



Key News

- **The euro zone's dominant service sector grew at its fastest pace in two years** in November suggesting an economic recovery will continue in the fourth quarter, albeit at a slower rate, a key survey showed on Monday. (Reuters)
- [Thailand's economy showed a modest growth in the third quarter](#) as economic conditions at home and overseas slowly recovered, stoking enough confidence for the government to forecast a rebound in growth in 2010. (WSJ)
- [New Zealand consumer confidence declined](#) for the first time in five months in November. (Bloomberg)
- [Chicago Federal Reserve President Charles Evans expects U.S. unemployment to peak](#) at around 10.5 percent next spring. (Reuters)
- [Singapore's consumer prices fell](#) in October for a seventh month. (AP)

Quotable

"[T]he sanguine outlook embedded in US bond markets creates risks for central banks wishing to tighten policy ahead of the major central banks. Synchronised policy easing to fight off the Great Recession means that the world's central banks will also be tightening monetary policy in a cluster, much like cyclists in a peloton. The front riders in a peloton typically have more flexibility but also face stronger headwinds than the other riders, who are content to reduce their wind-drag by riding in the mass of the group. Early-hiking central banks, similarly, face the dual headwinds of currency appreciation and unresponsive asset markets since the latter have strong ties to their counterparts in the major economies. Low bond yields in the US and other major economies tend to put downward pressure on bond yields elsewhere in the world. Early-hiking central banks like the BoJ, the RBA and the Norges Bank, and later the RBI and the BoK, will likely find it difficult to raise long-term interest rates while bond yields in the major economics are priced for perfection...for now!"

Manoj Pradhan, Morgan Stanley

FX Trading – Regulatory Bank Cure – A Massive Unintended Fear Move to Gold?

John Ross wrote in a recent *Currency Currents* he didn't want to rip-off the Milk Board advertising campaign by asking if you've "Got Gold." But it appears more and more have "Got Gold." Yet another new high was chalked up this morning in white-hot yellow metal. This comes at a very bad time for me and may reflect a lot deeper systemic concerns than we now realize.

Long-timer readers have heard the story of my father in law, whom I love dearly (most of the time). My father-in-law (MFL) has held gold and silver for a long-time, as long as I have been dating his best asset—that is going on 34-years now. MFL has been known to hide buckets of coins and said precious metals in his walls at times, which should give

you an idea of just how much of a bug he is. MFL will be attending the Crooks Thanksgiving feast on Thursday, thus my problem now that gold has surged again into the ozone (as I remember many times I shared the view with MFL that gold would never get above \$1,000 again). Thursday will be a day of Turkey, football games, and “I told you so” gold investing gloating—rightfully so I guess. But, I can take solace anyway, as he loves his daughter, and gold is doing good things for his estate. ☺

That long winded entry was an attempt to make this point: I think the gold move now represents much more than a US dollar fear move. As we’ve pointed out before, gold in a massive new high, and yet the US dollar index has still not breached its old low (presently the \$ index is trading about 7% above its March 2008 low). The move in gold appears to be more systemic, especially when you factor in the potential for disruption in the things we used to consider risk-free—government bonds.

In a great piece from *Financial Times* writer and assistant editor Gillian Tett, “Could sovereign debt be the new subprime?” she writes [our emphasis]:

“[A]s policymakers rush to implement reforms in response to one financial calamity, they are apt to create distortions that pave the way for the next disaster. **Just such an unintended consequence could now be festering in the banking sector, as its balance sheets are increasingly stuffed with government bonds.**

“These days, there is a near-unanimous belief among western regulators that one way to prevent a repeat of the 2007-08 crisis is to stop banks taking crazy risks with subprime mortgage bonds or complex instruments such as collateralised debt obligations (CDOs). Instead, banks are being urged to hold a higher proportion of their assets in the form of ‘safe’ instruments, most notably sovereign or quasi-sovereign debt. G20 regulators are holding regular meetings in Basel to draw up rules on how banks should do this, as part of a wider reform of financial regulation.

“In theory, that move sounds very sensible. One reason why large banks crumbled last year was that many were carrying vast quantities of highly rated CDOs and other toxic paper. These not only lost their value during the crisis, but also became impossible to trade, creating a liquidity shock for the banks.

“Government bonds, by contrast, remained liquid during the recent crisis (and have been so in the past few decades). **So it appears appealing to hold more of them, particularly given that sovereign debt is also widely presumed to be ultra safe;** so safe that the yield on government bonds is known as the ‘risk-free rate’.

“**But could this flight to the ‘safety’ of government bonds in itself be creating subtle new dangers?** Government debt, after all, has soared to levels not seen in peacetime for centuries, if ever, in many countries, not least the US and UK.

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Fiscal deficits are swelling across the western world. And the level of political commitment to curbing those deficits remains uncertain – not least because with yields currently so low there is less pressure on politicians to push through reform.

In other words, **the bank regulatory cure which governments are so proud of is part and parcel to the massive global liquidity bubble being created.** Gee, unintended consequences flowing from governments who typically lag the real world by a massive degree? Now that's just shocking!!

Back to Gillian:

“Finance ministries are hardly likely to complain about the banks’ investments. **Major industrialised countries will need to sell more than \$12,000bn worth of government bonds this year and next to fund their fiscal hole. This is a rise of at least a third, or \$3,000bn, in just two years.**”

The government, thanks to its reform, has insured ready buyers for all its paper; this allows them to more easily paper-over the initial stimulus they created, with taxpayer money, which ended up to a large degree on the balance sheets of the same banks (thanks to the incentive of risk-free spread borrowing at zero and holding government paper at 3%) that will be buying more of the paper created to cover the holes created by the stimulus, which will be eventually plugged by more taxpayer money.

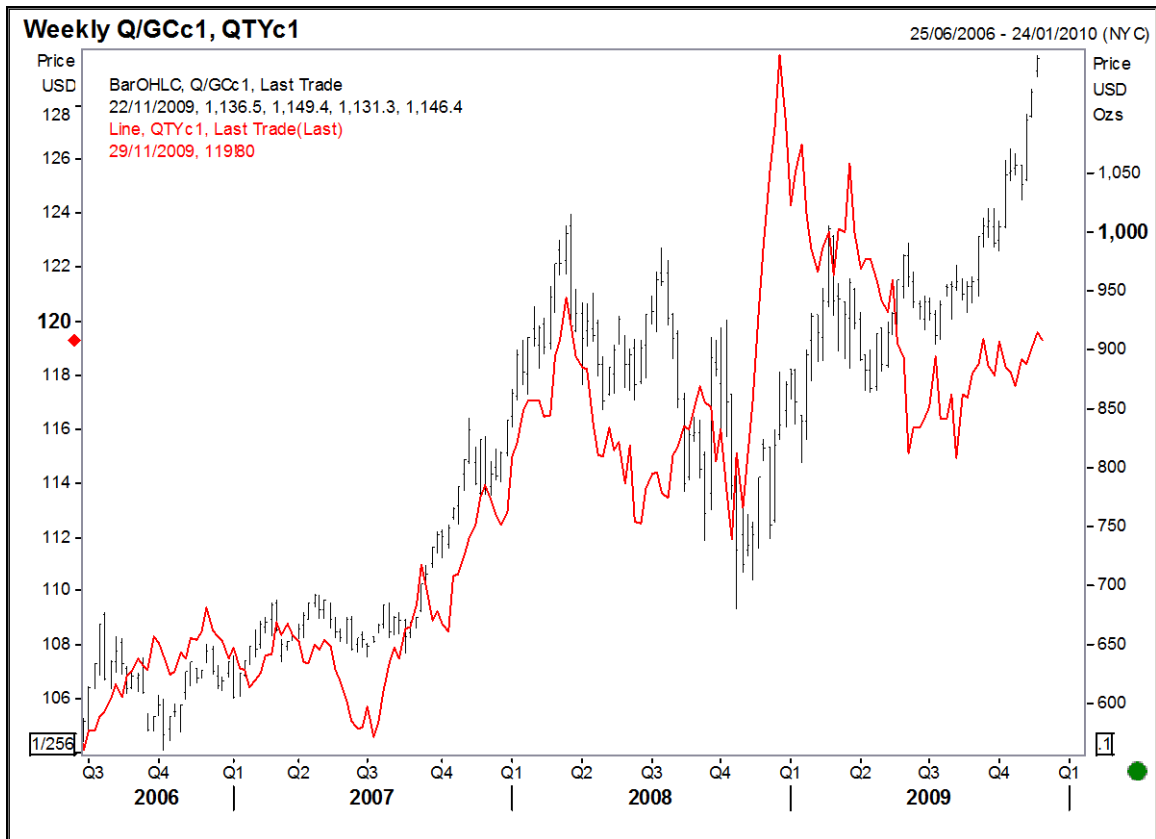
Convoluting? It's not hard to see why unintended consequences can flow from that sequence of blunders is it?

Credit default swaps (yet another invention from our Wall Street Frankenstein builders) are reflecting growing concern among sovereign debt of core European countries—Greece, Italy, Spain, Portugal (PIGS when put in the right order), add Ireland, Iceland, Eastern Europe, etc. Fitch has already warned the UK on debt and the possibility of a ratings downgrade. Japan now above 200% debt to GDP recently received a stern Fitch lecture. And of course, the risk-free or all standard risk-free credits, the US, can't continue to skate by given their massive fiscal irresponsibility consistently flowing from its policies.

Thus, if the risk-free rate, upon which a whole lot of financial theory and portfolio modeling is based, becomes in doubt, the game changes in a big way, and not a good way. A search for risk-free may come right back to the question: “Got gold.” I'm sure it's a question I will get on Thanksgiving Day.

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Gold (black) vs. US 10-yr Treasury Note prices (red) Weekly:



Happy Monday!

Jack Crooks

Black Swan Capital LLC www.blackswantrading.com

Long-term trends, major global economic issues, interviews with top traders, book reviews...

We do it all in our [Currency Investor](#) newsletter that's geared toward newcomers and experienced investors who are looking for a conservative approach to the foreign exchange market.

In our November issue, we published a great interview with former Olympic bobsledder, and now [FX trader/teacher extraordinaire, Mr. Chris Lori](#). He shared some incredible insights about trading and the currency markets with our readers. Thanks again Chris.

We also took a look at the key long-term wealth drivers for the emerging markets that will be in play for many years to come.

In plain language we deliver global macroeconomic analysis and actionable ideas geared toward exchange rate fluctuations.

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