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THE DIFFERENCE BETWEEN USD AND USDX THE CHARTS AND INSIGHTS OF TRADER DAN

Written and published by Warren Pollock, pollock.warren@verizon.net

Editing services by Jeremy Irwin, jc9cz@yahoo.com

On January 4, I wrote that I expected 'the USD to continue to devalue, but this time against Asian currencies. The dollar traded index (USDx) intentionally underweights the importance of Asia and overweights an anemic Europe. Therefore, the next dollar devaluation will be stealthy because it won't be telegraphed in the USDx which gets traded as a surrogate for USD.'

One day's trading does not make a trend, but on Friday, January 14 the euro weakened significantly against the dollar, while the yen gained value. Additionally, gold gained slightly against the euro. *(In the background, a trend has been established whereby the Yen has been gaining ground vs. euro.)*

If someone's liabilities are someone else's assets, the dollar index needs to reflect ownership of dollars. The two charts on the next page contrast the national currencies which comprise the USDx with ownership of dollars. As you can see, based on this metric the USDx dollar traded index has no relevance whatsoever to the reality of dollar value.

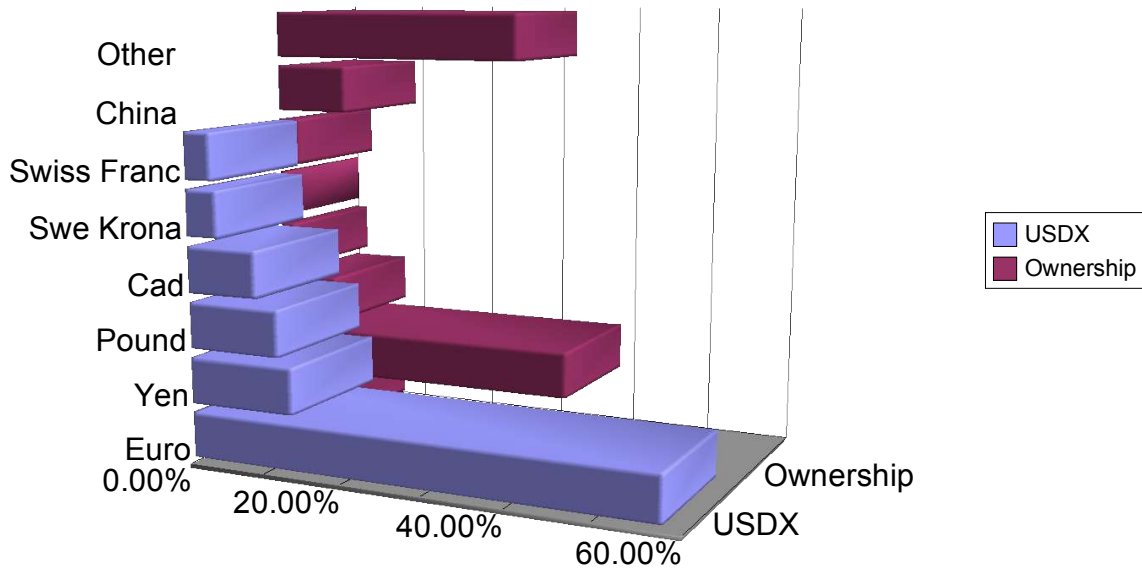
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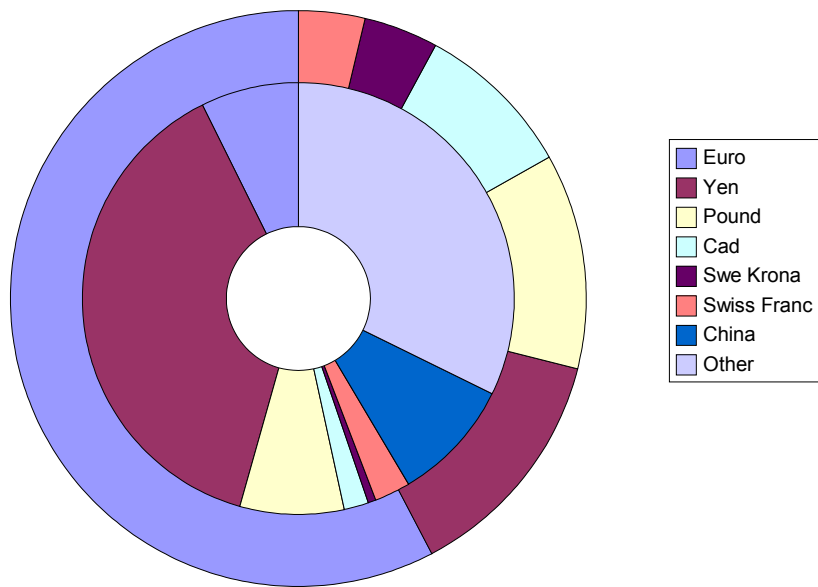
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USDX vs Holders of Dollars



USDX (out) vs. Holders of Dollars (in)



Insights and Charts from Trader Dan Norcini

(Editor's note: The following remarks from Dan Norcini are taken from an e-mail he wrote to me when we were discussing the above charts. They are reproduced here with his kind permission.)

I track the gold price daily in both euro and yen as well, and had noticed that the yen-gold price was breaking down and that the euro-gold price was actually moving up a tad, or had at least stopped its near freefall of late. This is in stark contrast to what we have seen for most of the past few months, where the euro-gold price was taking a real beating while the yen-gold price had made a new multi-year high.

ECB president Trichet was talking the other night about the euro taking the brunt of the dollar's devaluation, calling in effect for the Asians to take their turn as patsy for the dollar. Reading between the lines, he is trying to jawbone the Chinese into floating the yuan, or at least allowing it to move in a greater range against a basket of currencies, with the expectation that the Japanese would follow and take their quasi-peg off the yen. The Koreans – no slackers themselves when it comes to soft-pegging the won – would also be expected to follow suit.

All hinges on China.

If (and this is a big 'if') the Chinese loosen the restrictions on the yuan, then yen will indeed be more likely to rise since the Japanese will not be as concerned about their US export market suffering, provided that China no longer has the currency advantage it has had in the past. I personally do not think China is ready to do this just yet. Their banking system is too messed up, although they are working to clean it up.

The EUR/JPY cross would then head lower as the yen gains against the euro. This would tend to spill over a bit into the EUR/USD cross, pushing the euro down against the dollar. To counter that, however, there should be less buying of EUR/USD as forex traders look to take USD/JPY lower aggressively. This would allow the USDX to continue to sink, although at a slower rate since the USDX is heavily weighted in favor of the euro, as you have observed.

That is why the trade-weighted basket of currencies which comprise the USDX should better reflect who is actually holding the greater portion of dollars in their reserves.

Failing that, it should at least be rebalanced to adjust for more recent trade data. The euro region has a cumulative year-to-date (YTD) trade surplus with the US of \$75.3 billion. Japan's YTD trade surplus with the US is \$68.3 billion; China's is \$147.7 billion. That is hardly reason enough to give the euro a 57 per cent weighting in the USDX, as the Feds have done.

If gold cannot break free from the dollar very soon, we will see the same thing happen to the yen-gold price as has happened to euro-gold. If you look at the euro-gold chart, you will see that the price of gold for Europeans has gone *nowhere* since the beginning of 2003 (two years ago now), and is only seven euros higher than it was at the beginning of 2002. For Americans, the price of gold has also gone nowhere over the last year. Yes, we did manage to hit \$460 but did not stay there very long. We are trading below where we began 2004.

That to me is the reason gold continues to get smashed on these rallies. It is a US phenomenon only at this point – with the exception of the yen thus far, capped as it was in its rise against the dollar by the Bank of Japan for the better part of last year. That could all change very quickly if the yen were to take off and gold did not follow upward at the same rate or even faster.

These two charts make all this a bit easier to see.

