



Black Swan Capital

# Currency Currents

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Wednesday 15 July 2009

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## Key News

- [China's foreign-exchange reserves, the world's biggest, topped \\$2 trillion for the first time.](#) (Bloomberg)
- [The German manufacturing sector's work force decreased](#) by 2.3 percent in the year to May, its sharpest decline in five years, government data showed Wednesday. (AP)
- [UK unemployment climbed by a record](#) 281,000 to hit 2.38 million in the three months to May, the highest level since October 1995. (Times)
- UK consumer price index fell to an annual 1.8% in June, from 2.2% in May.

## Key Reports Due (WSJ):

**8:30 a.m. June Consumer Price Index:** Expected: +0.7%. Previous: +0.1%.

**8:30 a.m. June Consumer Price Index, ex-food energy:** Expected: +0.1%. Previous: +0.1%.

**8:30 a.m. July Empire State Fed Manufacturing Survey:** Expected: -4. Previous: -9.41.

**9:15 a.m. June Industrial Production:** Expected: -0.6%. Previous: -1.1%.

**9:15 a.m. June Capacity Utilization:** Expected: 67.9. Previous: 68.3.

**10:30 a.m. Jul 10 US Energy Dept Oil Inventories**

**2:00 p.m. Federal Reserve FOMC Minutes**

## Quotable

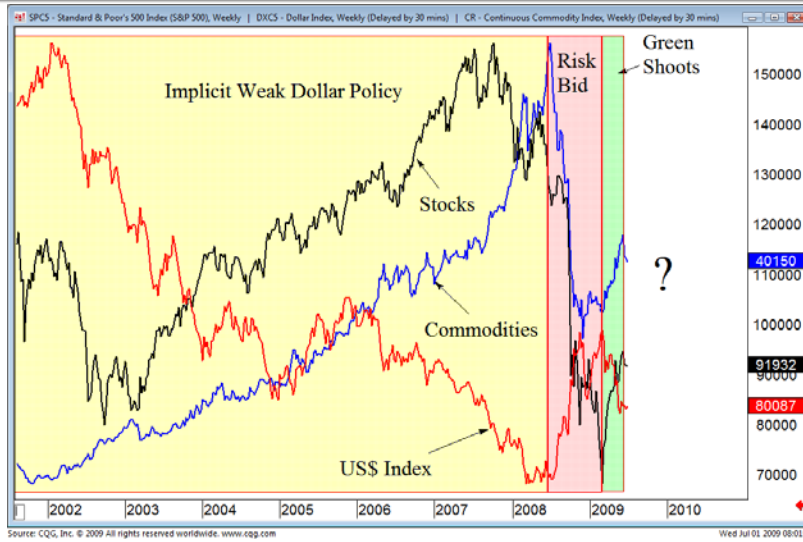
"Bankers know that history is inflationary and that money is the last thing a wise man will hoard."

Will Durant

## FX Trading – A weak dollar scenario...a policy prescription from Mr. Soros?

We do our best to build alternative plausible scenarios that are in competition to our current trading positions; we say our best because we know by virtue of taking a position, the bias already exists. One of the scenarios we laid out recently in a seminar was our view the dollar had the potential to become the carry trade currency (borrow dollar at low rates and reinvest in higher yielding asset classes) should the US government conclude a weak dollar is what's needed to get "things moving again" and move back into an implicit weak dollar policy environment (yellow area in the chart below).

# Where we've been! ...where are we going?



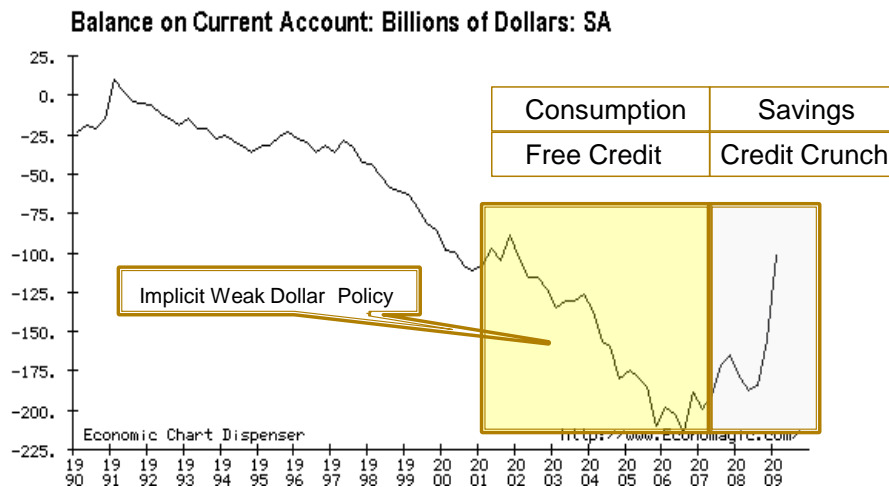
Implicit Weak Dollar Policy Funding Global Liquidity – Asian Surplus Recycling

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This would be an attempt to take us back to the midst of the last cycle, whereby dollar-based credit, enhanced by newly manufactured derivative securities, was pumped out to boost financial asset markets far and wide—thus the boom in the current account deficit (yellow area in the chart below).

## US Current Account Swing Rebalancing is underway...



Lower CA Deficit Means US Requires Less Int'l Funding



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Notice the subsequent improvement in the current account deficit in the chart above as the credit crunch has led Mr. US Consumer to spend less and save more (a nod to falling energy prices too).

As we said, the credit crunch was a game changer. Credit markets globally seized up, as you know. Thus, it became especially important the world reserve currency did not fall off the cliff. This we think sparked a change in the US government implicit weak dollar policy; we think it occurred in March of 2008, before the US dollar caught its huge risk aversion bid in July 2008 (red area in the first chart above).

Why March '08? Keep in mind the Fed is the world's de facto central bank. Despite all its ills, the Fed's raw material for policy action is the dollar--the world reserve currency. A dollar crisis and a credit crisis would likely have plunged the world deep into depression.

Thus, the dollar garnered unrecognized support from mid-March (bottoming on the exact same day coincidentally that Bear Stearns was rescued) to July '08 before it soared on risk as everyone started deleveraging and hiding in US Treasuries at the same time (the big move in the dollar and bond prices in the chart below).

## Bonds vs. US\$ Index

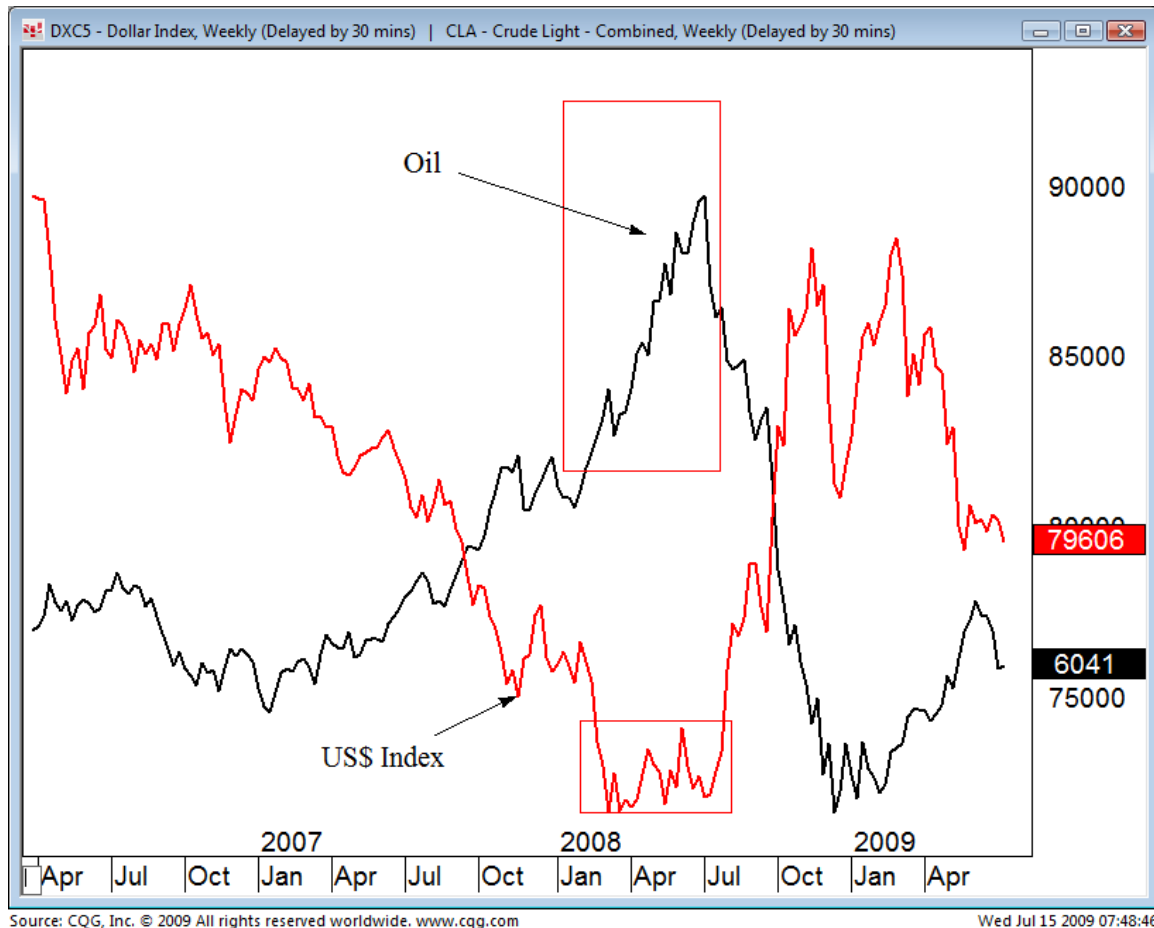


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We refer to the Mar –Jul '08 as unrecognized and think the Saudi's played a role i.e. stopped reallocating dollar for dollar oil revenue into another currency. Our market evidence/guess was based on our view that something must have changed because oil prices jumped 40% during that period, while the dollar rose 2%. It was an abrupt

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change in what was a very high and negative correlation between crude and the dollar as you can see in the chart below (rectangles).



So, now maybe the US government in its infinite wisdom as global stimulator of last resort has decided credit market have healed enough, and it's time for dollar-based credit to be pumped out again...

Here is a possible policy prescription that seems to fit the script of Economic Czar Larry Summers...interestingly this script is from George Soros, writing in his book *Alchemy of Finance*, back in August of 1985:

“The new constellation is almost the exact opposite of the Imperial Circle [Soros’ term for the financial policies arranged during the Reagan administration]: a weak dollar and subdued economy are accompanied by lower budget and trade deficits and, most important, by lower interest rates. With the help of a weaker dollar, prices are going to rise somewhat faster than previously, rendering the change in real interest rates all the more pronounced. Declining real interest rates, together with a possible pickup in exports, will replace the budget deficit as the main driving force in the economy. Rising prices will help counteract the erosion of collateral values and prevent a self-reinforcing, deflationary process from taking hold. At the same time, the coordination of economic policies will keep the decline of the dollar within bounds, thereby eliminating the

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possibility of a self-reinforcing inflationary process. The outcome would be a greater degree of stability than we have experienced since the breakdown of Bretton Woods.”

All good in print, but managing the dollar is still equivalent to herding cats. But, we can see the attraction this would have for those who reside in hallowed halls of government:

- Pump up consumer wealth effect with rising collateral values
- Generate some inflation in a world now threatened by deflation
- Keep the Chinese happy with a lower but stable dollar
- Rising exports continue to balance growth keeps the current account in check

This view may be all wet, but maybe it’s plausible enough to consider. Stay tuned.

Jack Crooks

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