Black Swan Capital

Currency Currents

Tuesday 21 July 2009 www.blackswantrading.com

Key News

- Total outstanding government debt in the UK has risen to a record £799bn, or 56.6% of UK GDP - the highest since records began in 1974. (BBC)
- Australian Treasurer Wayne Swan Tuesday said the worst of the global recession may be over as he welcomed a new report which predicted a rebound in the country's growth next year. (AFP)

Key Reports (WSJ):

ICSC-Goldman Store Sales • 7:45 AM ET
Redbook • 8:55 AM ET
4-Week Bill Auction • 1:00 PM ET
Fed Chairman Bernanke speaking today

Quotable

"Early in life I had noticed that no event is ever correctly reported in a newspaper."

George Orwell

FX Trading – Questions and few answers…

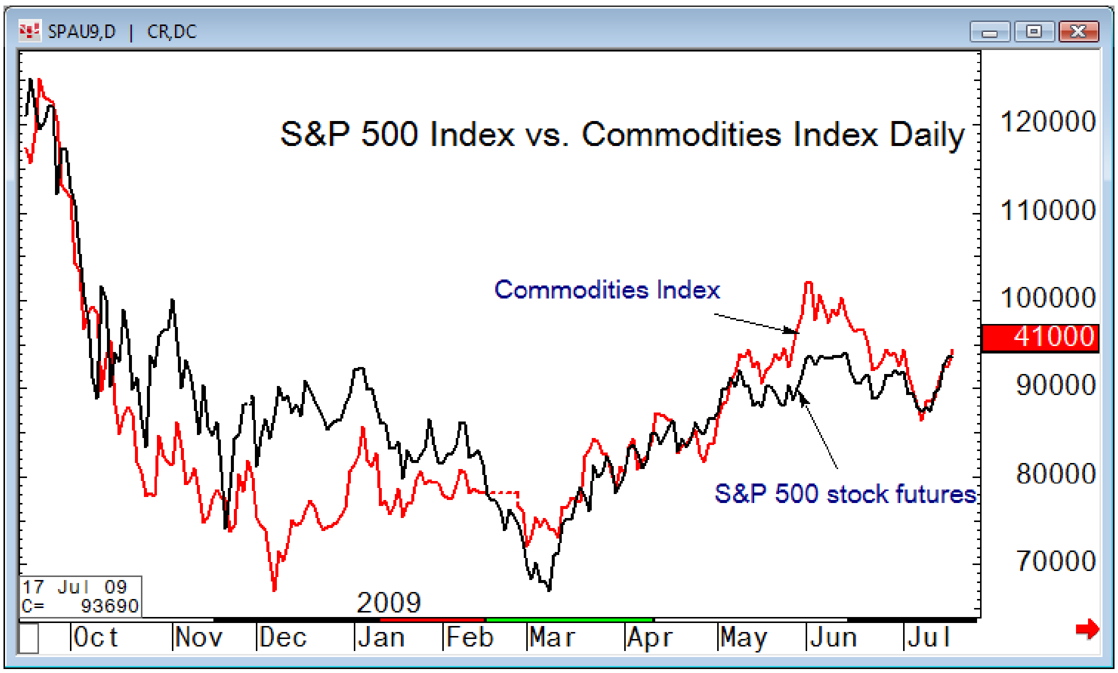
If we have learned one thing over the many years following markets it is this: If you are paying attention, there are always many more questions than answers. And if you are highly confident about future price action, you have either never traded real money or you haven't a clue. The best it seems one can do is build a scenario based on some form of analysis that has worked in the past, and then pull the trigger on a trade.

I was graciously invited to speak at the Agora Financial conference in Vancouver this week (my invite is a mystery to me too). It is a very good conference, no doubt. And there are is a very interesting mix of speakers: it contains seasoned vets who have fallen on their swords a time or two, and the usual newsletter gurus who pretend to trade. The gurus are usually quite easy to spot—they are highly confident about their ability to predict the future down to the most precise detail. Either way, there is much to be learned.

In the world of investing, I think it's healthy to believe questions trump answers. But unfortunately in the end we must boil the trading decision down to a yes or no…in or out, long or short, hedged or one-way bet. It just seems unusually hard to boil it down now, as questions not only trump, but seem to overwhelm answers that provide trigger pulling confidence one is seeking…

News about the debt backdrop facing the US seems to be lurching from bad to worse, thanks primarily to a government that seems to think its job is to replace private deleveraging (the activity usually associated with market cleansing and preparation for fresh new strong economic growth) with public debt in its role as "global stimulator of last resort." Dollar demise on this alone makes sense.

But, how is it stocks can rally into such dire news? Why are commodities rallying while demand from the world's biggest economy still seems in the tank and on a course for Armageddon?



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Two points:

1) Markets discount and it doesn't matter what we think about the fundamentals now or what our forecast may be, the price is the price and that's it. This is why Bill Dunn, one of the most successful commodities trading advisors alive has always followed a trend trading model. As smart as Mr. Dunn is, he admits he can't forecast the future so why try. All he does is "ride the bucking bronco" he says. And it's why we have developed our own trend following model for our managed money side of the fence, and said model will be integrated more into everything we do for our Members at Black Swan Capital.

2) Markets can exhibit degrees of rationality and irrationality, and these periods can last longer than we think. To paraphrase Keynes, markets can remain irrational longer than we can remain solvent.

In short, the fundamentals, or various interpretations of the fundamentals, don't matter till they matter. I agree with Soros that markets at the core are simply boom-bust cycles that move in self-reinforcing trends based on the flawed expectations of people who move money that move markets. In short, market prices are always irrational or flawed to some degree all the time. Which goes to the heart of economics that says markets are cleared by equilibrium, the price; but the reality is markets may tend toward equilibrium but never get there; otherwise there would be no exchange. As a buyer, I value something slightly more than the seller, therefore the exchange is made.

But what is interesting about the dollar perma bear camp (and granted interesting in another way for those of us who dare say good things about the buck on occasion), much of their premise is rooted in US economic demise. But if the US is taken out of the picture, the price of those things now driving the market lower will likely be demanded less, market price clearing will take place at a much lower price on those fundamentals alone, not to mention the potential self-feeding aspect.

So the next questions: Doesn't US demise denude the doom story and lead back to risk aversion story i.e. falling stocks and falling commodities, leading to a dollar risk bid at the expense of other currencies? The dollar cannot be bought and sold in isolation, it must be paired with something.

Can dollar perma bears have it both ways? Maybe, but it's a lot to ask for. And if the US is recovering, and corporate earnings are rebounding, then isn't it then a race between who rebounds first? China and other emerging markets are in the lead, no doubt. And it seems Australia by proximity and demand composition with commodities may be too; but what about our friends across the pond?

Even here there is "rational" justification to suggest the euro can continue to rally based on the fact the ECB has it under control, and will remove the punch bowl first? This rational expectation is of course predicted on the belief the ECB is not woefully behind the stimulus curve in the first place. But if they are behind the curve (evidenced rising unemployment in still rigid labor markets, falling productivity and increasing unhappiness among the core European Monetary Union countries—Greece, Spain, and Italy) then it is likely the US economy may arise from the recessionary ashes first. After all, the US went in first.

After the dollar beating yesterday, the market is flat this morning. The pound is down a bit on the debt news, but not much. Crystal balls are unusually cloudy now, but it seems a lot of bets have been placed nonetheless. Bets validated in any way can trigger powerful self-reinforcing trends; but those same bets can also set the stage for a big surprise.

Big Ben speaks today—will answers follow?

Jack Crooks
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