requirements for the current week to close in the upper third of its range and for the previous week to have a lower low than the previous four weeks, the pattern is built around the relative positioning of the open and closing prices to each other (and to the midpoint of the second-to-last week). In this case, none of the parameters were optimized in any way; the positioning of the current week's close and the four-week low requirement were kept "loose," based on a handful of observations, to avoid intentionally selecting patterns that appeared to work best in the past.

FIGURE 1: DOLLAR DOWN

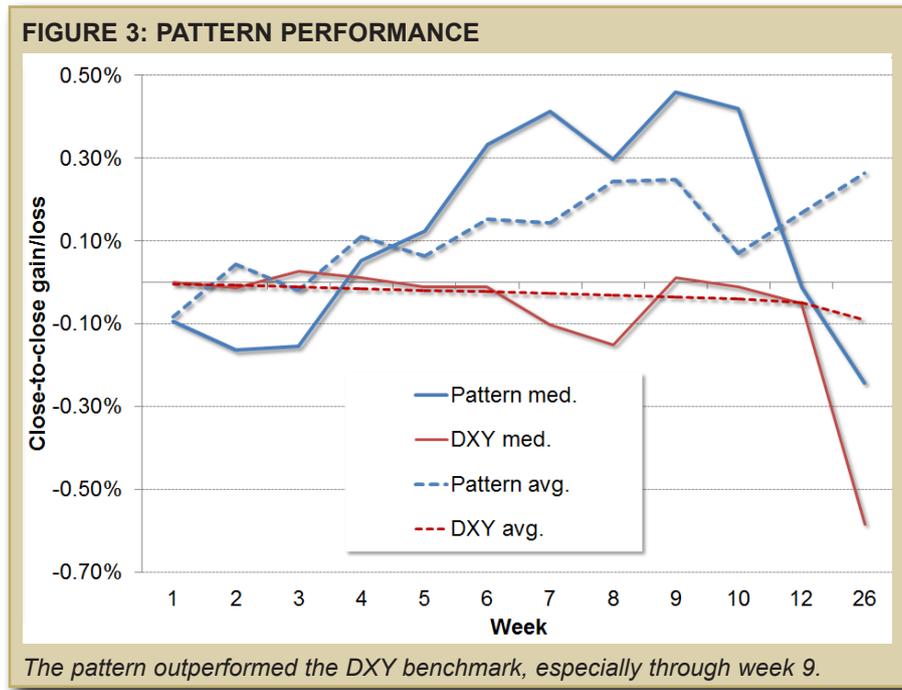


The dollar's history over the past 35 years has mostly been one of bear markets.

FIGURE 2: BUY SIGNAL



The long setup triggers when a bullish week reverses the momentum of the previous down week.



Pattern performance

Between July 22, 1977 and July 21, 2012, the pattern formed 99 times in the dollar index, the first instance in March 1978 and the most recent in the week ending March 2, 2012 (the final signal in Figure 2).

Figure 3 shows median and average weekly close-to-close moves 1 to 10, 12, and 26 weeks after the pattern (solid and dashed blue lines, respectively) and compares them to the median and average moves for all 1- to 10-, 12-, and 26-week periods in the analysis period (solid and dashed red lines). The DXY's red benchmark performance lines show the dollar's downward bias: The average line steadily declines, from virtually unchanged at week 1 to a 0.09-percent loss at week 26. The median line reflects the market's volatility, swinging above and below breakeven before dropping to a 0.58-percent loss at week 26.

The blue lines indicate the DXY has an upside bias after the pattern, although the median line's gyrations hint at the volatility of the returns, as well as the tendency for the dollar's long-term downside bias to reassert itself at the longer holding periods. Referencing both the average and median lines, however, the bullishness through week 9 (especially weeks 4 to 9) was reasonably consistent.

However modest this performance might seem, it should be put in the context of the DXY's overall bearishness. Long-side signals in this market are akin to short-side signals in the equity market: They exist, but they operate at a

disadvantage to signals that trigger in the direction of the long-term bias (the past decade in the stock market notwithstanding).

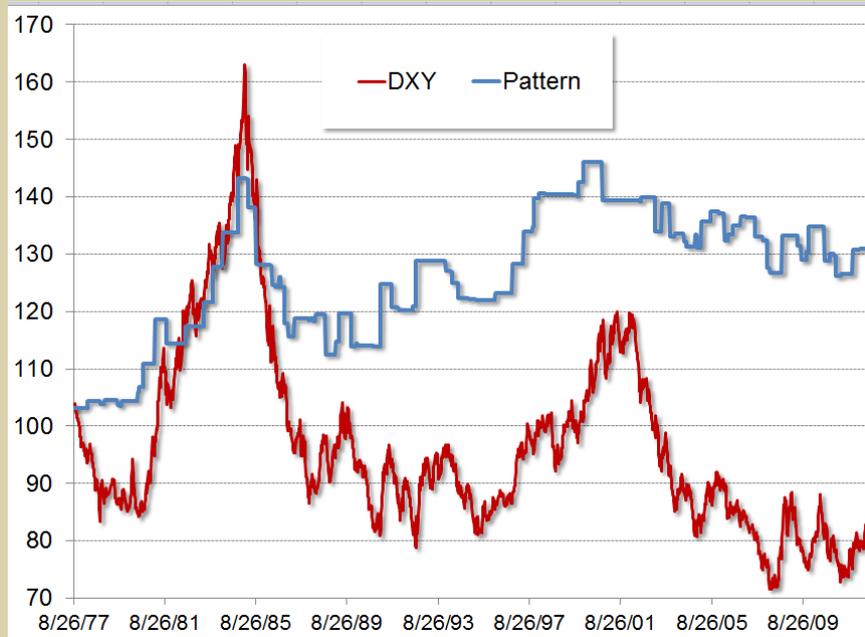
Trading observations

Although the signal could be used as an exit point for a short DXY strategy, Figure 2 suggests the pattern also has potential as a buy setup — perhaps with an optimal holding period in the 7- to 9-week range.

The early weakness in the median line's performance in weeks 1 to 3 also suggests the possibility of entering long on a pullback after the signal occurs, although this would have to be tested to determine how much upside potential is given away by passing up signals that are followed immediately by rallies. Table 1 compares the percentage of times the DXY closed higher each week after the pattern to the odds of a higher DXY close overall; price was higher after the pattern in weeks 1 to 3 (and week 12) less often than the index as a whole.

Nonetheless, a simple strategy that exited a long trade on the close after nine weeks outperformed the dollar index by a wide margin between July 1977 and July 2012. Figure 4 compares DXY to the nine-week trade, incorporating a stop-loss rule based on the observation that many losing trades were characterized by price dropping in week 1 below the low of the entry week. Accordingly, in week 1, trades were stopped out 0.02 below the low of

FIGURE 4: PATTERN VS. INDEX



The pattern outperformed the DXY while trading only 99 times and never being in the market longer than nine weeks.

the entry week (if DXY opened above the entry week's low) or at the close of week 1 (if DXY opened below the entry week's low). Unless DXY traded below the entry week's low in week 1, the position was held until the close of week 9. The pattern line in Figure 4 is indexed to the DXY's Aug. 26, 1977 closing price of 103.11, with subsequent point gains and losses added to and subtracted from this price.

Even though as of late July the pattern line was still below its mid-2000 peak around 146, it was 48 points (more than 57 percent) above the DXY, which closed at 82.79 on July 30. Furthermore, the pattern's drawdown after the 1985 peak was miniscule compared to DXY's, and it ended four years earlier (1988 vs. 1992). The pattern went on to make a new high in 2000 while the index made

a much lower high, and its subsequent stagnation pales in comparison to DXY's 40-percent slide.

This basic performance suggests the pattern might underperform the DXY during very strong uptrends, but it will also likely lose much less during dollar downtrends. Overall, if you had to be long the dollar over the past 35 years, you could have done much worse than buying and holding for a maximum of nine weeks on 99 different occasions, and short-term traders would have been positioned to take quick profits out of the market after these signals.

Also, the rudimentary application of the pattern leaves ample room for improvement. In addition to experimentation with the pattern parameters, more sophisticated risk control and profit-taking rules would likely be able squeeze more out of the signal. ☒

TABLE 1: PERCENTAGE OF HIGHER CLOSES

Week	1	2	3	4	5	6	7	8	9	10	12	26
Pattern	45.45%	46.46%	45.45%	51.52%	52.53%	55.56%	55.56%	53.54%	55.56%	56.57%	48.48%	48.98%
DXY	49.83%	49.56%	50.94%	50.39%	49.94%	50.17%	49.61%	49.00%	50.44%	50.22%	49.67%	46.39%

Price closed higher after the pattern more often than the DXY's historical percentage in weeks 4-10. The lower percentages in weeks 1-3 correlate to the initial weakness in the median return line in Figure 3.



Viewing the yuan from a grassier knoll

Looking for a link between the yuan and the U.S.? Focus on the switchover between who gets to finance the U.S. — China or the Federal Reserve.

BY HOWARD L. SIMONS

Rivalry makes the world go round (actually, the conservation of angular momentum within orbital mechanics does, but why quibble?). For every yin there is a yang, for every Muhammad Ali there's a Joe Frazier, for every Larry Bird a Magic Johnson. As an aside, would Tiger Woods have collapsed as quickly as he did after his dalliances came to light had he ever been humanized by losing every now and then to a bona fide rival?

Future historians will marvel at the strange mutualism between the U.S. and China in the early 21st century. China kept its people employed and the cash flowing in by selling the U.S. all manner of cheap goods, but then was forced to keep buying dollar-denominated assets with the proceeds. This was the Ricardian theory of competitive advantage in international trade run amok, and it invited all manner of suspicions about what deals were reached on both sides to keep the game going. China's competitive advantage was earning money; the United States' competitive advantage was borrowing and spending what others had earned.

Some 'splainin' to do

One of the original arguments made during the late 1960s and early 1970s for floating exchange rates was they would lead to self-correcting trade balances via the currencies of net exporters strengthening and making their exports less

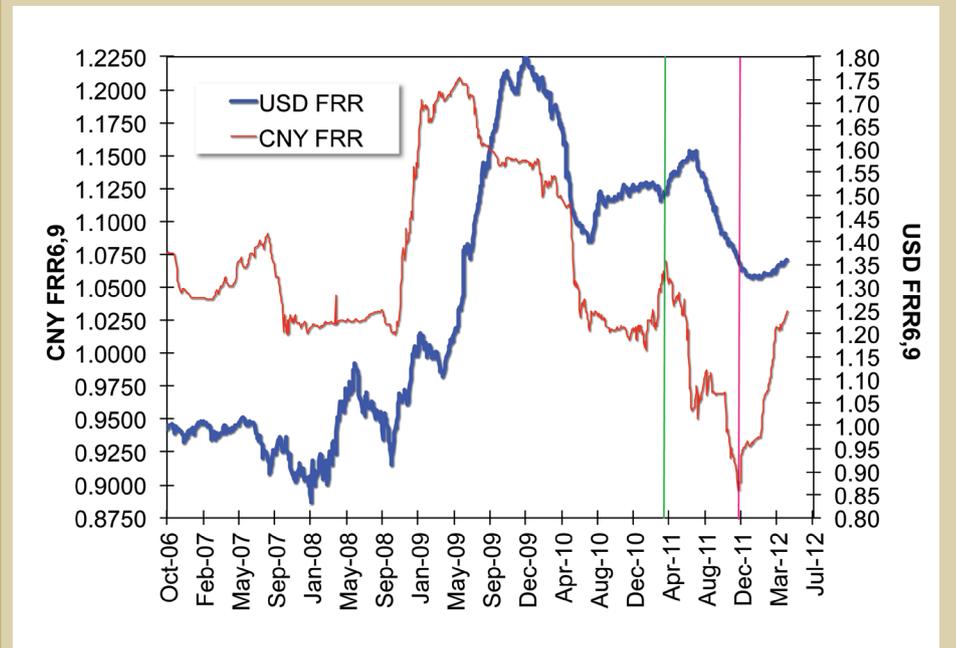
competitive, a theory proven consistently wrong for more than four decades and yet still permitted within polite circles (see "Currencies and Federal Reserve trade weights," *Currency Trader*, July 2007). Accordingly, we should have expected the Chinese yuan (CNY) to have appreciated, and appreciated substantially, a long time ago. It did not.

A second failed theory held as gospel in too many places is that a country in massive fiscal disarray and with a currency that has been weakening irregularly for decades should see higher long-term interest rates. By this token, long-term interest rates in the highly profligate U.S. should have increased a long time ago. They did not.

Currency Trader offered one explanation for these two puzzling non-developments in February 2011: China would deploy its massive foreign exchange reserves to buy dollar-denominated assets as a way of keeping the CNY undervalued, of financing its largest customer, and of shipping excess funds out of the country to cool domestic inflation (see "Viewing the yuan from the grassy knoll").

If both China and Japan (see "Yen and Treasuries: Back to the future," *Currency Trader*, November 2011) use their purchases of dollar-denominated assets to manage their currencies and domestic monetary policies, they certainly have had company in this regard since the financial crisis began in 2007. The Federal Reserve expanded its balance sheet enormously in 2008, went to quantitative easing in

FIGURE 1: MONEY MARKET YIELD CURVES NOW RECONVERGING



The November 2011 move corresponded to the expansion of currency swap lines by a consortium of central banks — every move made by China always appears linked to a deal made behind closed doors.

March 2009 and then re-entered quantitative easing in November 2010. As these measures predictably did not succeed in stimulating output and employment, they will be tried again and again until they do.

Revaluation and quantitative easing

Has there been a link between China’s on-again, off-again yuan revaluation and quantitative easing? The evidence is compelling for the following chain:

China purchases large quantities of dollar-denominated assets to suppress the CNY, finance its customer, and drain excess CNY from its banking system. These markets are characterized by a relatively slow or even non-existent pace of CNY revaluation, a flat CNY money-market curve, declining long-term rates, and TIPS breakeven rates of inflation in the U.S.

Once China stops this process, CNY revaluation accelerates, the CNY money-market curve stops flattening, and both long-term interest rates and TIPS breakevens start to rise in the U.S.

The Federal Reserve then steps into the asset-buying breach abandoned by China and begins quantitative easing.

Let’s trace these developments through the spring of 2012. The shapes of the USD and CNY money-market yield curves are measured by the forward-rate ratios between six

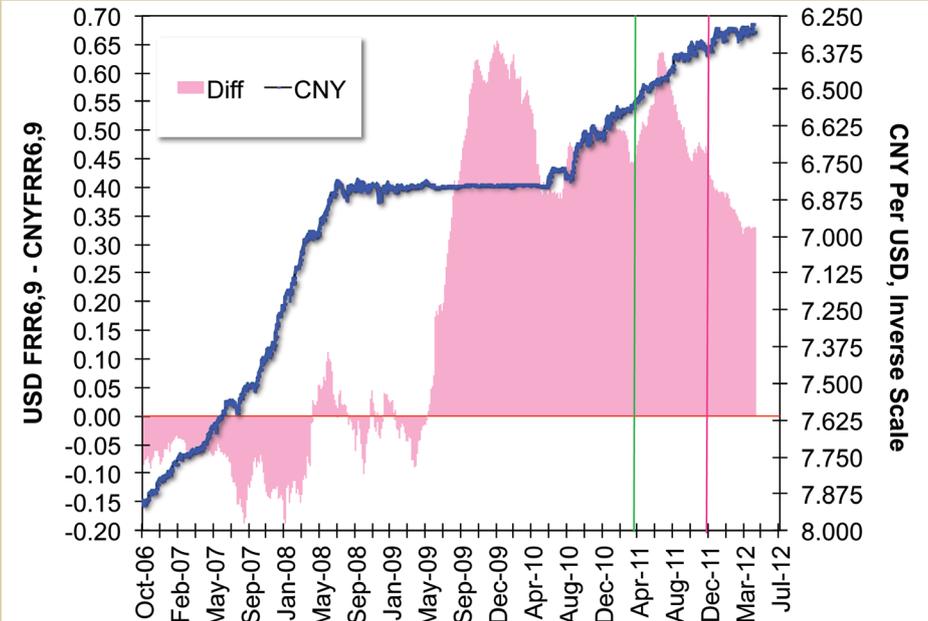
and nine months ($FRR_{6,9}$) for the two currencies. This is the rate at which borrowing can be locked in for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is.

In Figure 1 the April and November 2011 dates at which the CNY $FRR_{6,9}$ began to flatten and then steepen again are marked with green and magenta vertical lines, respectively. The November 2011 move corresponded to the expansion of currency swap lines by a consortium of central banks; every move made by China always appears linked to a deal made behind closed doors.

Now let’s look at the different interest rate expectations implied in these two yield curves and relate them to changes in the CNY itself (Figure 2). Both currencies have been managed for years; China has been more successful at maintaining the CNY in an undervalued state by virtue of its tight control over the state banks, while the USD has had several periods of revaluation during periods of dollar-scarcity or simple fear of embracing its principal alternative, the Euro. The net result, alas, is no one should try to trade the CNY/USD rate off of relative interest rate expectations; it simply will not work.

Now let’s add the Treasury rate map to that of the CNY $FRR_{6,9}$ (Figure 3). The mechanism involved in this bullish flattening of the Treasury yield curve is capital exports

FIGURE 2: USD MONEY MARKET CURVE IN RELATIVE FLATTENING



Don't try to trade the CNY/USD rate off of relative interest rate expectations — it simply won't work.

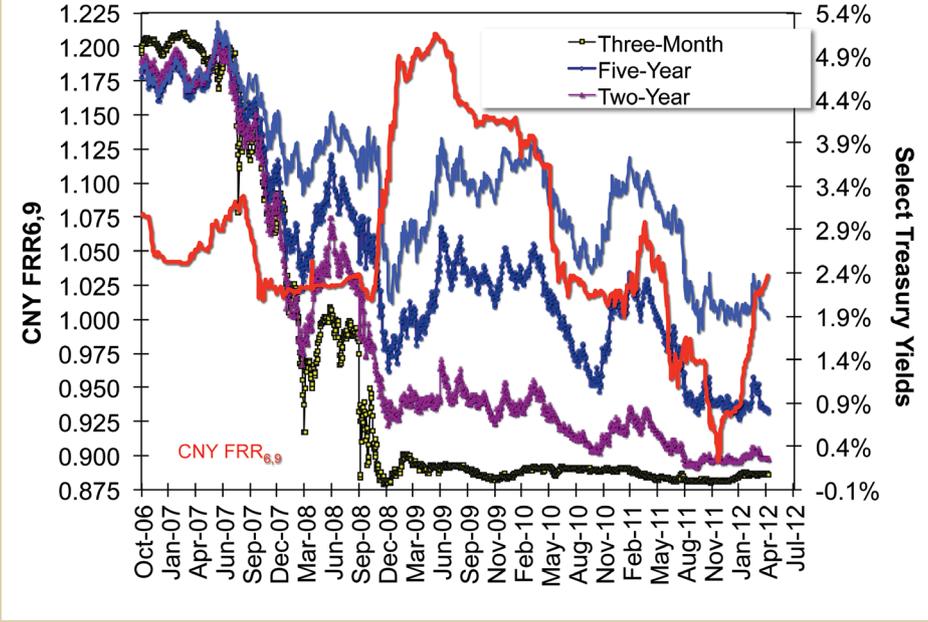
from China associated with credit-tightening moves there finding their way into the U.S. Treasury market. This is far cheaper for the Chinese authorities than tightening domestic credit by issuing bonds to soak up the cash. That would involve paying interest; shipping money to the U.S. involves receiving interest. In addition, please note how the rapid re-steepening of the CNY FRR_{6,9} between December 2011 and March 2012 led an upturn in five- and 10-year Treasury rates.

The yuan and U.S. inflation

Any discussion of inflation in the U.S. should be split into reported inflation, as measured by indices such as the Consumer Price index and the Producer Price index (and all of their major sub-indices), and expected inflation, as measured by the breakevens rates implied in the TIPS market — with all of the TIPS market's faults acknowledged in advance (see "TIPS, Treasuries, and insurance," *Active Trader*, May 2008, or "Trading inflation impossible in a deflationary world," *Active Trader*, August 2009).

One of the fears expressed in the U.S. about yuan revaluation is it would force the prices of Chinese imports higher and therefore would constitute an inflationary impulse all by itself. This does not appear to be the case in the TIPS market. If we map the CNY against TIPS breakevens over a range of maturities, we see a very large degree of

FIGURE 3: TREASURY YIELDS & CHINESE MONEY MARKET YIELD CURVE



The rapid re-steepening of the CNY FRR_{6,9} between December 2011 and March 2012 led an upturn in five- and 10-year Treasury rates.

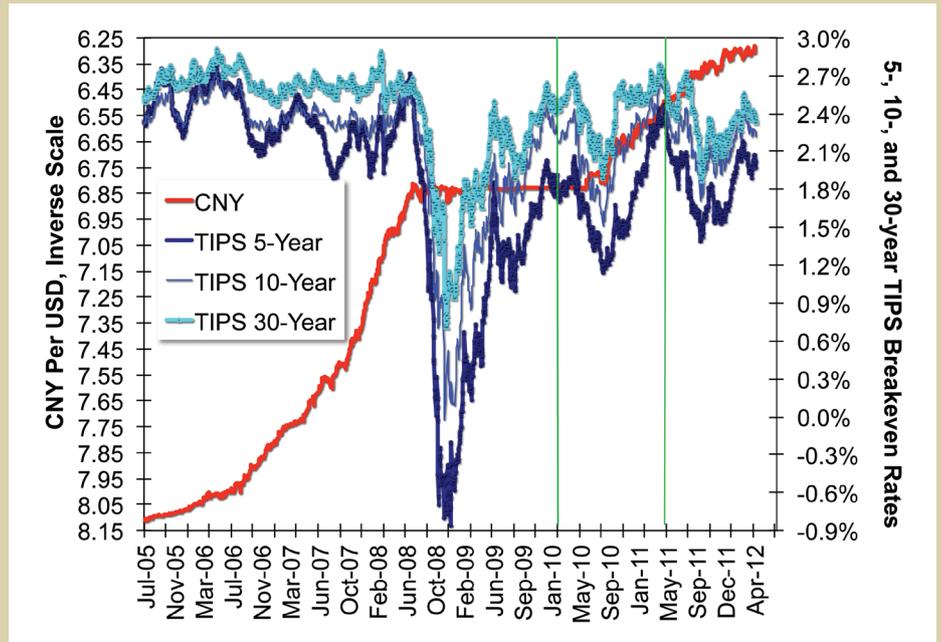
independence (Figure 4). The first revaluation, between July 2005 and July 2008, preceded the 2008 financial crisis and its collapse in inflation expectations. The second revaluation, beginning in June 2010, occurred after the end of QE1 and within the period of declining inflation expectations that ended with Fed Chairman Ben Bernanke's August 2010 Jackson Hole speech. Inflation expectations turned lower very shortly after the CNY FRR_{6,9} began to flatten in April 2011; this also coincided with the impending end of QE2. Finally, TIPS break-evens rebounded following the expansion of currency swap lines as liquidity poured into global markets.

What should be expected here? The answer seems linked to a perception the CNY has found some measure of natural equilibrium. Its stall near 6.30 was followed quickly by a downturn in TIPS break-evens as Chinese capital exports fell and the Federal Reserve was hesitant to launch QE3 in an election year wherein the central bank's policies were themselves an issue.

If we turn our attention to the yuan and measured inflation, we see year-over-year changes in both the CPI and PPI (led one month) preceded year-over-year changes in the CNY (Figure 5). Nothing here suggests any opposite causation; a stronger CNY does not lead to changes in U.S. reported inflation.

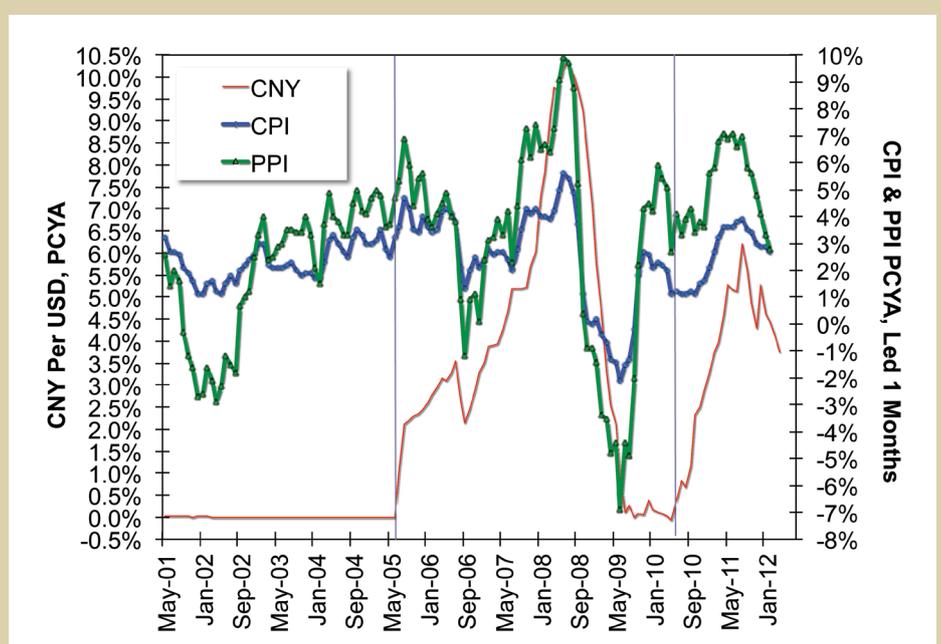
Finally, let's take a look at the changes over time for the CPI

FIGURE 4: THE YUAN AND INFLATION EXPECTATIONS



The CNY's stall near 6.30 was followed by a downturn in TIPS break-evens as Chinese capital exports fell and the Federal Reserve was hesitant to launch QE3 in an election year.

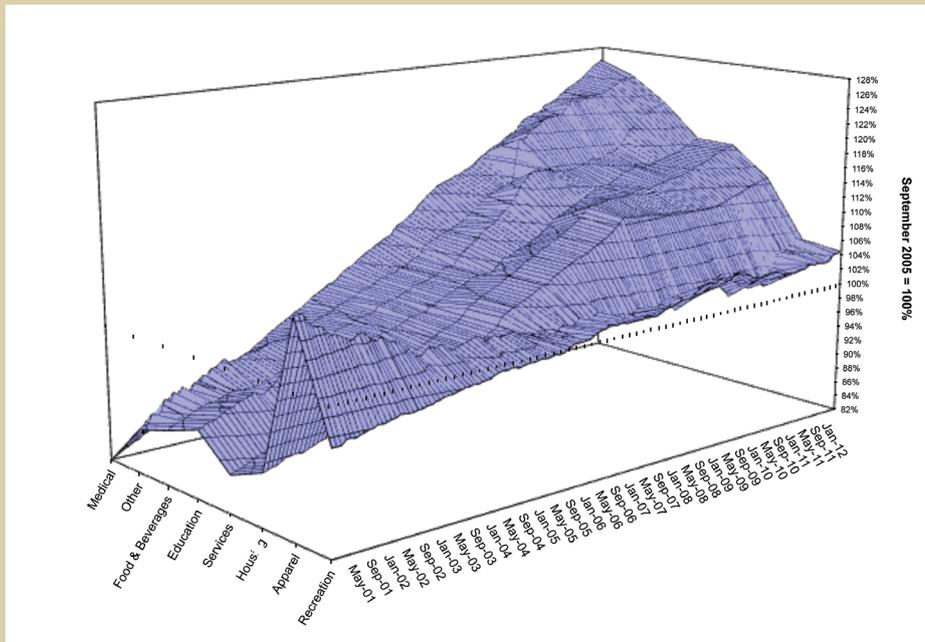
FIGURE 5: MEASURED INFLATION ROSE BEFORE YUAN'S SECOND REVALUATION



Year-over-year changes in both the CPI and PPI (led one month) preceded year-over-year changes in the CNY.

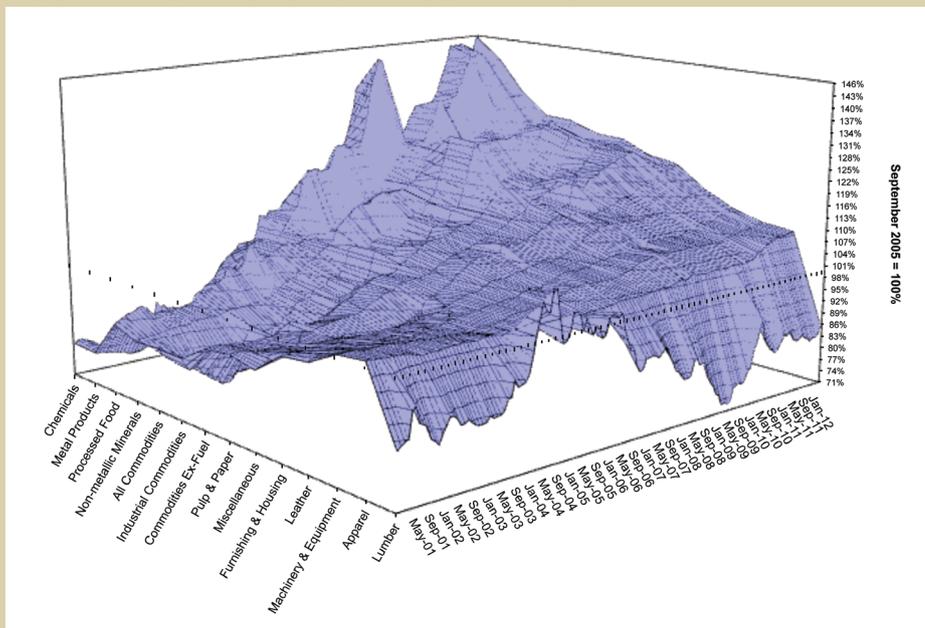


FIGURE 6: DISTRIBUTION OF CPI SUBINDICES



The highest gainers, the sub-indices of “other,” medical, food and beverages, and education, have almost no international exposure or international competition capable of suppressing price increases.

FIGURE 7: DISTRIBUTION OF PPI SUBINDICES



On balance, it’s difficult to explain the U.S. reported price picture in terms of the yuan.

and PPI subindices; these will be rebased to September 2005, the first month the first yuan revaluation could have any effect whatsoever. In the case of the CPI, we still see evidence of the old phenomenon of Chinese exports pushing prices lower in the apparel category (Figure 6). The highest gainers, the subindices of “other,” medical, food and beverages, and education, have almost no international exposure or international competition capable of suppressing price increases.

The producer price map is a little more telling if for no other reason than it has greater detail (Figure 7). Here the most rapid price increases are occurring in categories where China is a major importer, such as metal products and chemicals. The lowest price increases include apparel and the housing-related category of lumber. On balance, though, it is very difficult to explain the U.S. reported price picture in terms of the yuan.

The strongest linkages between the yuan and the U.S. appear to occur in the switchover between who gets to finance the U.S. — China via its massive foreign reserves or the Federal Reserve via the printing press.

Economic theory favors China assuming that role, but China is recalcitrant to do this too much and is equally recalcitrant about yuan revaluation. The result, therefore, starts to be a switch-off between periods of slow yuan revaluation and high Chinese purchases of dollar-denominated assets and periods of more rapid yuan revaluation and U.S. money-printing. Future economic historians are going to love explaining this. ☒

For information on the author, see p. 4.



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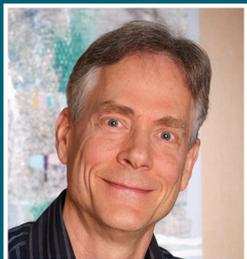
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CPI: Consumer price index
 ECB: European Central Bank
 FDD (first delivery day): The first day on which delivery of a commodity in fulfillment of a futures contract can take place.
 FND (first notice day): Also known as first intent day, this is the first day on which a clearinghouse can give notice to a buyer of a futures contract that it intends to deliver a commodity in fulfillment of a futures contract. The clearinghouse also informs the seller.
 FOMC: Federal Open Market Committee
 GDP: Gross domestic product
 ISM: Institute for supply management
 LTD (last trading day): The final day trading can take place in a futures or options contract.
 PMI: Purchasing managers index
 PPI: Producer price index

Economic release (U.S.)	Release time (ET)
GDP	8:30 a.m.
CPI	8:30 a.m.
ECI	8:30 a.m.
PPI	8:30 a.m.
ISM	10:00 a.m.
Unemployment	8:30 a.m.
Personal income	8:30 a.m.
Durable goods	8:30 a.m.
Retail sales	8:30 a.m.
Trade balance	8:30 a.m.
Leading indicators	10:00 a.m.

The information on this page is subject to change. *Currency Trader* is not responsible for the accuracy of calendar dates beyond press time.

August	
1	U.S.: July ISM manufacturing report and FOMC interest-rate announcement
2	UK: Bank of England interest-rate announcement ECB: Governing council interest-rate announcement
3	U.S.: July employment report LTD: August forex options; August U.S. dollar index options (ICE)
4	
5	
6	Brazil: July PPI
7	
8	Brazil: July CPI
9	U.S.: June trade balance Australia: July employment report Japan: Bank of Japan interest-rate announcement Mexico: July 31 CPI and July PPI
10	Canada: July employment report Germany: July CPI Hong Kong: Q2 GDP Japan: July PPI UK: July PPI
11	
12	
13	Japan: Q2 GDP
14	U.S.: July PPI and retail sales France: July CPI Germany: Q2 GDP India: July PPI UK: July CPI
15	U.S.: July CPI UK: June employment report
16	U.S.: July housing starts Hong Kong: May-July employment report
17	U.S.: July leading indicators Canada: July CPI Germany: July PPI
18	

19	
20	
21	Hong Kong: July CPI South Africa: July CPI
22	
23	Brazil: July employment report Mexico: Q2 GDP and Aug. 15 CPI
24	U.S.: July durable goods Mexico: July employment report
25	
26	
27	
28	South Africa: Q2 GDP
29	U.S.: Q2 GDP (second) and fed beige book Canada: July PPI
30	Germany: July employment report South Africa: July PPI U.S.: July personal income
31	Brazil: Q2 GDP Canada: Q2 GDP India: Q2 GDP and July CPI Japan: July employment report and CPI

September	
1	
2	
3	
4	U.S.: ISM manufacturing report
5	Australia: Q2 GDP Brazil: August CPI Canada: Bank of Canada interest-rate announcement
6	Australia: August employment report Brazil: August PPI France: Q2 employment report UK: Bank of England interest-rate announcement ECB: Governing council interest-rate announcement



EVENTS

Event: The World MoneyShow San Francisco
Date: Aug. 24-26
Location: San Francisco Marriott Marquis
Show focus: Technology
For more information: Go to www.moneyshow.com

Event: CBOE Risk Management Conference Europe
Date: Sept. 5-7
Location: Ritz-Carlton Powerscourt, County Wicklow, Ireland
For more information: www.cboermceurope.com

Event: The Forex & Options Expo
Date: Sept. 13-15
Location: Las Vegas, Paris Hotel
For more information: Go to www.moneyshow.com

Event: The Free Paris Trading Show
Date: Sept. 21-22
Location: Espace Champerret, Paris, France
For more information: www.salonAT.com



Market	Sym	Exch	Vol	OI	10-day move / rank	20-day move / rank	60-day move / rank	Volatility ratio / rank
EUR/USD	EC	CME	266.9	317.5	-0.14% / 0%	-3.15% / 65%	-6.71% / 89%	.21 / 20%
AUD/USD	AD	CME	141.0	126.7	2.58% / 95%	2.83% / 69%	2.43% / 30%	.38 / 77%
GBP/USD	BP	CME	103.5	115.9	0.52% / 56%	0.19% / 17%	-2.91% / 87%	.35 / 43%
CAD/USD	CD	CME	94.7	89.4	1.31% / 95%	1.58% / 79%	-1.33% / 13%	.37 / 48%
JPY/USD	JY	CME	71.2	124.6	0.83% / 33%	2.13% / 81%	2.75% / 45%	.21 / 40%
CHF/USD	SF	CME	43.7	58.2	-0.18% / 6%	-3.25% / 66%	-6.68% / 87%	.22 / 15%
MXN/USD	MP	CME	38.0	138.6	-0.27% / 0%	0.81% / 12%	-2.15% / 26%	.40 / 78%
U.S. dollar index	DX	ICE	23.7	66.5	-0.42% / 50%	1.05% / 26%	3.96% / 70%	.28 / 40%
NZD/USD	NE	CME	16.5	19.8	1.41% / 77%	1.05% / 10%	1.19% / 2%	.37 / 73%
E-Mini EUR/USD	ZE	CME	3.4	5.5	-0.14% / 0%	-3.15% / 65%	-6.71% / 89%	.21 / 20%

Note: Average volume and open interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity is based on pit-traded contracts.

The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields. Note: Average volume and open interest data includes both pit and side-by-side electronic contracts (where applicable).

LEGEND:

Volume: 30-day average daily volume, in thousands.

OI: 30-day open interest, in thousands.

10-day move: The percentage price move from the close 10 days ago to today's close.

20-day move: The percentage price move from the close 20 days ago to today's close.

60-day move: The percentage price move from the close 60 days ago to today's close.

The "% rank" fields for each time window (10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the % rank for the 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, it shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, it shows how the most recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100% means the current reading is larger than all the past readings, while a reading of 0% means the current reading is smaller than the previous readings.

Volatility ratio/% rank: The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The % rank is the percentile rank of the volatility ratio over the past 60 days.

BarclayHedge Rankings: Top 10 currency traders managing more than \$10 million (as of June 30 ranked by June 2012 return)

	Trading advisor	June return	2012 YTD return	\$ Under mgmt. (millions)
1.	Harmonic Capital (Gl. Currency)	8.38%	18.02%	949.0
2.	Regium Asset Mgmt (Ultra Curr)	4.89%	15.50%	28.7
3.	Gedamo (FX Alpha)	4.63%	7.39%	18.1
4.	Iron Fortress FX Mgmt	4.04%	13.69%	10.3
5.	ROW Asset Mgmt (Currency)	3.84%	7.37%	10.0
6.	Alder Cap'l (Alder Global 20)	3.80%	-6.98%	472.0
7.	DynexCorp Ltd. (Currency)	3.51%	-1.55%	41.5
8.	Gedamo (FX One)	2.97%	4.24%	37.8
9.	Silva Capital Mgmt (Cap. Partners)	2.48%	5.97%	18.7
10.	Alder Cap'l (Alder Global 10)	1.90%	-3.17%	11.0

Top 10 currency traders managing less than \$10M & more than \$1M

1.	Adantia (FX Aggressive)	23.63%	7.12%	2.7
2.	Hartswell Capital Mgmt (Apollo)	20.62%	27.12%	2.0
3.	Anello Asset Mgmt (Plexus FX)	1.83%	1.31%	4.6
4.	GAM Currency Hedge (USD)	1.67%	5.93%	6.7
5.	Northbridge Park Asset Mgmt	1.51%	5.40%	4.1
6.	BBK (RESCO L/S FX)	1.44%	-5.18%	3.3
7.	Valhalla Capital Group (Int'l AB)	1.10%	3.69%	1.5
8.	TMS (Arktos GCS II)	0.89%	0.16%	9.7
9.	BEAM (FX Prop)	0.54%	-3.96%	2.0
10.	Four Capital (FX)	0.49%	-2.20%	1.6

Based on estimates of the composite of all accounts or the fully funded subset method. Does not reflect the performance of any single account. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE PERFORMANCE.



CURRENCIES (vs. U.S. DOLLAR)

Rank	Currency	July 27 price vs. U.S. dollar	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	Australian Dollar	1.035325	3.15%	-0.20%	-2.62%	1.1028	0.9478	2
2	Indian rupee	0.01792	2.28%	-4.66%	-9.81%	0.0226	0.0174	15
3	Singapore dollar	0.797725	2.11%	0.00%	0.32%	0.832	0.7606	7
4	Swedish krona	0.14434	1.99%	-3.07%	-2.57%	0.1592	0.1374	3
5	Brazilian real	0.49264	1.77%	-7.23%	-13.77%	0.65	0.4801	17
6	Russian ruble	0.030755	1.72%	-6.48%	-6.48%	0.0364	0.0291	16
7	Japanese yen	0.01279	1.71%	3.65%	-0.74%	0.0132	0.0119	6
8	Taiwan dollar	0.033915	1.62%	-0.43%	1.39%	0.03480	0.032	14
9	Canadian dollar	0.98747	1.43%	-2.93%	-1.06%	1.059	0.9467	5
10	South African rand	0.119795	1.37%	-7.07%	-5.99%	0.1498	0.1159	13
11	New Zealand dollar	0.795405	0.68%	-2.47%	-2.93%	0.8797	0.7397	1
12	Thai baht	0.031625	0.52%	-2.41%	-0.94%	0.0336	0.031	12
13	Hong Kong dollar	0.128905	0.02%	0.02%	0.01%	0.129	0.1281	8
14	Great Britain pound	1.55698	-0.21%	-3.78%	-0.69%	1.6507	1.5308	11
15	Chinese yuan	0.156585	-1.02%	-1.20%	-1.46%	0.1589	0.1548	4
16	Swiss franc	1.01604	-2.37%	-7.70%	-6.52%	1.3779	1.0074	9
17	Euro	1.220215	-2.37%	-7.75%	-7.03%	1.4506	1.2099	10

GLOBAL STOCK INDICES

	Country	Index	July 27	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Germany	Xetra Dax	6,689.40	7.39%	-1.65%	2.72%	7,282.01	4,965.80	14
2	France	CAC 40	3,280.19	7.09%	0.43%	-1.16%	3,722.59	2,693.21	10
3	Brazil	Bovespa	56,553.00	6.48%	-8.33%	-10.10%	68,970.00	47,793.00	15
4	Switzerland	Swiss Market	6,362.80	6.11%	4.03%	5.46%	6,362.80	4,695.30	4
5	Singapore	Straits Times	2,998.49	5.52%	0.57%	2.82%	3,227.28	2,521.95	6
6	Mexico	IPC	41,476.48	5.03%	5.47%	11.54%	41,476.48	31,659.30	1
7	U.S.	S&P 500	1,385.97	4.06%	-1.24%	5.29%	1,422.38	1,074.77	11
8	Australia	All ordinaries	4,234.40	3.68%	-4.49%	-2.62%	4,595.00	3,829.40	12
9	Canada	S&P/TSX composite	11,766.36	3.11%	-3.85%	-5.62%	13,047.80	10,848.20	13
10	South Africa	FTSE/JSE All Share	34,671.00	2.73%	0.79%	2.29%	34,788.37	28,658.57	9
11	Italy	FTSE MIB	13,596.88	2.21%	-8.00%	-14.74%	18,796.40	12,295.80	7
12	UK	FTSE 100	5,627.20	1.87%	-2.59%	-1.85%	5,989.10	4,791.00	3
13	Hong Kong	Hang Seng	19,274.96	0.51%	-7.07%	-5.98%	22,808.30	16,170.30	5
14	India	BSE 30	16,839.19	-0.76%	-1.72%	-0.14%	18,523.80	15,135.90	2
15	Japan	Nikkei 225	8,566.64	-1.88%	-10.02%	-3.11%	10,255.20	8,135.79	8

NON-U.S. DOLLAR FOREX CROSS RATES

Rank	Currency pair	Symbol	July 27	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Aussie \$ / Franc	AUD/CHF	1.01898	5.65%	8.13%	4.18%	1.0251	0.7477	6
2	Aussie \$ / New Zeal \$	AUD/NZD	1.301625	2.46%	2.33%	0.33%	1.3229	1.2354	18
3	Pound / Franc	GBP/CHF	1.532465	2.21%	4.25%	6.24%	1.5434	1.1778	11
4	Aussie \$ / Canada \$	AUD/CAD	1.048465	1.70%	2.81%	-1.57%	1.0755	0.9981	8
5	Euro / Franc	EUR/CHF	1.20102	1.53%	-0.05%	-0.54%	1.2406	1.0376	21
6	Aussie \$ / Yen	AUD/JPY	80.94	1.40%	-3.73%	-1.90%	88.31	72.72	7
7	Aussie \$ / Real	AUD/BRL	2.10157	1.35%	7.58%	12.94%	2.1094	1.6402	1
8	Yen / Real	JPY/BRL	0.025965	-0.06%	11.77%	15.12%	0.0262	0.0197	4
9	Canada \$ / Yen	CAD/JPY	77.195	-0.30%	-6.38%	-0.34%	84.49	72.63	10
10	Canada \$ / Real	CAD/BRL	2.00443	-0.34%	4.64%	14.74%	2.0301	1.6107	3
11	New Zeal \$ / Yen	NZD/JPY	62.18	-1.03%	-5.94%	-2.23%	68.81	57.23	2
12	Pound / Canada \$	GBP/CAD	1.576735	-1.61%	-0.88%	0.37%	1.6354	1.5429	17
13	Pound / Yen	GBP/JPY	121.66	-1.95%	-7.25%	-0.02%	132.81	117.58	16
14	Euro / Pound	EUR/GBP	0.78371	-2.16%	-4.13%	-6.39%	0.8853	0.7779	9
15	Pound / Aussie \$	GBP/AUD	1.503855	-3.26%	-3.59%	1.98%	1.626	1.4637	20
16	Franc / Canada \$	CHF/CAD	1.028935	-3.74%	-4.91%	-5.52%	1.3569	1.0244	13
17	Euro / Canada \$	EUR/CAD	1.2357	-3.74%	-4.97%	-6.04%	1.4253	1.2305	15
18	Euro / Yen	EUR/JPY	95.395	-4.02%	-11.03%	-6.36%	112.95	94.65	14
19	Franc / Yen	CHF/JPY	79.43	-4.03%	-10.99%	-5.85%	105.79	78.81	12
20	Euro / Real	EUR/BRL	2.476875	-4.07%	-0.56%	7.82%	2.6261	2.2216	5
21	Euro / Aussie \$	EUR/AUD	1.178635	-5.35%	-7.57%	-4.53%	1.4011	1.1708	19

GLOBAL CENTRAL BANK LENDING RATES

Country	Interest rate	Rate	Last change	Jan. 2012	July 2011
United States	Fed funds rate	0-0.25	0.5 (Dec 08)	0-0.25	0-0.25
Japan	Overnight call rate	0-0.1	0-0.1 (Oct 10)	0-0.1	0-0.1
Eurozone	Refi rate	0.75	0.25 (July 12)	1	1.5
England	Repo rate	0.5	0.5 (March 09)	0.5	0.5
Canada	Overnight rate	1	0.25 (Sept 10)	1	1
Switzerland	3-month Swiss Libor	0-0.25	0.25 (Aug 11)	0-0.25	0.25
Australia	Cash rate	3.5	0.25 (June 12)	4.25	4.75
New Zealand	Cash rate	2.5	0.5 (March 11)	2.5	2.5
Brazil	Selic rate	8	0.5 (July 12)	10.5	12.5
Korea	Korea base rate	3	0.25 (July 12)	3.25	3.25
Taiwan	Discount rate	1.875	0.125 (June 11)	1.875	1.875
India	Repo rate	8	0.5 (Apr 12)	8.5	8
South Africa	Repurchase rate	5	0.5 (July 12)	5.5	5.5

GDP		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	Q1	6/8	-4.3%	13.7%	9/21
	Brazil	Q1	6/1	-5.6%	7.4%	8/31
	Canada	Q1	6/1	0.6%	4.1%	8/31
EUROPE	France	Q1	6/29	0.3%	1.8%	9/28
	Germany	Q1	5/15	0.9%	3.0%	8/14
	UK	Q1	6/28	0.5%	1.9%	9/27
AFRICA	S. Africa	Q1	6/21	0.8%	7.8%	8/28
ASIA and S. PACIFIC	Australia	Q1	6/6	0.3%	4.1%	9/5
	Hong Kong	Q1	5/11	-8.0%	3.2%	8/10
	India	Q1	5/31	3.4%	12.0%	8/31
	Japan	Q1	5/17	1.0%	4.1%	8/13
	Singapore	Q1	5/25	0.2%	1.6%	8/24

Unemployment		Period	Release date	Rate	Change	1-year change	Next release
AMERICAS	Argentina	Q1	5/18	6.7%	-0.5%	-0.6%	8/21
	Brazil	June	7/26	6.1%	0.3%	-0.1%	8/23
	Canada	June	7/6	7.2%	-0.1%	-0.2%	8/10
EUROPE	France	Q1	6/7	9.6%	0.3%	0.4%	9/6
	Germany	June	7/31	5.2%	-0.3%	-0.8%	8/30
	UK	March-May	7/18	8.1%	-0.2%	0.4%	8/15
ASIA and S. PACIFIC	Australia	June	7/12	5.1%	0.0%	0.1%	8/9
	Hong Kong	April-June	7/19	3.2%	0.0%	-0.4%	8/16
	Japan	June	7/31	4.3%	-0.1%	-0.4%	8/31
	Singapore	Q2	7/31	2.0%	-0.1%	-0.2%	10/31

CPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	June	7/13	0.7%	9.9%	8/10
	Brazil	June	7/6	0.1%	4.9%	8/8
	Canada	June	7/20	-0.4%	1.5%	8/17
EUROPE	France	June	7/12	0.0%	1.8%	8/14
	Germany	June	7/11	-0.1%	1.7%	8/10
	UK	June	7/17	0.4%	2.4%	8/14
AFRICA	S. Africa	June	7/18	0.2%	5.5%	8/22
ASIA and S. PACIFIC	Australia	Q2	7/15	0.5%	1.2%	10/24
	Hong Kong	June	7/23	-0.1%	3.7%	8/21
	India	June	7/31	1.0%	10.1%	8/31
	Japan	June	7/27	-0.5%	-0.2%	8/31
	Singapore	June	7/23	0.0%	5.3%	8/23

PPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	June	7/13	1.0%	12.8%	8/10
	Canada	June	7/31	-0.3%	40.0%	8/29
EUROPE	France	June	7/31	-0.9%	1.3%	9/28
	Germany	June	7/20	0.1%	1.6%	8/17
	UK	June	7/6	-0.4%	2.3%	8/10
AFRICA	S. Africa	June	7/26	4.4%	6.6%	8/30
ASIA and S. PACIFIC	Australia	Q2	7/23	0.5%	1.1%	11/2
	Hong Kong	Q2	7/27	-0.5%	3.6%	9/13
	India	June	7/16	0.2%	7.3%	8/14
	Japan	June	7/11	-0.4%	-0.5%	8/10
	Singapore	June	7/27	-3.8%	-2.4%	8/29

As of July 31 LEGEND: Change: Change from previous report release. NLT: No later than. Rate: Unemployment rate.