THERE's 'SOMETHING' WEIRD GOING ON

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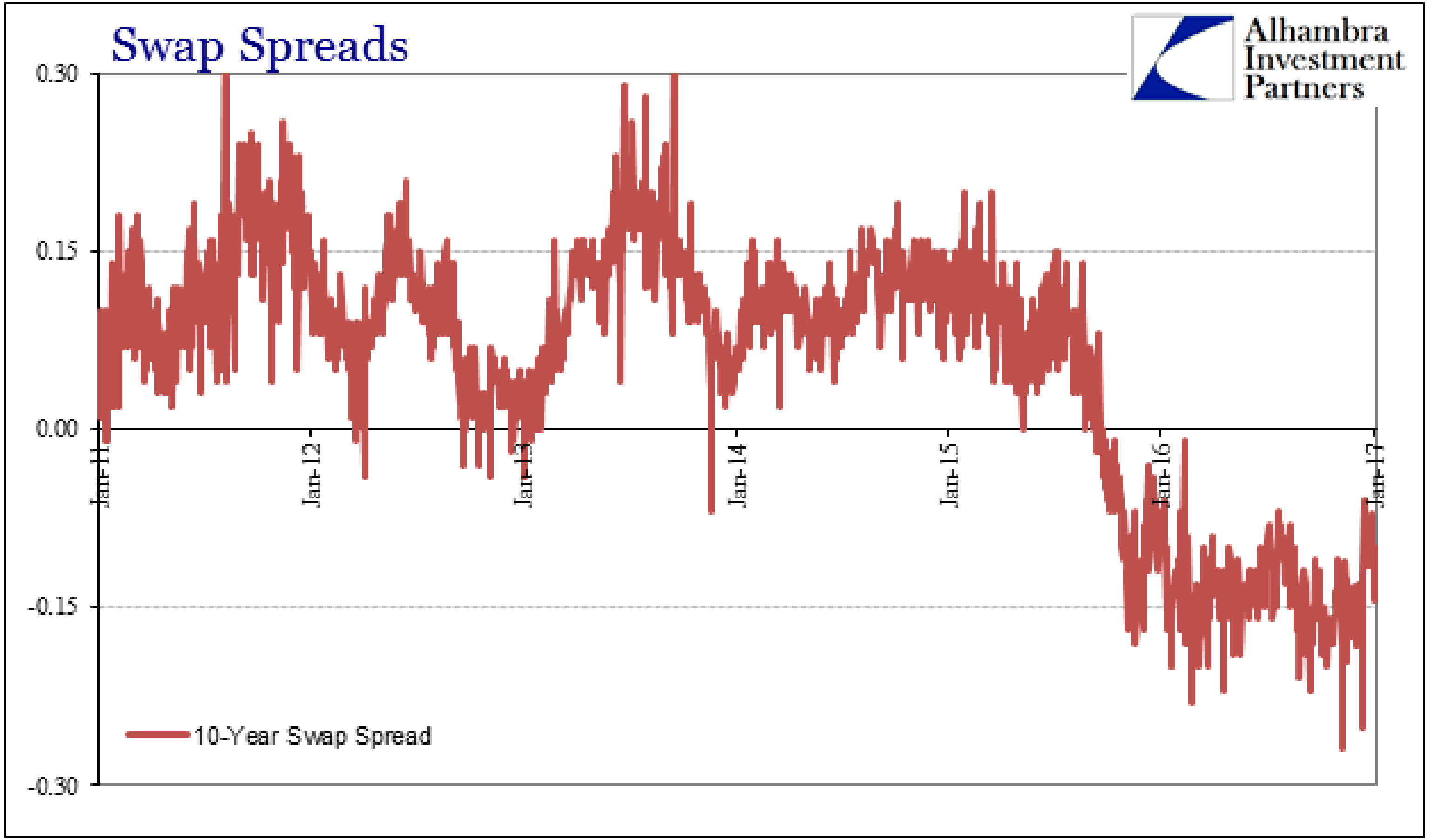

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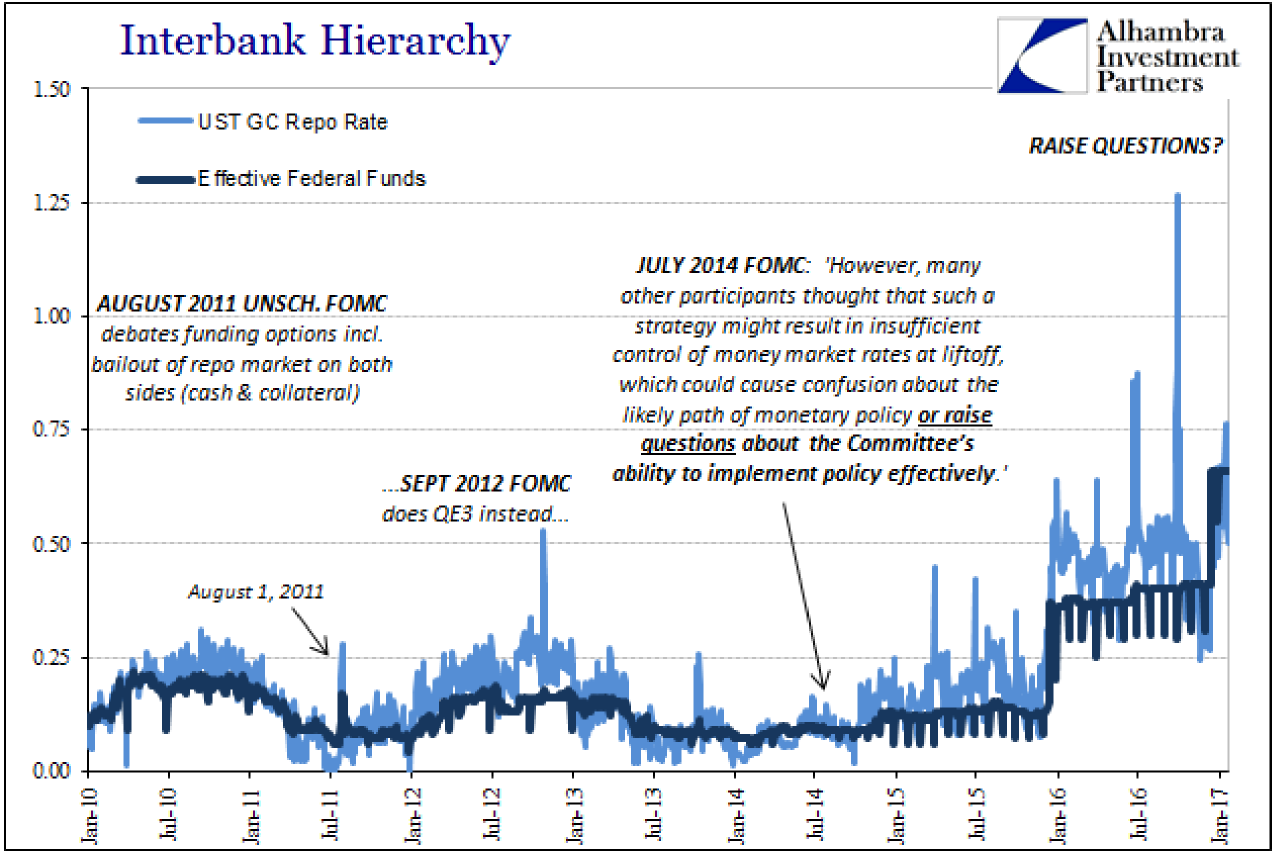

Courtesy Paul Mylchreest, ADM Investor Services Int'l

“

Any speculator or bank with spare “dollars” could lend them in a yen basis swap meaning an exchange into yen. Because you end up with yen you are forced into some really bad investment choices such as slightly negative 5-year government bonds, but that is just part of the cost of keeping risk on your yen side low. Instead, the real money is made in the basis swap itself since it now trades so highly negative. The very fact of that basis swap spread means a huge premium on spare dollars; which is another way of saying there is a “dollar” shortage. Because of the shortage and its premium, you can swap into yen and invest in negative yielding JGB’s in size and still make out handsomely. There has been, in fact, a rush of foreign “money” into Japan to take advantage of this dollar shortage; **the fact that there has been such enthusiasm and it still has not alleviated the imbalance proves scale and intractability**. [emphasis added]

> A stronger dollar goes hand-in-hand with bigger deviations from CIP and contractions of cross-border bank lending in dollars. Differential sensitivity of CIP deviations to the strength of the dollar can explain cross-sectional variations in CIP arbitrage profits. Underpinning the triangle is the role of the dollar as proxy for the shadow price of bank leverage…
>
> CIP is perhaps the best-established principle in international finance, and states that the interest rates implicit in foreign exchange swap markets coincide with the corresponding interest rates in cash markets. Otherwise, someone could make a riskless profit by borrowing at the low interest rate and lending at the higher interest rate with currency risk fully hedged. However, the principle broke down during the height of the 2008-2009 crisis. After the Great Financial Crisis (GFC), CIP deviations have persisted and have become more significant recently, especially since mid-2014.

BIS Working Paper No 592

> It is the closest thing to a physical law in international finance (e.g. Obstfeld and Rogoff 1996, Krugman et al. 2015), except that it has been consistently violated for almost a decade now. Textbooks, it seems, will have to be rewritten.

Paul Krugman

DANCING AROUND THE OBVIOUS SHORTAGE

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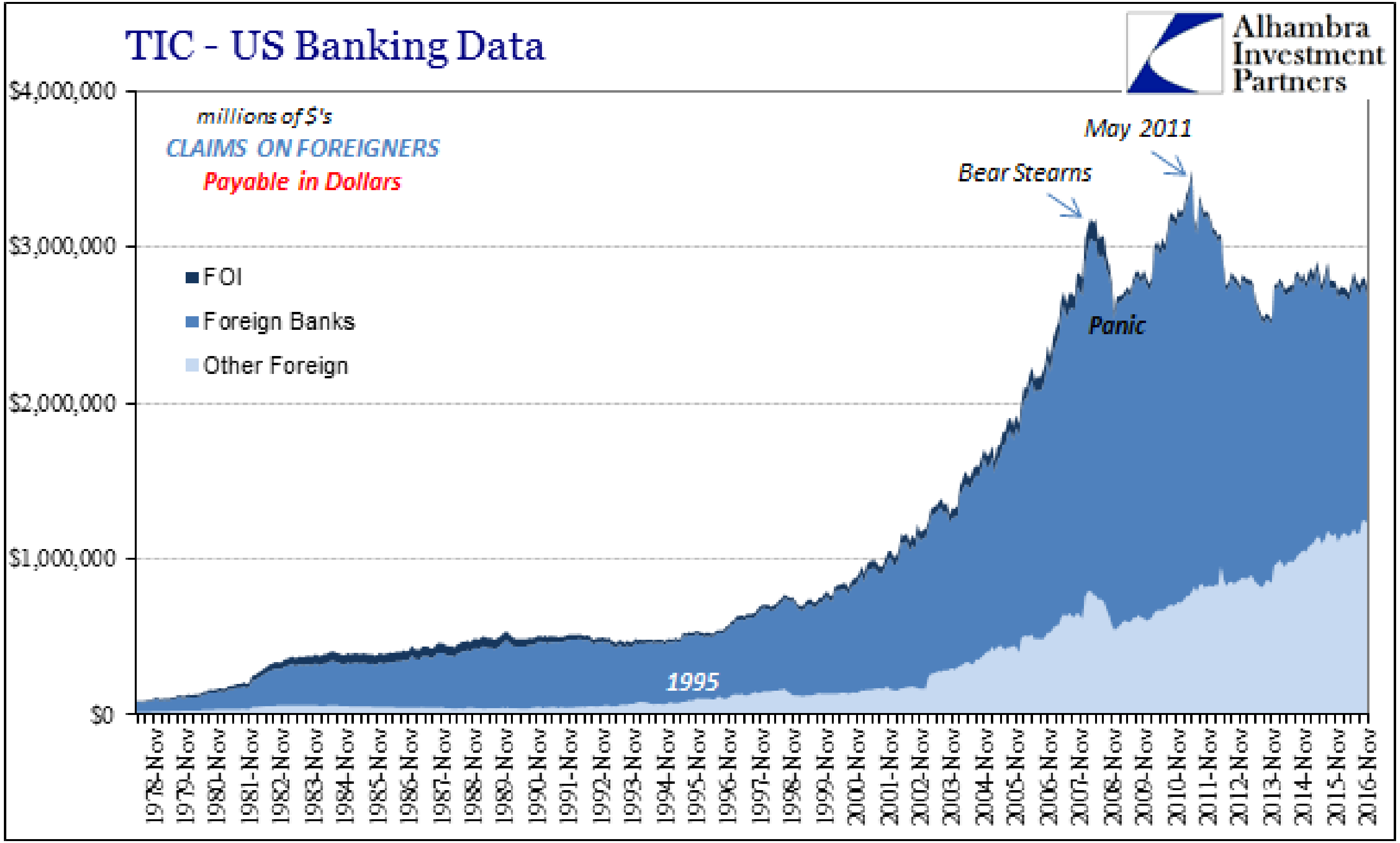

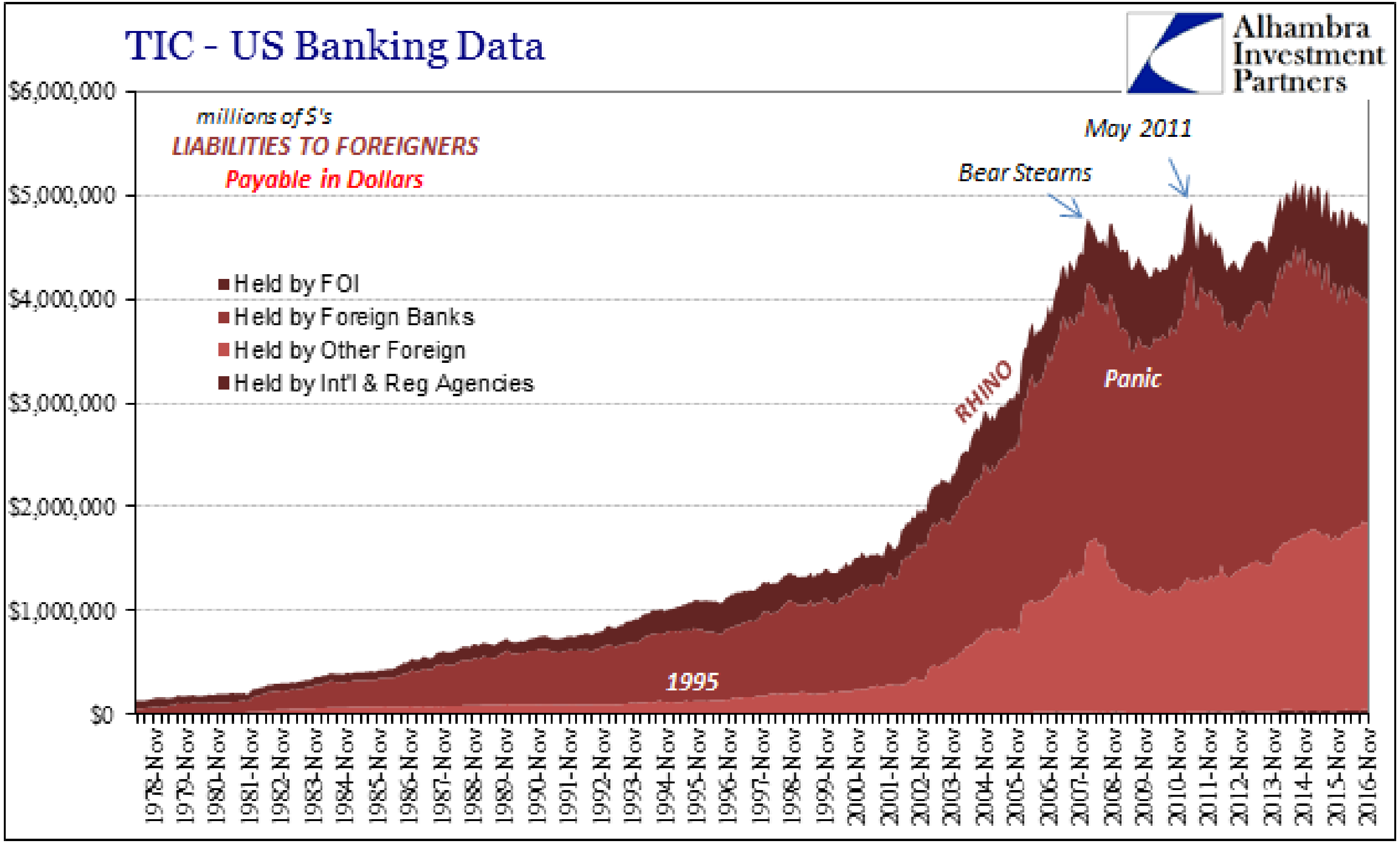
TIC - US Banking Data
Alhambra Investment Partners
millions of $'s
LIABILITIES TO FOREIGNERS
Payable in Dollars
Held by FOI
Held by Foreign Banks
Held by Other Foreign
Held by Int'l & Reg Agencies
Bear Stearns
May 2011
RHINO
Panic
1995
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
1978-Nov
1979-Nov
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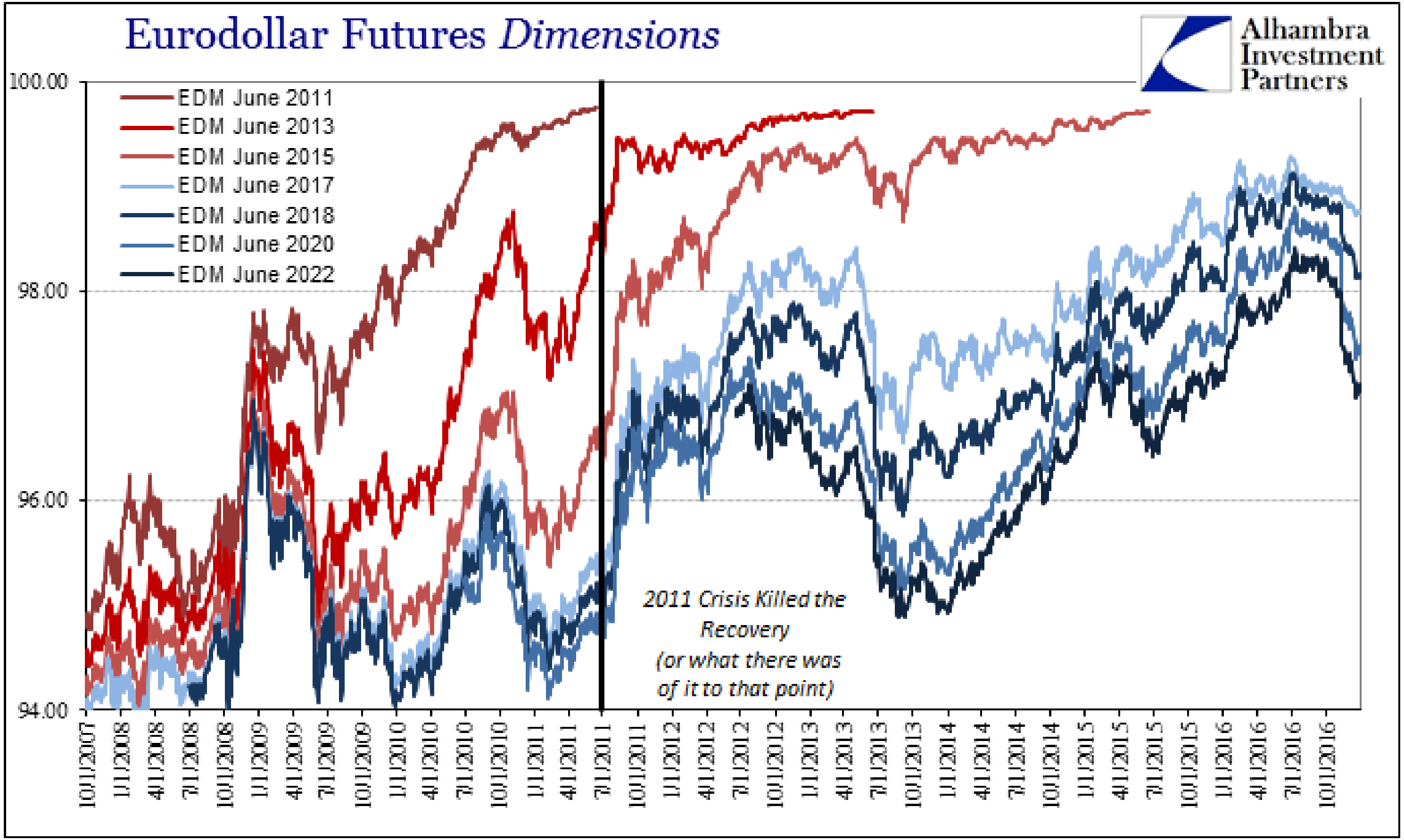

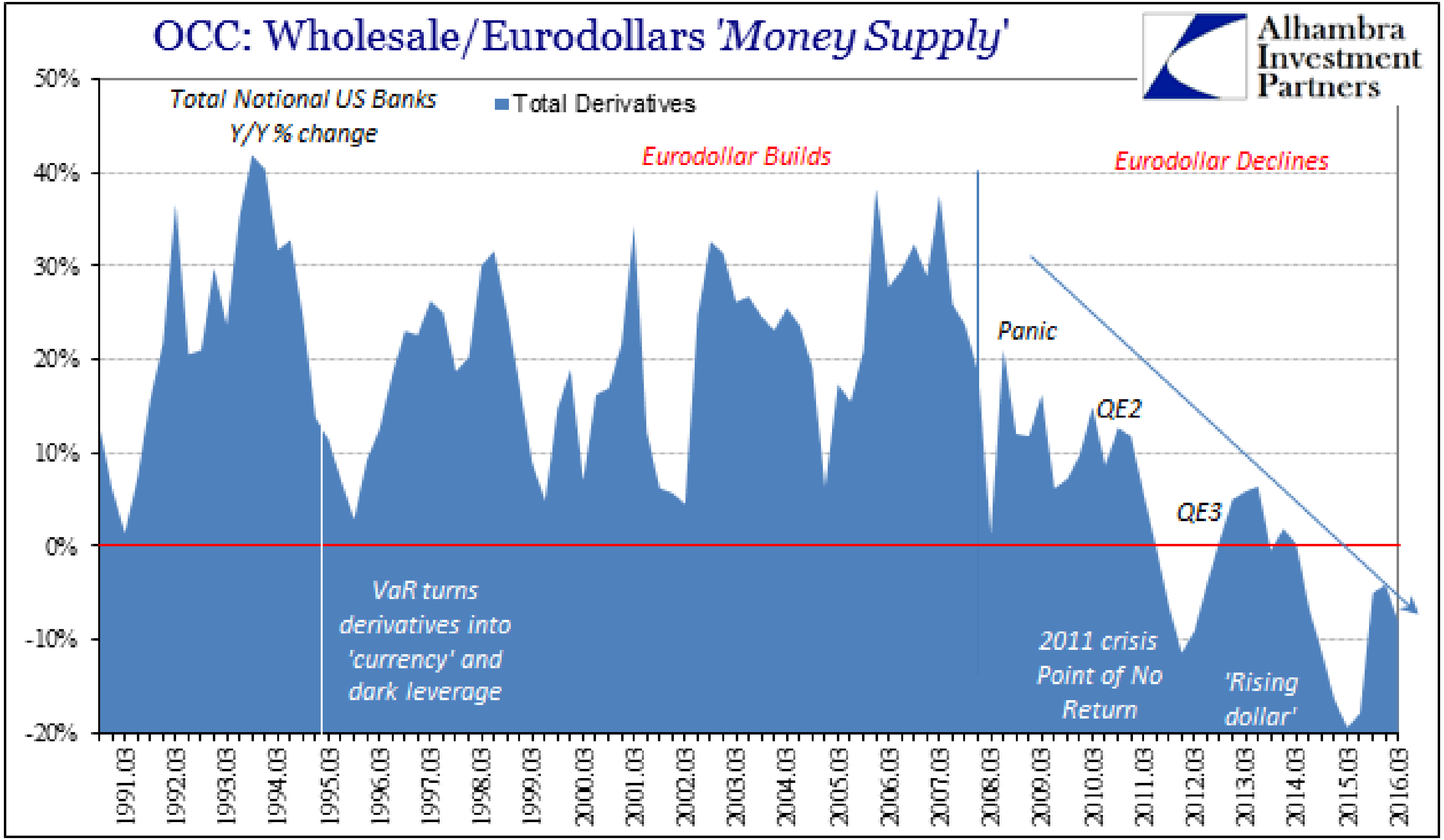
OCC: Wholesale/Eurodollars 'Money Supply'
Alhambra Investment Partners
Total Notional US Banks
Y/Y % change
Total Derivatives
Eurodollar Builds
Eurodollar Declines
Panic
QE2
QE3
VaR turns derivatives into 'currency' and dark leverage
2011 crisis Point of No Return
'Rising dollar'
50%
40%
30%
20%
10%
0%
-10%
-20%
1991.03
1992.03
1993.03
1994.03
1995.03
1996.03
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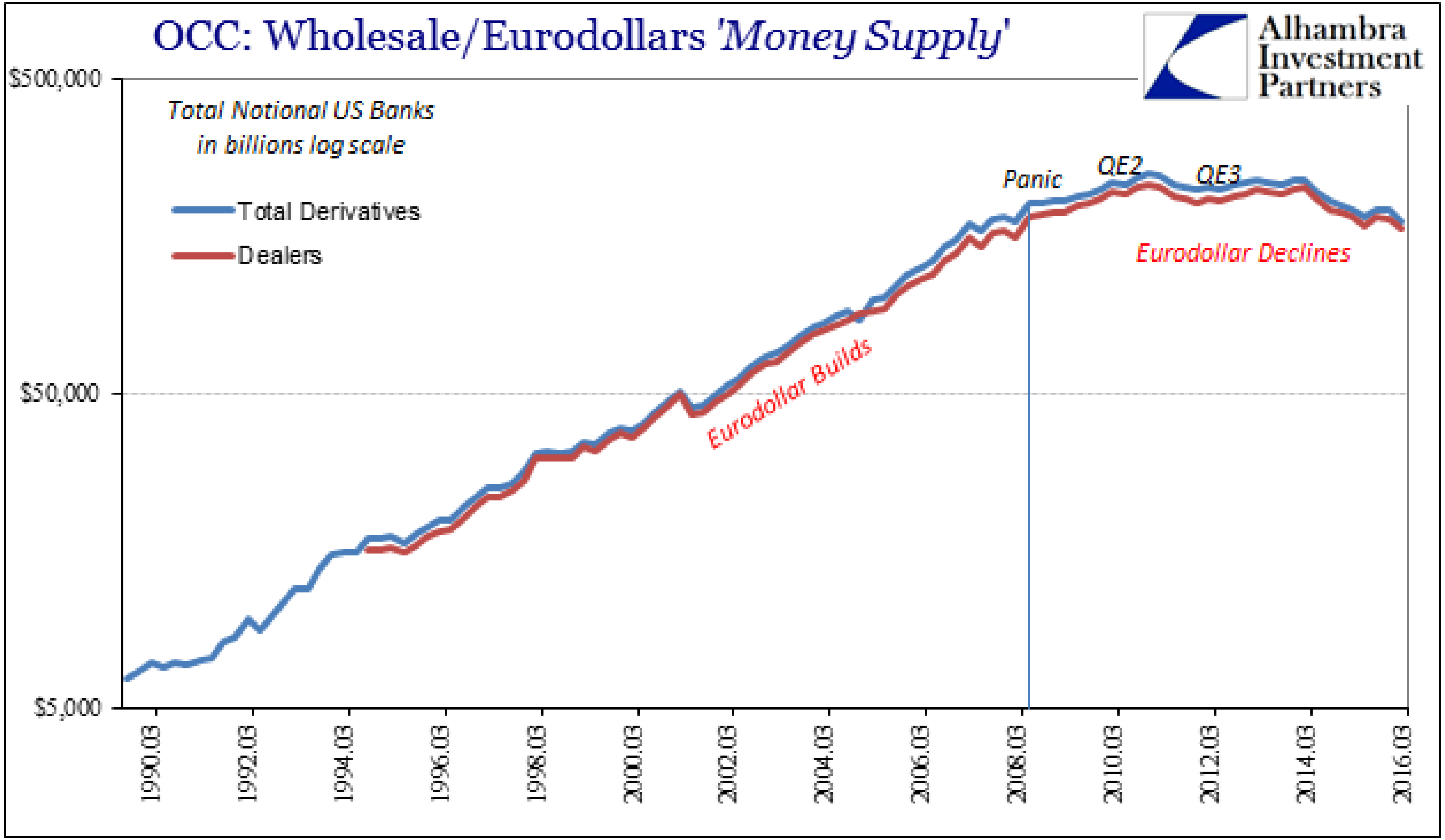
OCC: Wholesale/Eurodollars 'Money Supply'
Alhambra Investment Partners
Total Notional US Banks
in billions log scale
Total Derivatives
Dealers
Panic
QE2
QE3
Eurodollar Declines
Eurodollar Builds
$500,000
$50,000
$5,000
1990.03
1992.03
1994.03
1996.03
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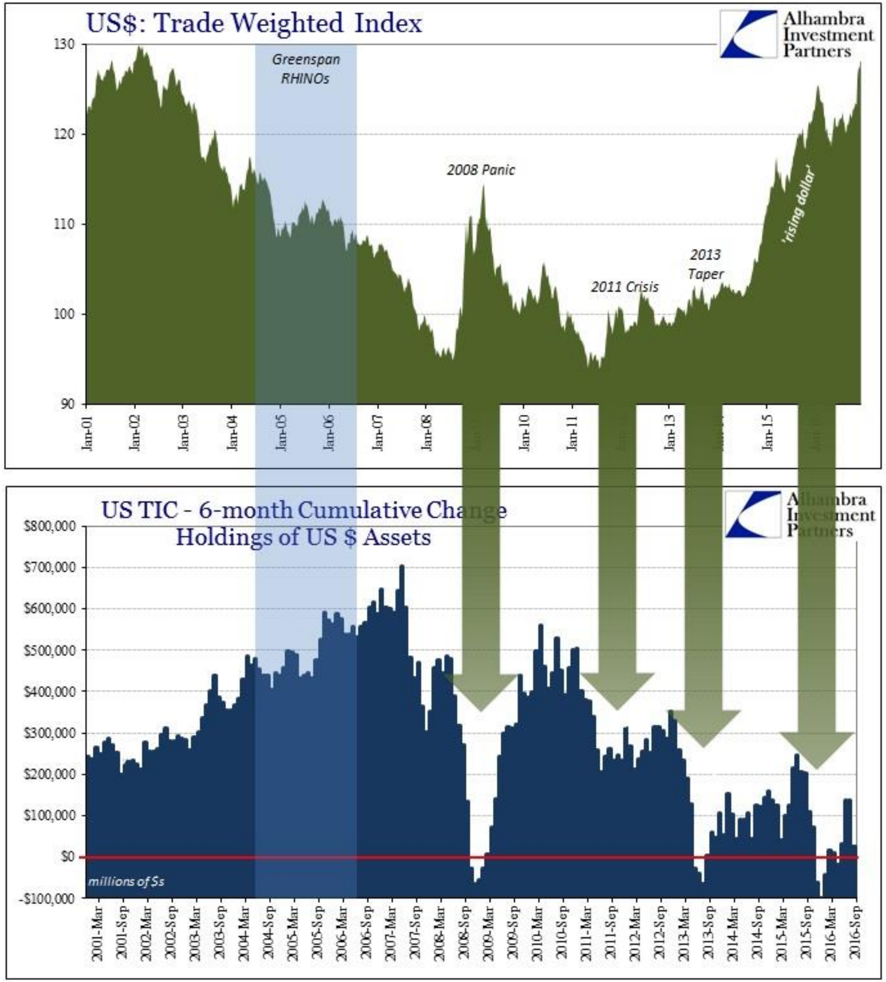
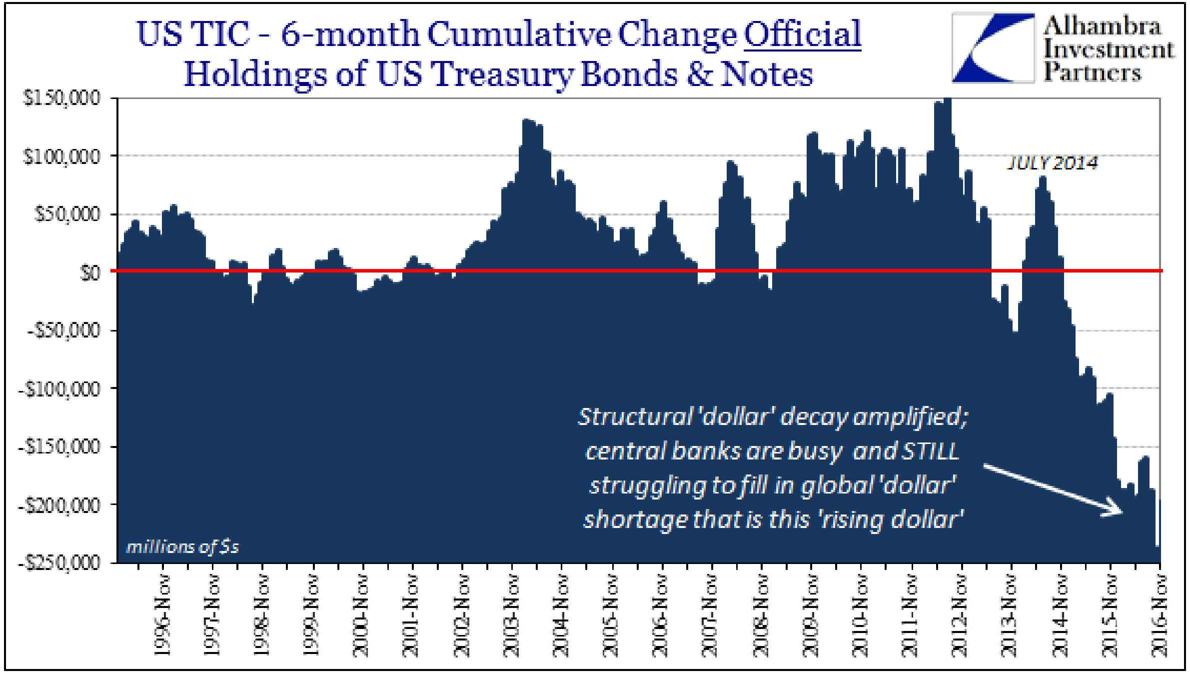
The term ‘rising dollar’ while appearing to denote the exchange value of the dollar is instead a euphemism for ‘dollar’ shortage



The term 'rising dollar' while appearing to denote the exchange value of the dollar is instead a euphemism for 'dollar' shortage…one that in the past few years has forced central banks to respond by trying (and failing) to fill that funding gap.



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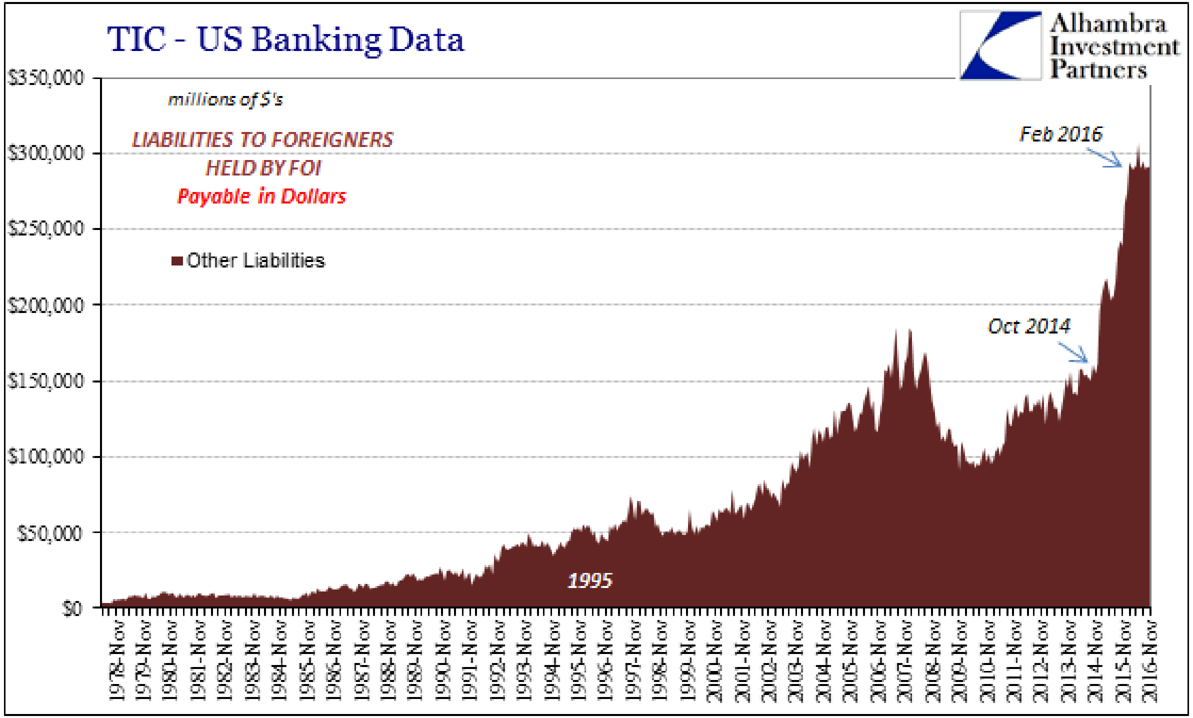
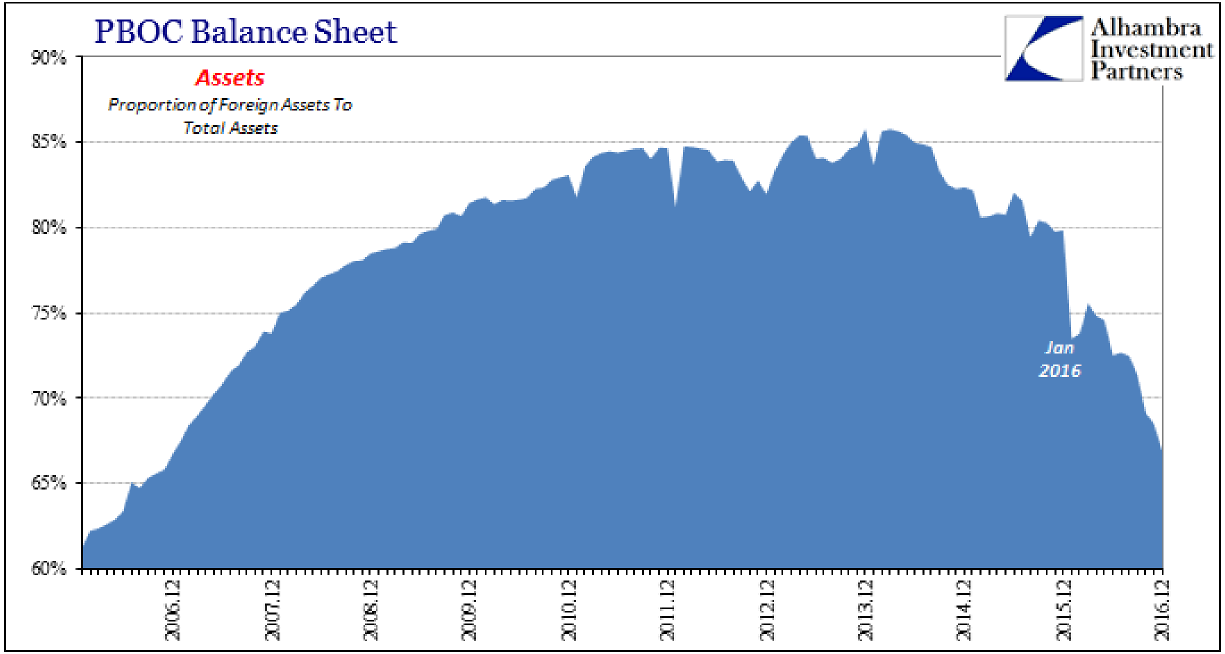


WHY DOES THE WORLD NEED SO MANY 'DOLLARs'?

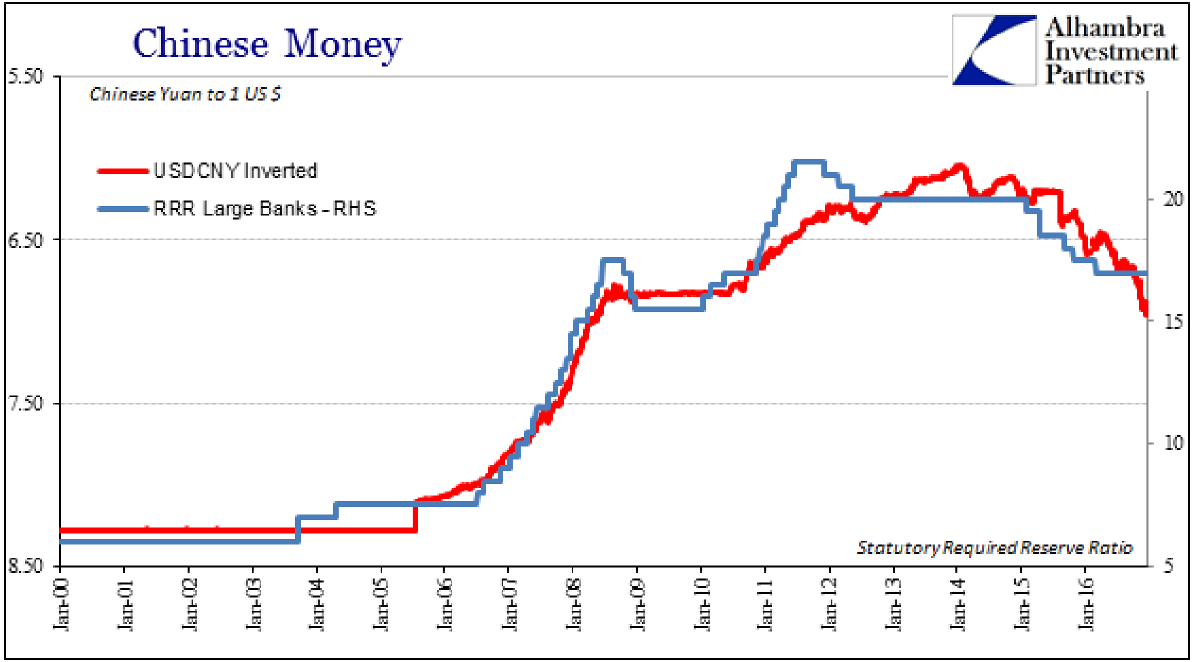
Take the example of firms not connected at all to the dollar directly; one in Sweden exporting goods to another in Japan. The Swedish firm must be paid in kronor, so the Japanese firm would contract with a Japanese bank to buy kronor at some specified time, usually three months forward timed to the expected delivery of the goods. If the Japanese bank carried reserves of kronor, not likely, the bank would simply charge its commission and everyone would move on. Holding reserves of this kind, however, is inefficient and costly. Instead, the Japanese bank would intermediate through eurodollars: buy dollars for yen and then sell dollars for kronor.

While that describes the intended channel, in actual practice **the Japanese bank would actually engage in eurodollar forwards** (or swaps). The Japanese bank could instead more efficiently buy a eurodollar deposit maturing in three months and simultaneously sell forward those dollars into kronor. In terms of actual money or currency, **delivery forward is no longer the responsibility of the Japanese bank nor of the Japanese importer; delivery rests upon the ability of the "market" to deliver on time in the form of another bank's liability in "dollars."** If at maturity, that eurodollar bank doesn't have "spare" dollars to place in the kronor account, that bank will simply "borrow" them elsewhere in the eurodollar market (if not simply create the requisite liability itself; but that is another story) because the "market" always has them (pre-August 2007).

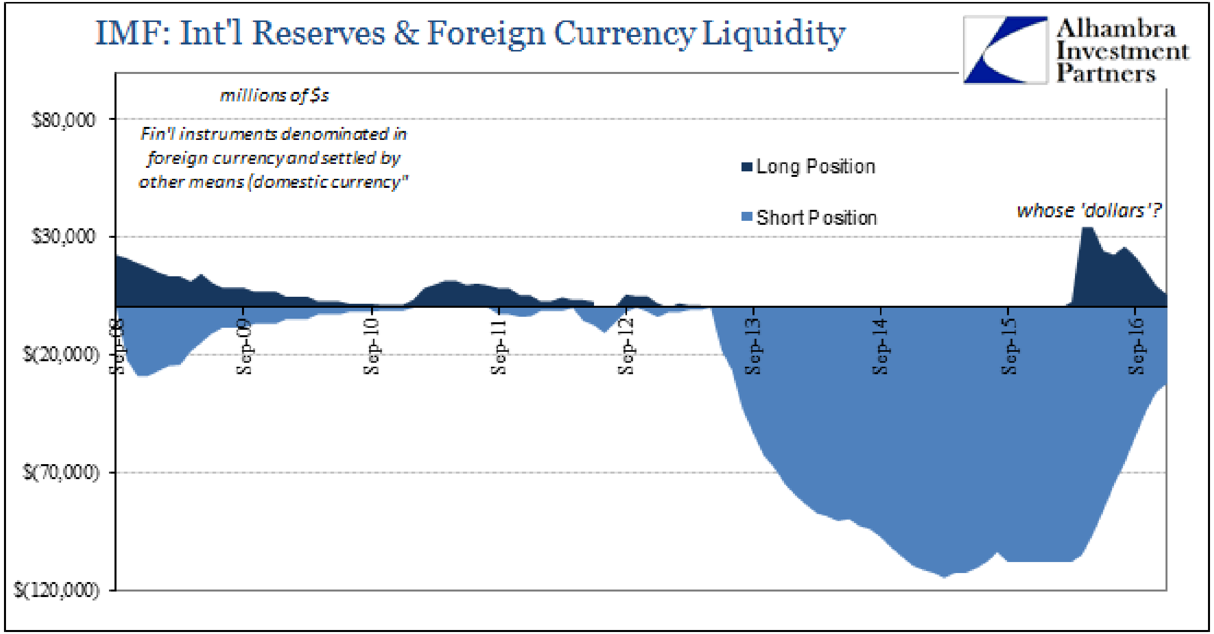
Bretton Woods *was not replaced in 1971 by swapping dollars for gold exchange, it was dismantled piece by piece throughout the 1960's by the* ***eurodollar*** *so that by 1971 it was the eurodollar system that functioned as the global reserve.*



Currency exchange rates don't tell us the price of any currency, rather they show us ***a measurement of eurodollar flow and flexibility****. As CNY appreciated before and after 2008, not during the crisis, it was as* ***'dollars' flowed in*** *such that they had to be locked up in higher bank reserve requirements. Conversely, since 2013, as CNY 'devalues'* ***as 'dollars' disappear*** *leaving the PBOC to either supply them itself or allow banks greater RMB flexibility through lower RRR.*



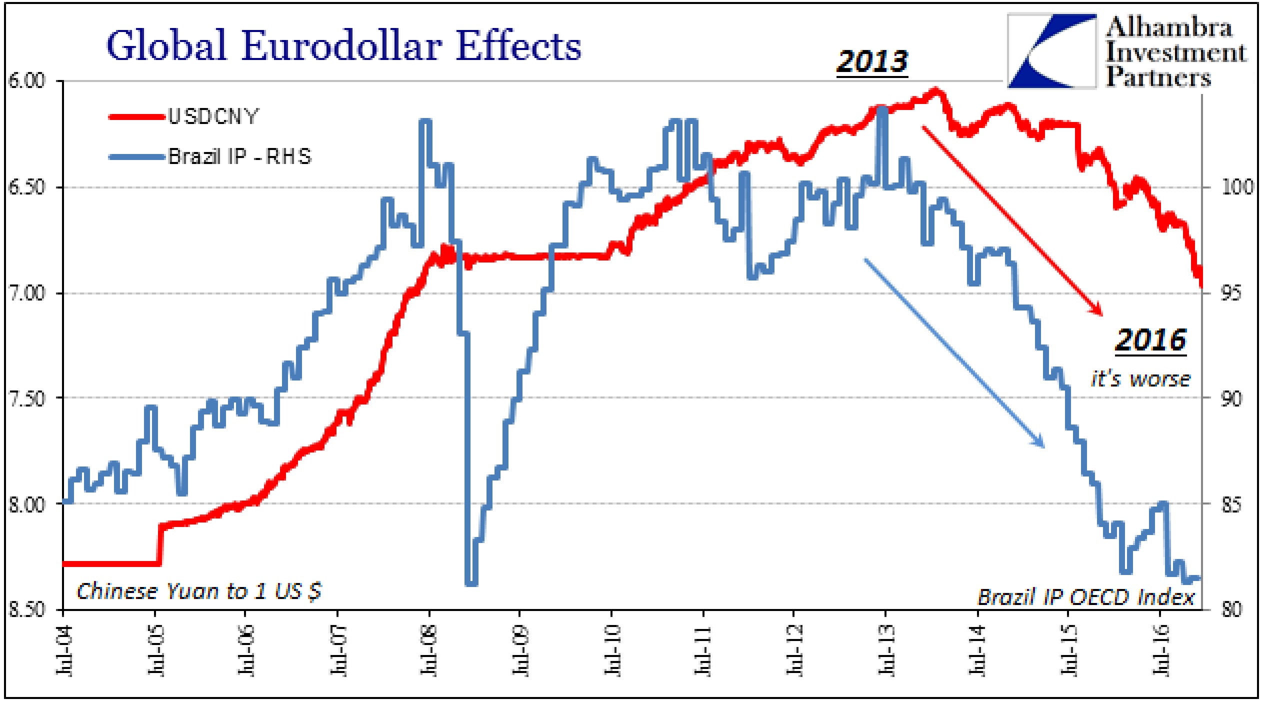
It's not just China; ***Brazil*** *for example:*



What you see above is as 'dollars' disappeared from Brazil starting in 2013

Banco do Brasil *trying ever more desperately* ***to fill the gap*** *– and failing to*

That is why we can see Brazil's ***economic disaster*** *written in China's* ***currency****:*



Because it's not really Brazil or China, it is always ***'dollar.'***

SO WHAT IS ‘REFLATION’?

Nothing goes in a straight line, and the history of the crisis era is written in ***specific eurodollar episodes****: 2008, 2011, 2014. 'Reflation' is nothing more than* ***the spaces in between them****, largely due to misunderstanding what is going on monetarily.*

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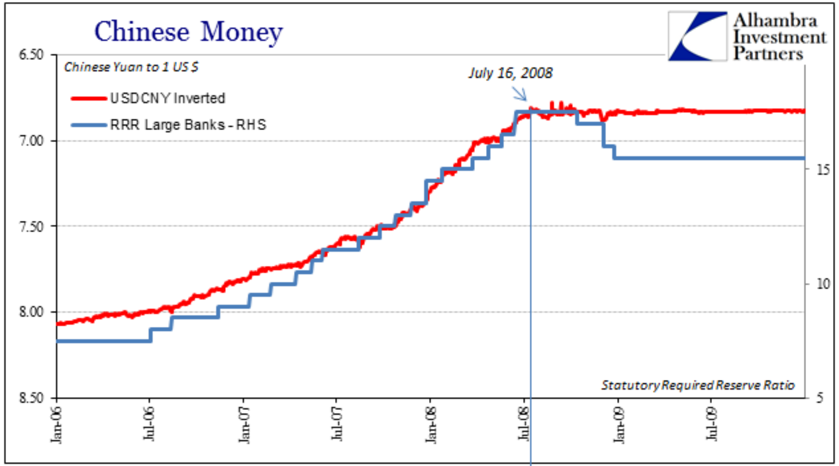
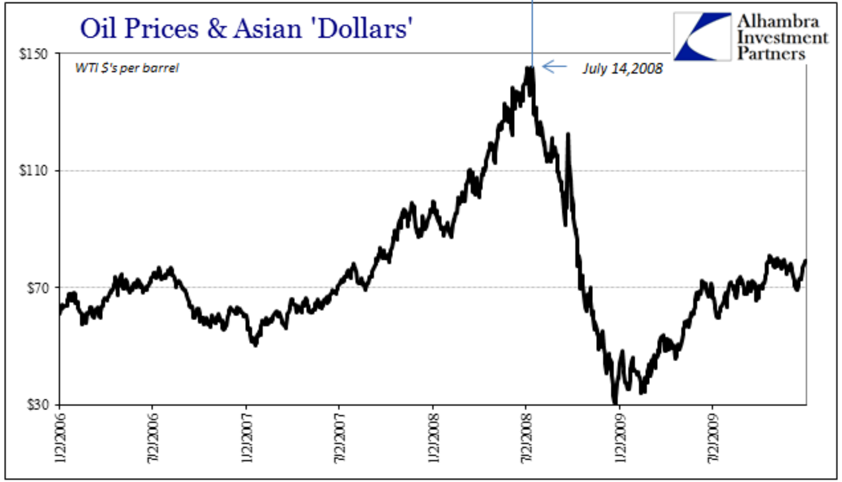
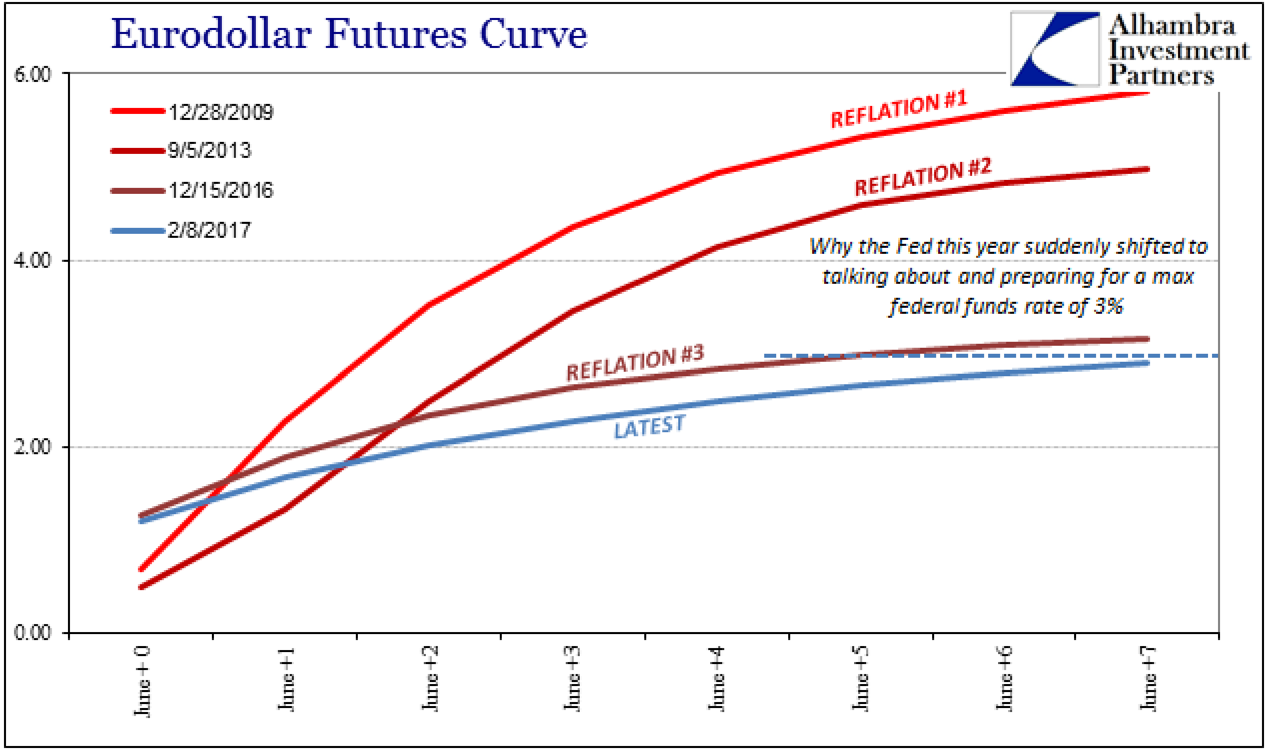
Throughout 2007 and early 2008 markets were convinced that not only was the Fed ***going to fix everything****, there was a danger* ***it might over-fix them*** *by doing too much and unleashing rapid inflation. In July 2008 instead markets learned that* ***the Fed wasn't the correct monetary factor****.*





Reflation ***always fails*** *because it isn't actually reflation. The market has learned that lesson over time, where repeated failure of monetary policy finally proves* ***what the Fed can actually do in a eurodollar system****. Very little if not nothing.*



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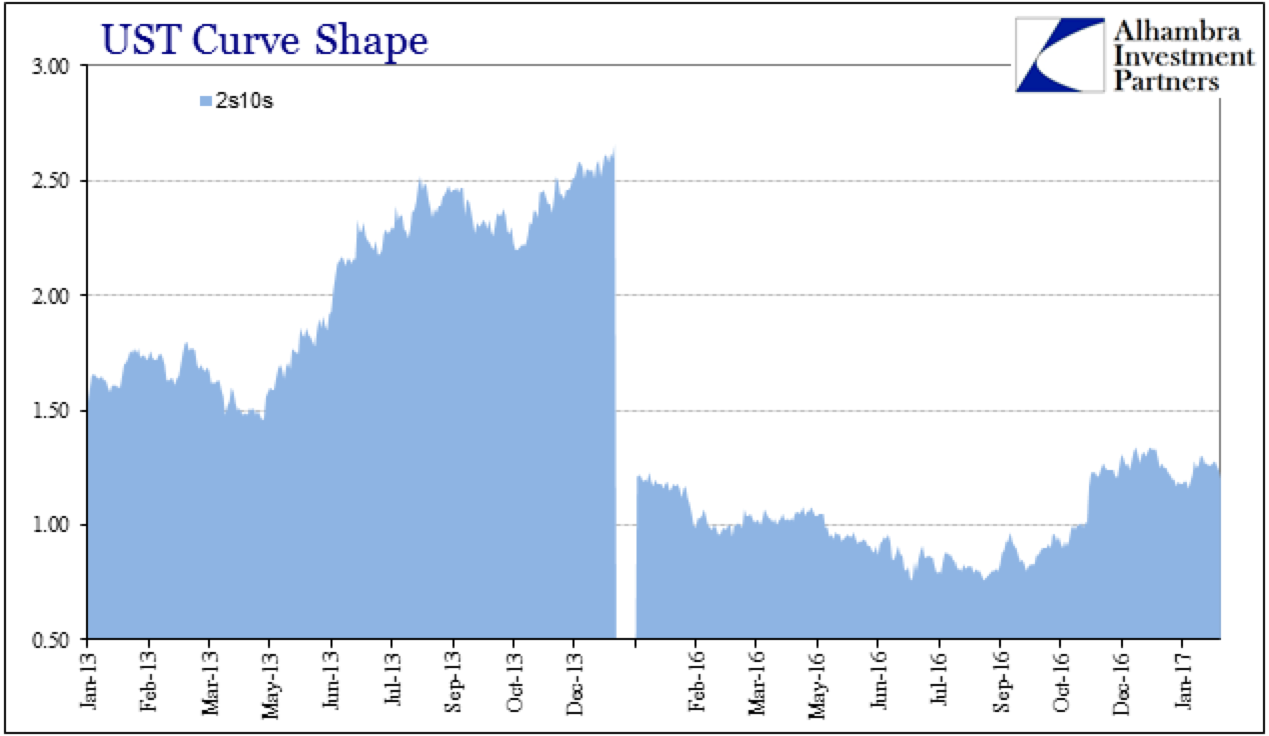
*That's why **this version** of 'reflation' is so **far less than even 2013's version**.*



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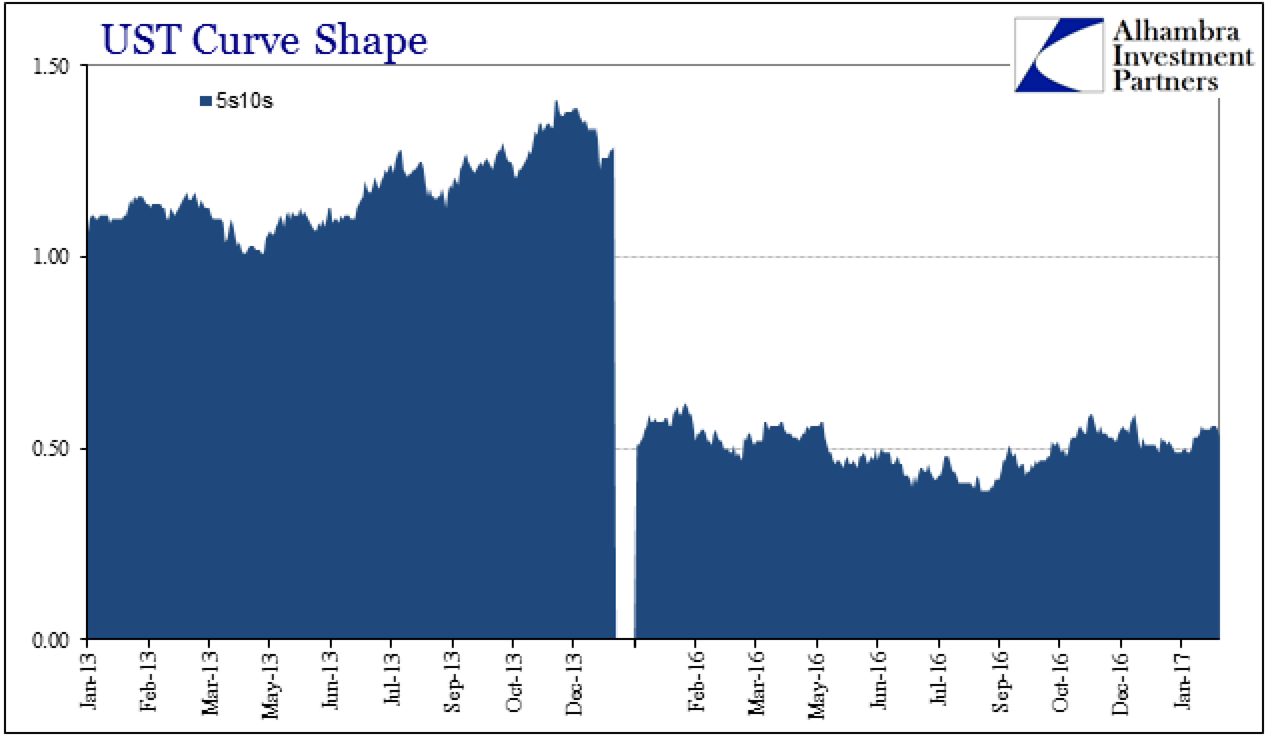

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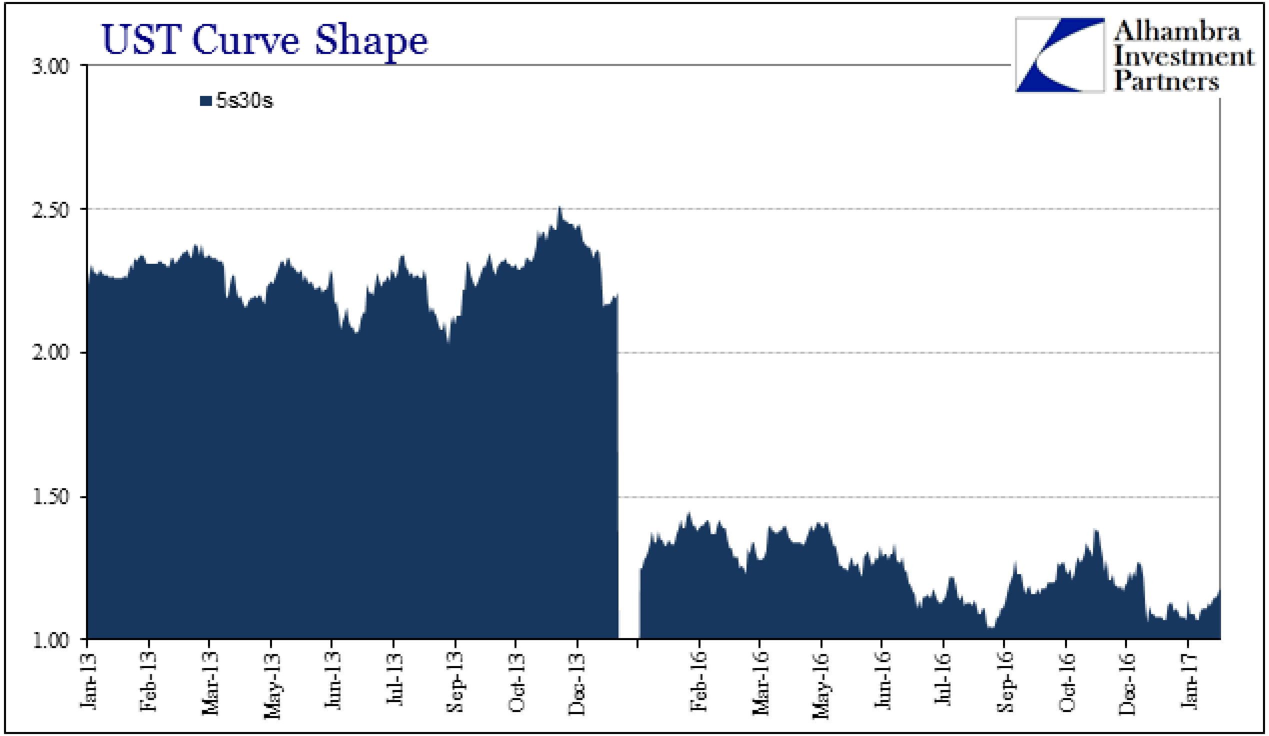

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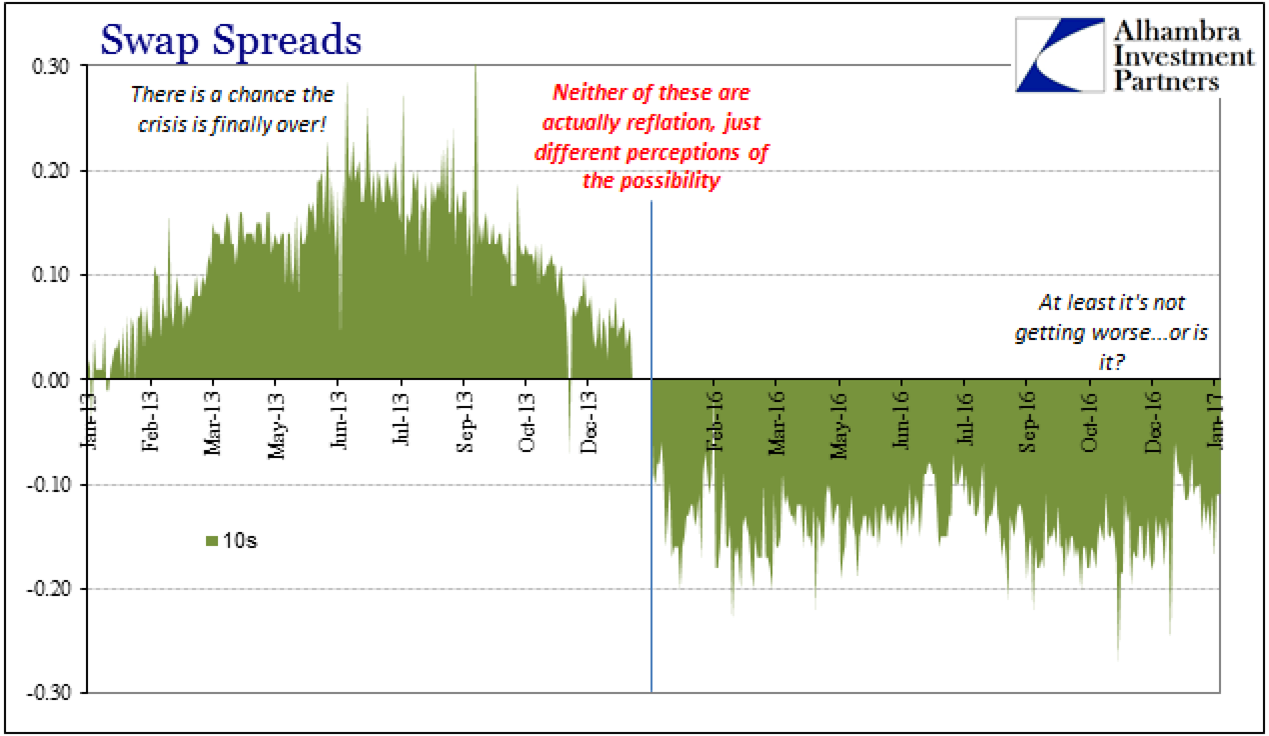

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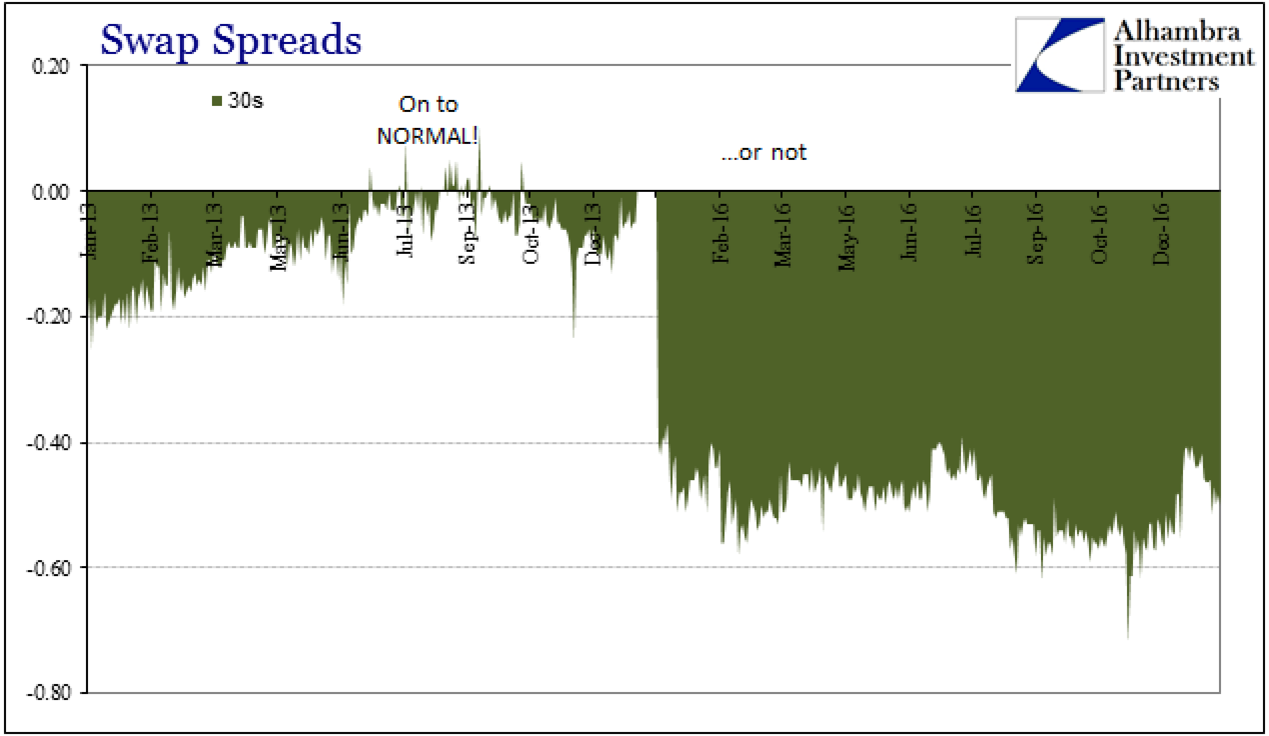
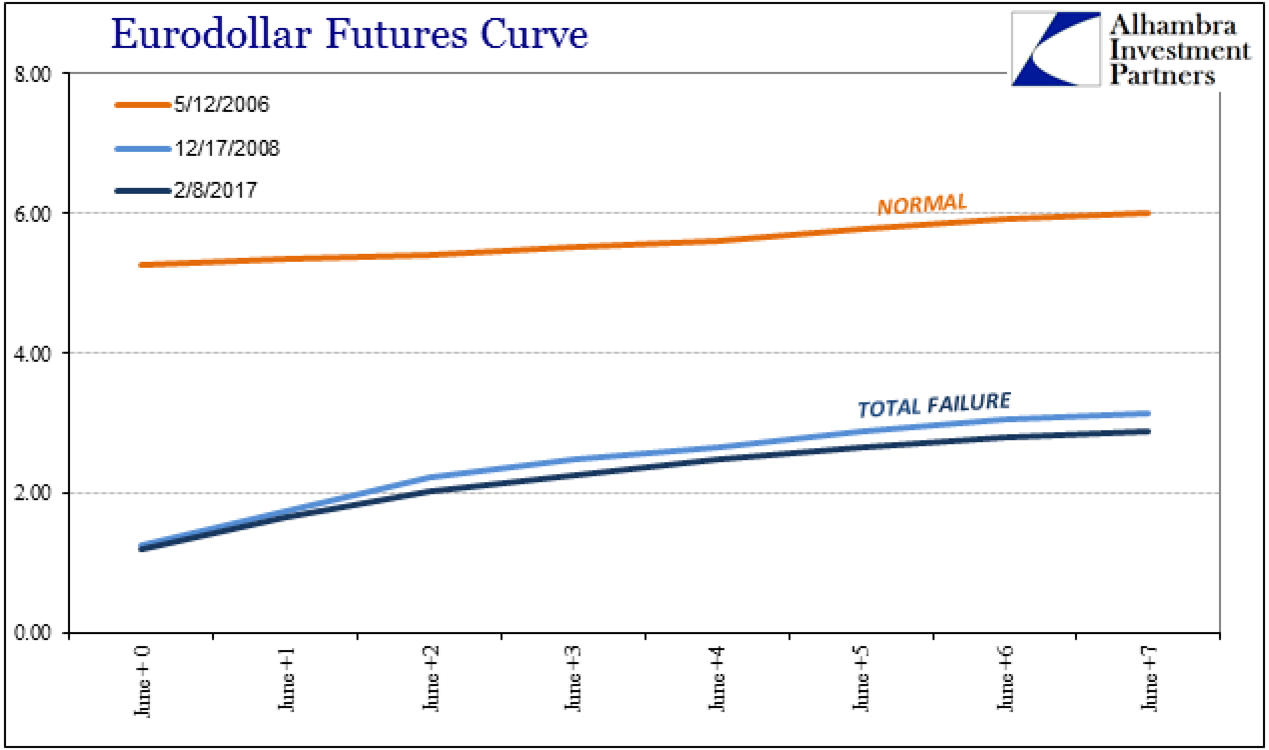
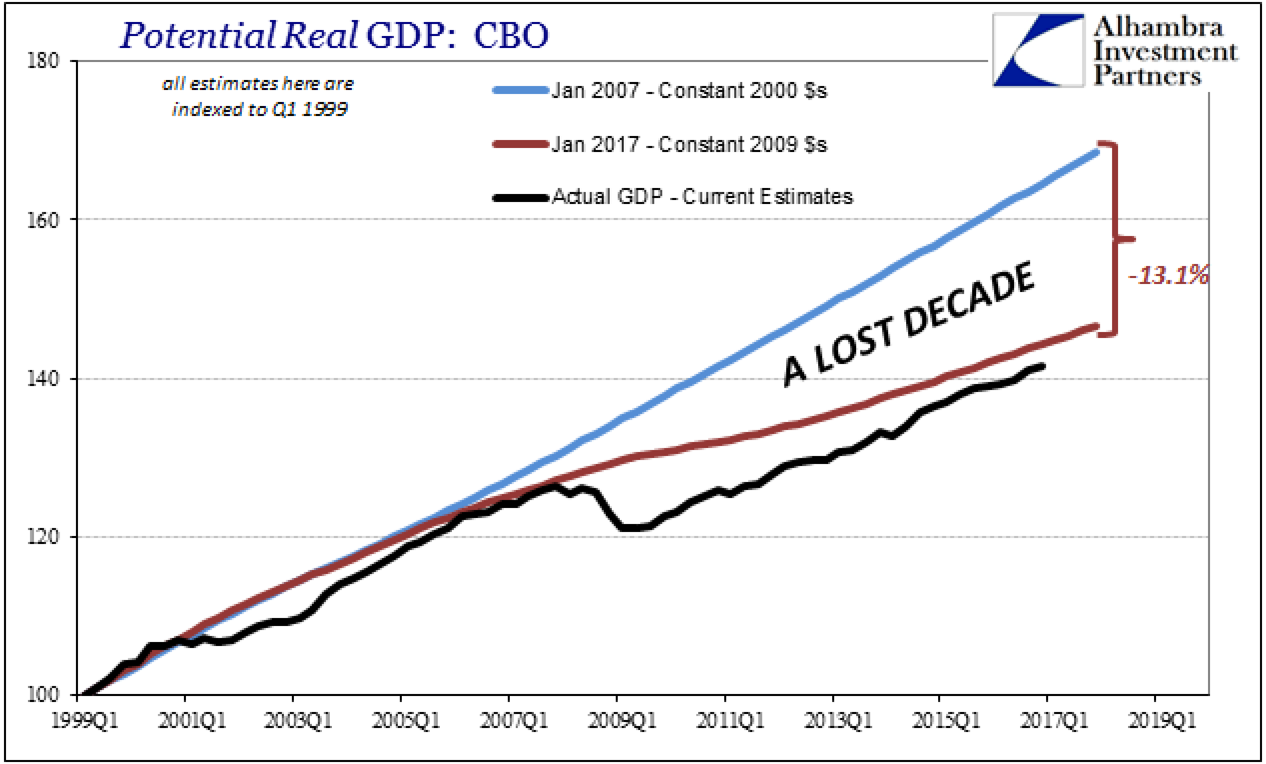


The Fed ***has fixed nothing*** *because the Fed can fix nothing.* ***Eurodollars are far beyond*** *the self-imposed limitations of orthodox Economics and the monetary policies created from it.*



*The **economic cost** of this chronic **eurodollar decay**, irregular as it has been and is likely still to be, is **already enormous**.*



Unfortunately, it has taken Economists ***a decade*** *just to realize the Great 'Recession'* ***wasn't actually a recession****. That leaves us with* ***depression****, a condition that is caused by* ***monetary problems****.*

We can't afford to wait another one before authorities figure out ***the cause*** *having finally realized the* ***economic effect.***