



BLACK SWAN CAPITAL

Currency Currents

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Key News

- Industrial production in Japan dropped more sharply than expected in February; falling 2.1% from the prior month. (WSJ)
- Key reports due today (WSJ):
8:30a.m. **Fourth-Quarter Final GDP. Consensus: +4.0%. Previous: +3.8%.**

Quotable

“Ask a profitable investor to explain the reasons for his success; he will offer some deep and convincing interpretation of the results. Frequently, these delusions are intentional and deserve to bear the name ‘charlatanism.’”

Nassim Taleb, *Foiled by Randomness*

(Correction: I erroneously attributed yesterday's quote to Andy Xie of Morgan Stanley—it was a quote from Morgan's Stephen Roach.)

FX Trading

Is an accident waiting to happen?

“While it is impossible to pinpoint exactly how much investors, particularly hedge funds, have borrowed to squeeze out profits in a world characterized by extremely low yields, there are indications that it is in record territory.

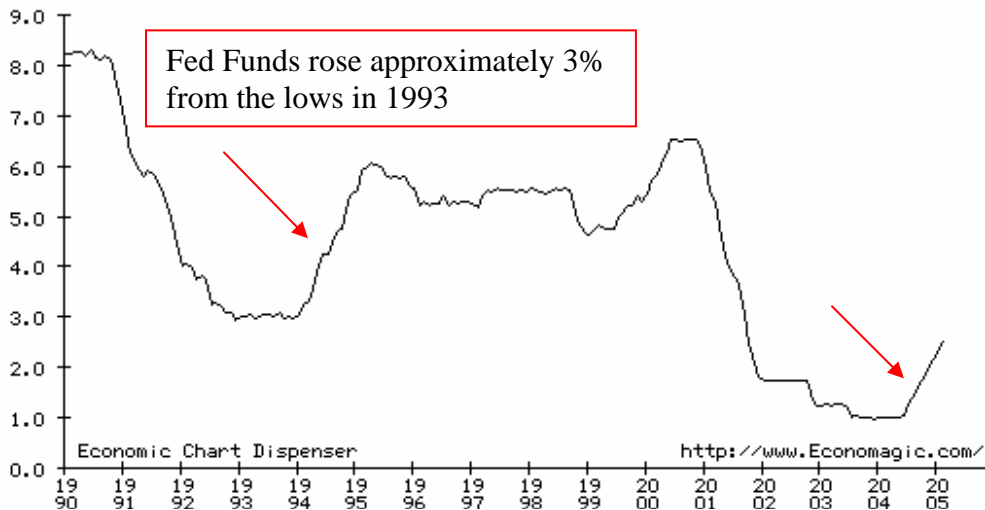
“Looking at the positions of primary dealers -- big banks that deal directly with the Federal Reserve -- Bianco Research notes that their net borrowing of bonds has soared in the past five years, above \$800 billion from approximately \$325 billion. Other indicators such as rising open interest in the 10-year and 30-year bond futures contracts also point to a highly leveraged marketplace,” writes Agnes T. Crane, in this morning's *Wall Street Journal*.

Many of the big funds are playing chicken with the Fed. Though they are concerned about rising rates, they don't think Mr. Greenspan and Co. have the intestinal fortitude to push rates high knowing the financial system is so highly leveraged. Don't bet on it.

“**Booms and busts are not symmetrical** because, at the inception of a boom, both the volume of credit and the value of collateral are at a minimum; at the time of the bust, both are at a maximum. But there is another factor at play. The liquidation of loans takes time; the faster it has to be accomplished, the greater the effect on the value of collateral. **In a bust, the reflexive interaction between loans and collateral becomes compressed within a very short time frame** and the consequences can be catastrophic. It is the sudden liquidation of accumulated positions that gives a bust such a different shape from the preceding boom,” according to George Soros in this book *Alchemy of Finance*.

Haven't we seen this before? Think 1994!

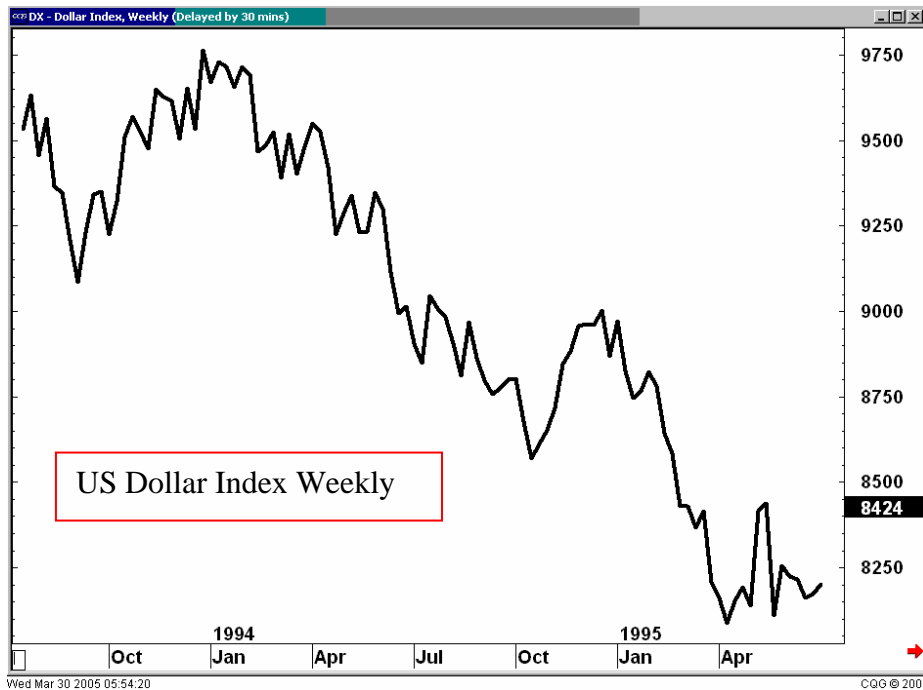
Federal Funds Rate



And a look at bond futures prices during 1994...



...and in case you're wondering, the dollar fell during 1994, bottoming in 1995, which began a 7-year rally...



Optimistically, we may be about half way through this process if we measure the peak in 30-year T-Bond futures prices from June 2003. But then again, there is that problem of an extra \$475 billion increase in net bond borrowings over the last five years, meaning there is much more to be “de-levered.” That could down even more than before.

Why do I think the dollar impact will be different this time if we see '94 again in the bond market? Because I believe there are bigger bets in the emerging market arena as institutions and individuals have stretched for yield. A break in long-bond prices could mean much of that money comes rushing back to US shores in the form of short-term deposits—very hot money at the margin, if you will. This could be a major net positive for the buck.

Jack Crooks