Black Swan Capital
Currency Currents

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Quotable

"I've learned many things from him [Soros], but perhaps the most significant is that it's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong."

Stanley Druckenmiller

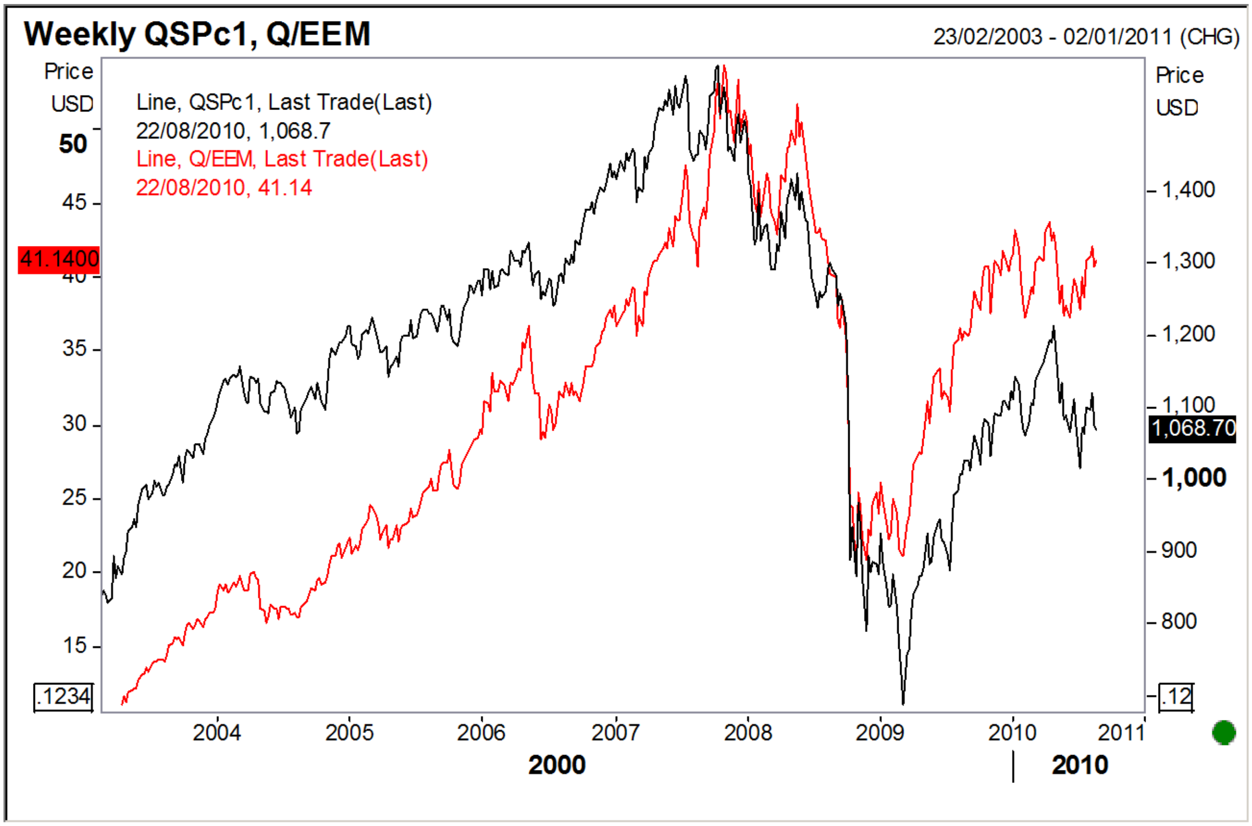
FX Trading - **Does any of this sound familiar?**

I read with interest the decision by Stanley Druckenmiller to close his global macro hedge fund. The guy was good—very good. He quietly went about his business of thinking about how the world works and positioning in front of capital flows—in or out—and got it right most of the time. It is easier said than done and, in his remarks describing why he was ending it, it was clear he spent much time working and not so much playing precisely because this stuff isn't easy; and to be as good as he was for so many years ... it's more than luck. It is hard work being open to what the market is really telling us. But a deep understanding of global capital flow from the top down seems the key to his success. We try to mimic that here as it relates to currencies.

I share that to share this: Last Saturday I visited my outlaws—mother-in-law and father-in-law. Yes, the aforementioned gold bug father-in-law. Despite my jabs at his bug status, my father-in-law is a seasoned and savvy investor who has seen most of this stuff before. He said to me last Saturday: "I get a kick out of these fund managers who show up on CNBC or Bloomberg and tell us they are really long-term bulls, but short-term we are a bit concerned and blah…blah…blah…", in effect constantly hedging themselves so they can be right both ways. Nothing new there if you've watched these guys; but what is funny, is that I tuned into CNBC yesterday afternoon, for some unknown reason, and they had emerging market analysts telling us how much they loved emerging markets … cash flow, P/E's, growth, China ... the usual stuff. But the funny part was one of them said exactly—I mean exactly—what my father in law said on Saturday.

Okay, now to the point. What is interesting about the emerging market analysts is they actually believe it is their bottom-up analysis and deep insights into balance sheets and annual reports and stuff like that which makes them successful. And I guess that has to be part of the shtick. I am sure Druckenmiller never saw it that way. He likely understood clearly that emerging market investment was about the liquidity flow model, plain and simple.

S&P 500 Index (black) versus Emerging Market Index (red) Weekly: It would be easier to find Waldo than it would to finding the decoupling in the series below.



Can you enhance return by being in the right emerging market company? Yes, absolutely. But emerging market stock analysts seem to think local factors are the biggest determinant of return. But the primary meat of return is liquidity flow from the center. This is the core of the decoupling debate. The EM guys, now with lots of ammunition now that China is the big dog, cheerlead for decoupling as reality; but Mr. Market has continued to show us otherwise for a very long time, through many global booms and busts going back hundreds of years.

Professor Michael Pettis summed up the liquidity flow model, what we refer to as the center to the periphery model, very well in his book, *The Volatility Machine*:

The expansion sequence (this should sound very familiar to all of us), we have added our comments to each in brackets based on our view of the most recent cycle—the credit crunch:

1. A banking innovation or other changes in financial structure in a capital center causes an expansion in the money base. Bank lending to local borrowers increases. [Greenspan pressing Fed Funds interest rate to 1%; major recycling of credit into US capital markets a la the symbiotic relationship between the US and China]
2. A period of economic growth and asset price growth follows. [The chart of the S&P above rocketed higher from this liquidity juice; that seems very clear.]
3. Asset price growth and the easy availability of money causes an increase in investor risk appetite, and investment behavior becomes speculative. [Bingo! Do you remember the term "Greenspan put?"]

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4. Some event turns attention to international loans, and the market for international lending takes off. [Chinese growth and the creation of the derivatives monster sold to everyone everywhere all the time—Peoria Public Schools to Swedish Garbage Workers Union.]

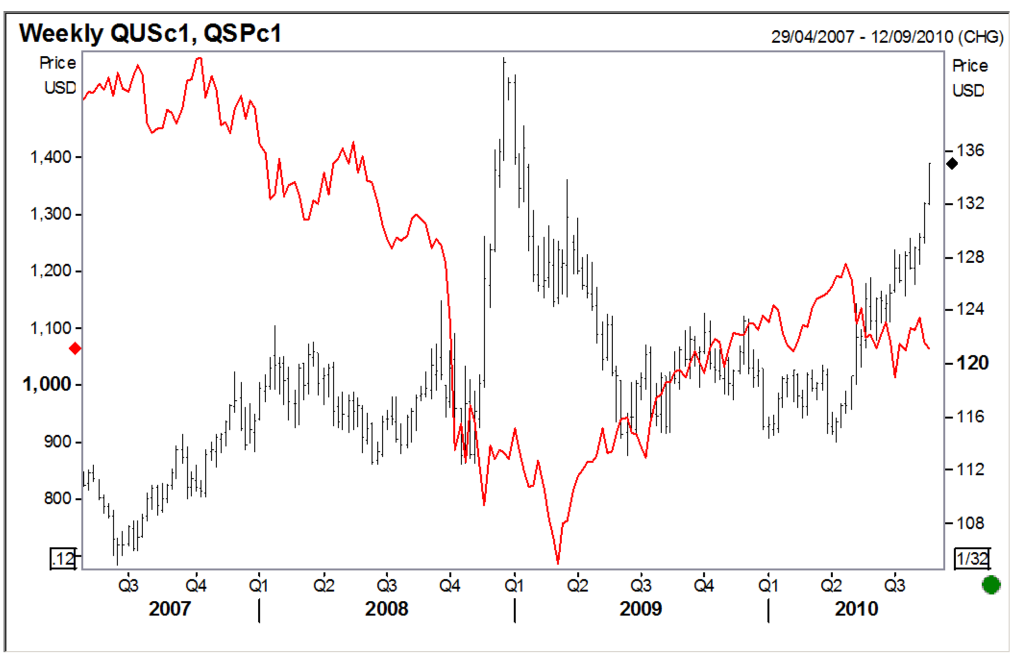
This pattern has about a 200-year history. But of course, it was "different" this time precisely because we now have China. Hmmm….

Now let's look at Doctor P's major trigger for financial crisis and see if we recognize anything familiar here [our comments in brackets as hint]:

> "Long-term liquidity contractions…These periods, such as those of 1870s, the 1930s, and the 1980s, in which rich country financial centers undergo a long-term and severe contraction of liquidity. In these cases, the reversal of the rapid liquidity expansion that had taken place over the previous years causes an increase in real interest rates [deflation] and a long-term reduction in the availability of risk capital [net deleveraging]. Sovereign borrowers that are unable to service their obligations without high export revenues [Germany and China sucking the wind out of others, but Mr. US Consumer back in the shell means exports won't be there to be had] and refinancing ease typical of the liquidity expansion years can be forced into defaults and restructuring [can you say Greece and Spain and Ireland and Hungary and…]. These are the crises that are generally referred to as global debt crises since the refinancing pressure affects all high-risk assets and borrowers."

And of course, the deleveraging means money runs back to the center, as in a gargantuan US bond market rally type of thing.

One more chart…**S&P 500 (red) and 30-year US Treasury Futures (black) weekly**:



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Can you say mirror image? If you can, that is all you need to know. It's the liquidity flow model of the world in play.

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