

Asian Bear Baiting

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South Korea's Central Bank was quick to correct recent statements on diversifying out of US Dollar holdings to mean US\$ paper would in the future be a smaller proportion of its buying. The market's initial reaction, that the Bank would be actively selling US\$ paper, caused the greenback to swoon by 1.5% overnight. Given South Korea is the fourth largest holder of US notes, its moving to stem the decline of a major asset is understandable.

The reality is that less exchange of Won for US\$ will mean a) someone else has to cover the US debt load, and b) the excess Won will be plumping up someone else's part of the currency index. At \$200 billion of reserves this would be enough to get noticed, particularly on smaller currencies (other than Euro or Yen) should they get focus.

This is also a signal that cannot be ignored by Japan's central bank. The BoJ is by far the largest buyer of Dollars, to support its growth-less trading economy.

Did we mention Japan? As this issue was being finished a couple of stories filtered out of Japan that must have sent shudders down the spines of currency traders (those long the US\$ at any rate). Japan's Prime Minister Koizumi made the following remark to the parliamentary budget committee in Tokyo *"I think it's necessary to diversify the investment destinations" of foreign reserves, Koizumi said "At the same time, we have to make a judgment in general, considering what's profitable and what's stable."*

The key words are "profitable" and "stable". Japan is the behemoth in the foreign reserve arena, with holdings approaching \$850 billion. Two thirds of those holdings are in Dollars, mainly in US T-bills. Japan's foreign exchange holdings carry unrealized losses in the order of \$110 billion, the bulk of it caused by; you guessed it, the falling Dollar.

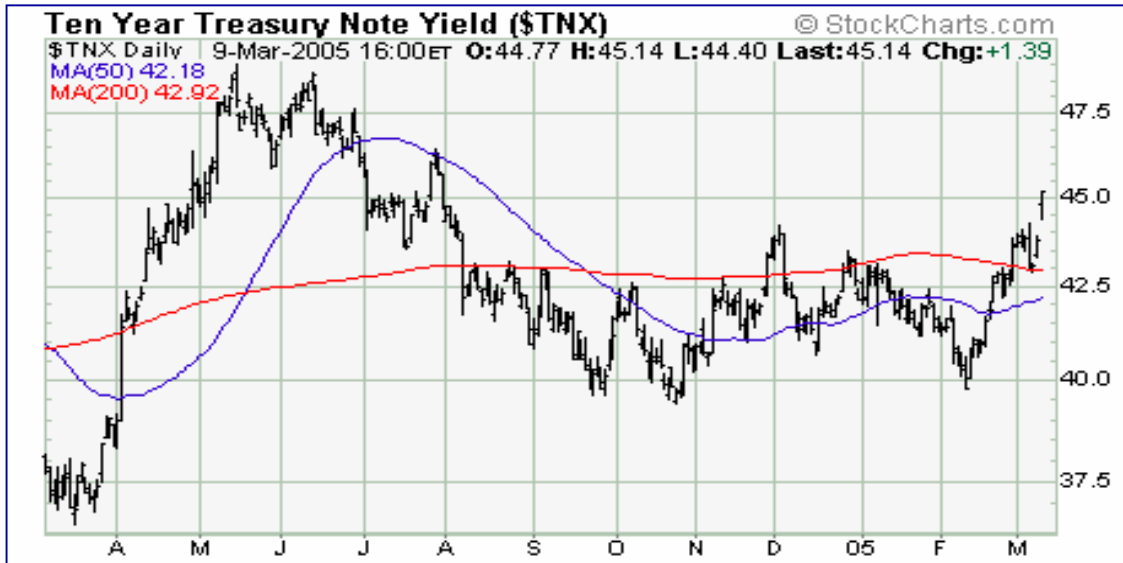
The damage control in Korea was mirrored in Tokyo. As soon as the words left Koizumi's mouth Finance Minister Tanigaki pounced on the comments and told the Parliament that Japan has to be "very cautious about foreign reserve decisions and take the market into account"

Our comments at the start of the section about Japan stand; we find it hard to believe that Tokyo will have the nerve to diversify in bulk away from the Dollar, at least not yet.

Some day Asia will generate enough internal trade that the Dollar holders will be comfortable moving funds elsewhere. Right now the US is still the great sucking sound that swallows savings and turns them into consumption. Even

so, \$110 billion in losses on Dollar holdings isn't chump change, and even the skittish bureaucrats at Japan's uber-ministry MITI must be starting to wonder if its really worth it.

All this currency musing brings us to the chart below. You may recall that we told you to keep any eye on the TNX index in the front page sidebar of the last issue. It simply made no sense to us that the Fed had been raising rates, even slowly, and the longer bond yield refused to budge.



The optimistic reading was that traders were confident in US growth prospects and snapping up US debt instruments. There's some truth to that but we see another explanation—that traders are voting on the Dollar with trades in the bond market and maybe, just maybe, there are some central banks in there trading too. It seems unlikely to be coincidence that that the latest drop in the Dollar mirrors—almost exactly—the rise in long bond yields.

Part of it is explained by recent (surprise!) inflation concerns but we can't help but wonder if some of these large bond holders are already starting to vote with their feet. Let's be clear, a run to say 5% on the TNX would probably not put a big dent in the economy but it would stall the equities markets. If traders get it in their heads that it's the leading edge of central bank liquidation things could get much nastier. Let's hope not.