



## **Quotable**

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“If Ben goes wacko in Jacko, could stocks spike like the Grand Teton?”

Peter Eavis, *The Wall Street Journal*

## **FX Trading – To QE2 or Not to QE2, That is the Question ...**

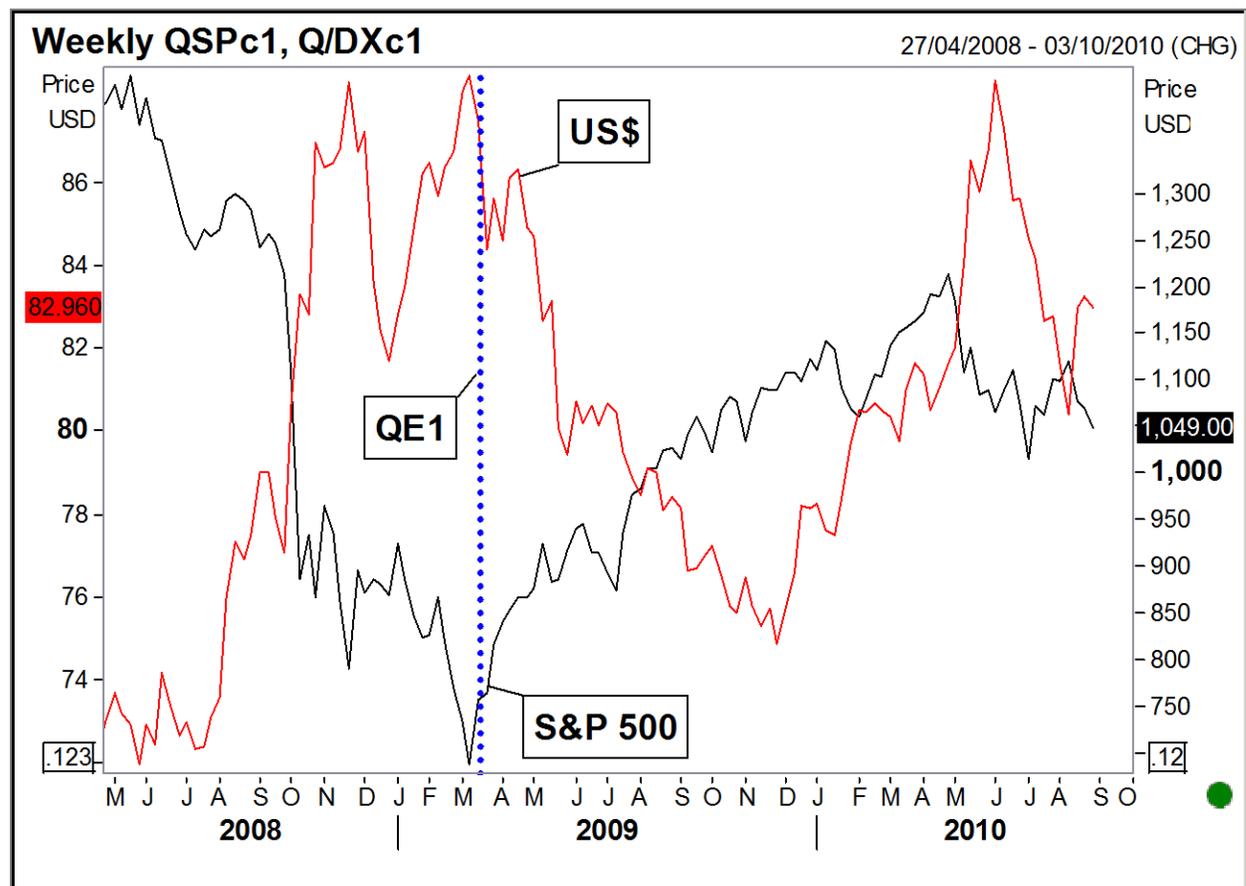
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Dong, dong, dong....as the hour of Big Ben’s speech this morning from Jackson Hole approaches, bets are being lined up as whether Mr. Bernanke will indeed rev up his helicopter for yet another strategic drop...

Action: Mr. Bernanke says yes, the Fed will embark on quantitative easing #2 (QE2).

### Reaction #1:

1. The **dollar get’s whacked hard**, as it did when the Fed embarked on QE1 back in March of 2009, thanks to falling US yield differential and larger supply of dollars on the market
2. **Stocks rally sharply on all the new liquidity** that will be used to bid up financial assets, knowing very little will likely leak out into the real economy anytime soon.



**Reaction #2:** My gosh! Is it really that dire? We really are in the soup. QE1 didn't work, and that was with the support of a massive fiscal stimulus to boot. What's the incentive to borrow and lend no matter how many more bank reserves are created. It's not real money until it gets into the real economy. Thus, this move will not keep us from tipping into deflation, which will only push consumers deeper into their respective shells and provide yet another disincentive for companies to invest or hire new employees.

1. Stocks tumble on the realization current earnings expectations are way out of whack.
2. Dollar support on the good old risk aversion trade.

Of course, Mr. Bernanke could say that yes we still have QE2 as ammunition in our arsenal, but we see no reason to use it now. Interest rates are already low, the credit market is functioning just fine, though the latest data has been soft -- we believe things are improving globally and there is very little chance of a double-dip recession. Germany is rebounding nicely and though China is slowing a bit, there is still brisk demand flowing from Asia and other emerging markets. Japan is hurting, but we expect new easing measures there will help boost growth and support the global recovery. Jobs growth has been disappointing, but recently we have witnessed job growth at the state level for the first time in a while, we think this is proof both monetary and fiscal policy, which always work with a lag, are now finally starting to

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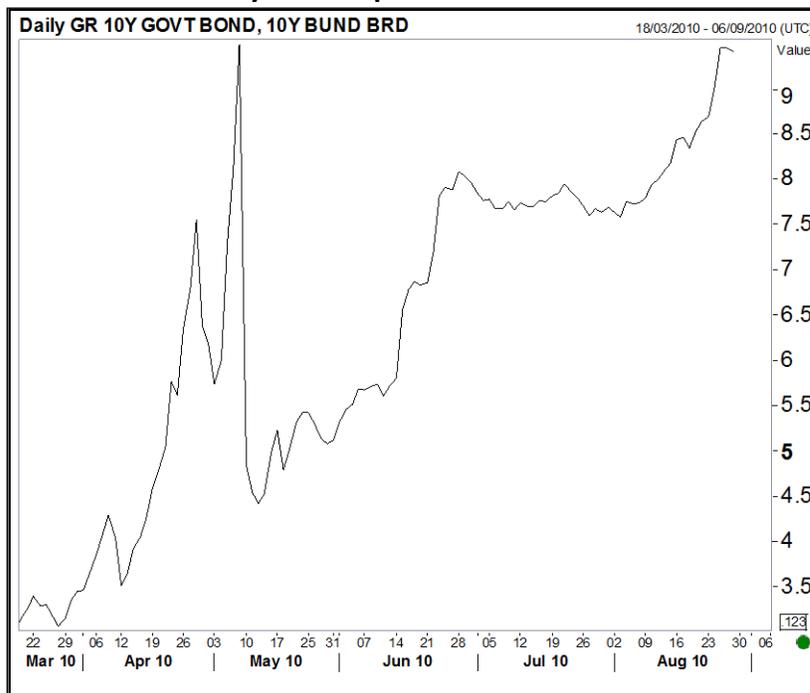
impact the real economy. Once that realization sets in, we think consumer sentiment will improve and in time lead to a self-reinforcing recovery, albeit below capacity. In this context, we see no reason for dire measures and will continue to support the market with low interest rates and provide all the liquidity needed to the market here and abroad.

1. Stocks rally on a shot of confidence building and assured liquidity backdrop.
2. The dollar gets hit, as commodity currencies lead the charge higher, with the European pack following.

Then there are the extenuating circumstances to deal with:

1. Yield spreads blowing out in Greece relative to German bonds tells us all is not well in the heart of single currency land.

### Greek-German 10-yr Bond Spread:



2. Possible intervention by the Bank of Japan in an attempt to weaken the yen, which recently surged to a 15-year high. Interesting note too, that long bonds prices in Japan fell sharply, on “fiscal” concerns. If bad news in Japan hits their bonds, then it may finally start feeding into the yen i.e. the catalyst some major weakening. But we need plenty more confirmation of that.

TOKYO, Aug 27 (Reuters) - Japanese government bonds plunged and the yield curve steepened sharply on Friday as superlongs crumbled on selling by banks, with fiscal

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worries re-emerging on concerns that a ruling party leadership vote planned for next month could dent the government's stance on fiscal austerity. Tokyo's Nikkei stock average gained 1 percent amid talk that some investors shifted money away from debt and into stocks.

3. China growth. China is pulling the global wagon and many corporate earnings are predicated on keeping the momentum there going. Risks are rising.

BEIJING (Wall Street Journal)—China's big banks are starting to cut back lending to local-government projects, walking a delicate line between addressing risks to the financial system and keeping up the flow of money to the infrastructure boom that supports the nation's economy.

The willingness of local governments to borrow—through off-budget companies they set up—and build public-works projects helped power China through the global financial crisis. But regulators have warned that loose standards for all this off-the-books borrowing will end up generating bad debts and have been tightening the rules in recent months.

...Yet even after the banks have been cleaned up, the massive expansion they have funded of these government-sponsored companies could continue to have effects on China's economy. Mr. Naughton said that is likely to result in more of the resources of the economy flowing into state-owned companies rather than the pockets of consumers—the opposite of the government's professed desire to boost household incomes.

You know the upshot: China will likely continue to be highly dependent on Western demand; and there is rising concern that demand could crater a la the double-dip.

Well, those are just a few of the things to think about; the permutations are virtually endless. I guess that is why they call it a market.

Happy Friday! And be careful out there.

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## **Leading the Way through Lower Highs, Lower Lows: An Opportunity!**

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You're probably well aware of the correlation between major asset classes by now. And that goes to the same risk-on, risk-off trading theme that's been driving capital flow.

The rally in stock markets through the month of July meant a similar rally in currencies, at the dollar's expense. We called the beginning of the correction back in June when we alerted our Currency Investor members to exit a position that profited from a weaker euro. That trade netted a very nice gain. Since then we've been waiting for signals that the correction has come to an end, that the euro would resume its decline. We seem to have reached that point.

Sentiment has shifted back into bearish territory ... and the major global risks have not been addressed to any meaningful extent. A new, deep move lower in the euro could be triggered by a coming collapse in stocks. A failed test on the S&P 500 of critical resistance has been followed by a lower low and a lower high – the markings of a downtrend in the making. Will you be ready to play it? Will you know how?

[Currency Investor.](#)

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