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Being short the US dollar has been expensive recently

♦ Carry trades that used other currencies to invest in dollars became very profitable in the second quarter.

♦ However, a changing global liquidity picture and in interest rate expectations has started to shift that.

♦ In the past month, investors using dollars to invest in other currencies would have lost money.

♦ The signal from China that it will allow the yuan to depreciate could also help push the dollar higher.

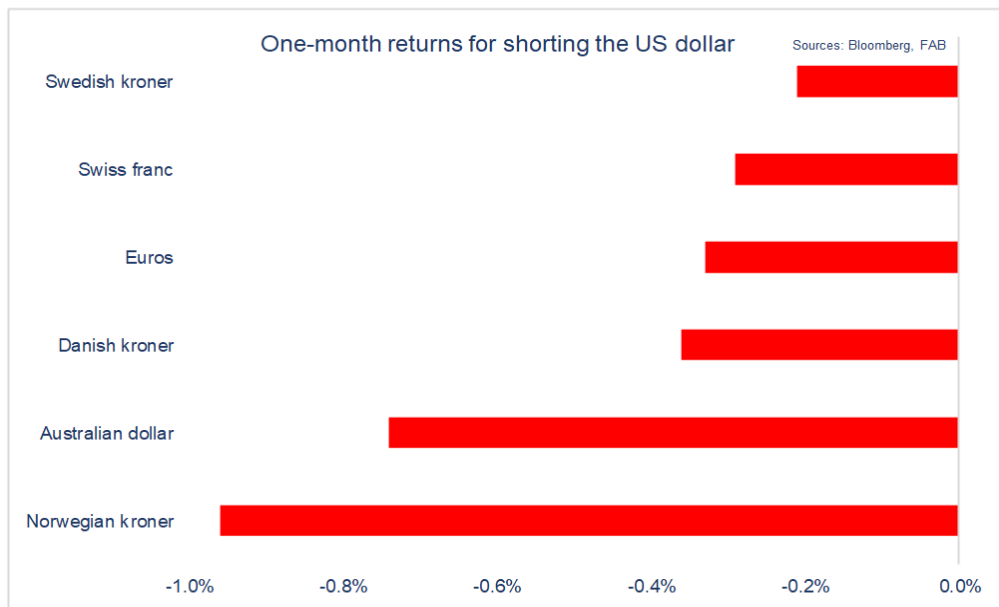
♦ The FAB AAC favour dollar-denominated corporate investment-grade bonds.

One of the consequences of the tsunami of liquidity unleashed by the Federal Reserve starting in late March has been a bout of dollar weakness. That actually helps the central bank in its dual mandates of inflation and employment.

A weaker dollar makes imported products more expensive and increased the general inflation index, but it also makes US exports cheaper, which boosts GDP and creates more jobs.

This dynamic, however, does not apply only to the US. Which is why central bankers in Australian, Europe, Japan and New Zealand all have voiced concerns about the strength of their currencies lately. That usually leads to actions that would increase liquidity in their currencies and push it down against the US dollar.

At least one major central bank took serious action to that effect this weekend: the People's Bank of China.



On Saturday, the PBOC scrapped a two-year old rule that required Chinese financial institutions to set aside up to 20% of their sales on some yuan forwards. That made it very expensive to short the yuan and helped push the currency, just last week, to its highest in 18 months.

Today, the PBOC fixed the yuan weaker than what the market had priced, signaling again that it intends to let the currency slip. As a result, the yuan fell 0.74%, the biggest one-day drop since March.

A weaker yuan should increase the liquidity onshore as it increases the currency supply. That helps to boost inflation and the economy though it could push interest rates higher too.

Great for China. The problem is that the country in point here is the world's second largest economy. Therefore, it is no surprise that the yuan has a high correlation with several other major currencies of developed nations.

In the past month it has been costly to be short the US dollar against some currencies

Which means that if the yuan starts to weaken it could drag the Australian dollar, the New Zealand dollar, the euro and even the British pound with it. These currencies are key components of the so-called US dollar index. That could prolong the recent bout of strength the US dollar is seeing.

There is something else. The economics of borrowing in US dollars to invest in other currencies are no longer favourable. Over the past month, that trade, which was almost easy money a few months ago, has been loss-making for most currency pairs. To be sure, the underlying fundamental issues that pushed the dollar weaker since March are still in place and are likely to return to the fore in due time. For now, however, there are several signs that the greenback is on the rise again.

Investment Strategy Update

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