

# Currency Currents

Friday 27 Jul 2007 7:28 a.m. EDT

## Key News

- **In the credit-derivatives markets, the rising cost of credit protection** for Bear Stearns Cos., Lehman Brothers Holdings Inc., Goldman Sachs Group Inc. and Merrill Lynch & Co., among others, coupled with declines in their respective stocks, reflect investors' concerns that banks and brokers are at risk of potential big losses. That's because Wall Street could be left holding the bag on billions of dollars of debt-laden corporate deals at a time when bad bets on risky home loans are already putting a crimp on earnings and business in the banks' mortgage units. (WSJ)
- Shares take a hit and emerging Asian currencies tumble amid a flight from risky credits and fears about banks' growing exposure to leveraged buy-out debts. (FT)
- **Blackstone's stock** declined yesterday to \$25.70, 17 percent below the initial public offering price of June 21, making it the worst-performing IPO this year for U.S. companies that raised more than \$500 million. (Bloomberg)

## Key Reports

**8:30a.m. 2Q GDP, advance.** Expected: +3.2%. Previous: +0.7%.

**10:00a.m. End-July Reuters/U Of Mich Sentiment Index.** Expected: 91.2. Previous: 92.4.

## Quotable

---

Some in clandestine companies combine;  
Erect new stocks to trade beyond the line;  
With air and empty names beguile the town,  
And raise new credits first, then cry 'em down;  
Divide the empty nothing into shares,  
And set the crowd together by the ears.

—Defoe

## FX Trading – How do you spell contagion? d-e-r-i-v-a-t-i-v-e-s

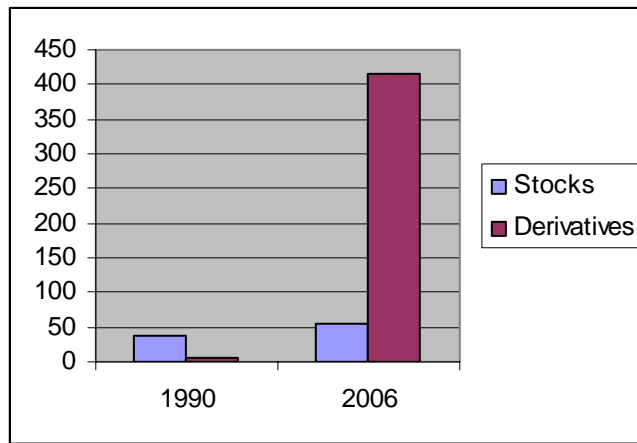
How many times did we here over the last several months this comforting phrase from analysts and credit market cheerleaders including our own illustrious Fed: “Oh, don't worry, the subprime problem is isolated to the US. And even there, subprime represents only a minor piece of the total credit market.”

Talk about talking your book!

In real markets, with real leverage, with real people motivated by fear and greed, with \$415 trillion or so in derivatives value, AND 3,000 hedge fund “masters of the universe” running rampant with real money, one should NEVER be complacent.

Total world stock market capitalization was about \$37 trillion in 1990; it grew to about \$51.225 trillion in March 2007. According to Morgan Stanley, the total world nominal value of derivatives stood at around \$5.7 trillion in 1990; it grew to \$415 trillion at the end of 2006. Here's what that looks like on a standard bar chart:

**Currency Currents** is strictly an informational publication and does not provide individual, customized investment advice. The money you allocate to options should be strictly the money you can afford to risk. While every effort is made to evaluate the actual experience of subscribers, all performance figures must be considered hypothetical, and past results are no guarantee of future performance.



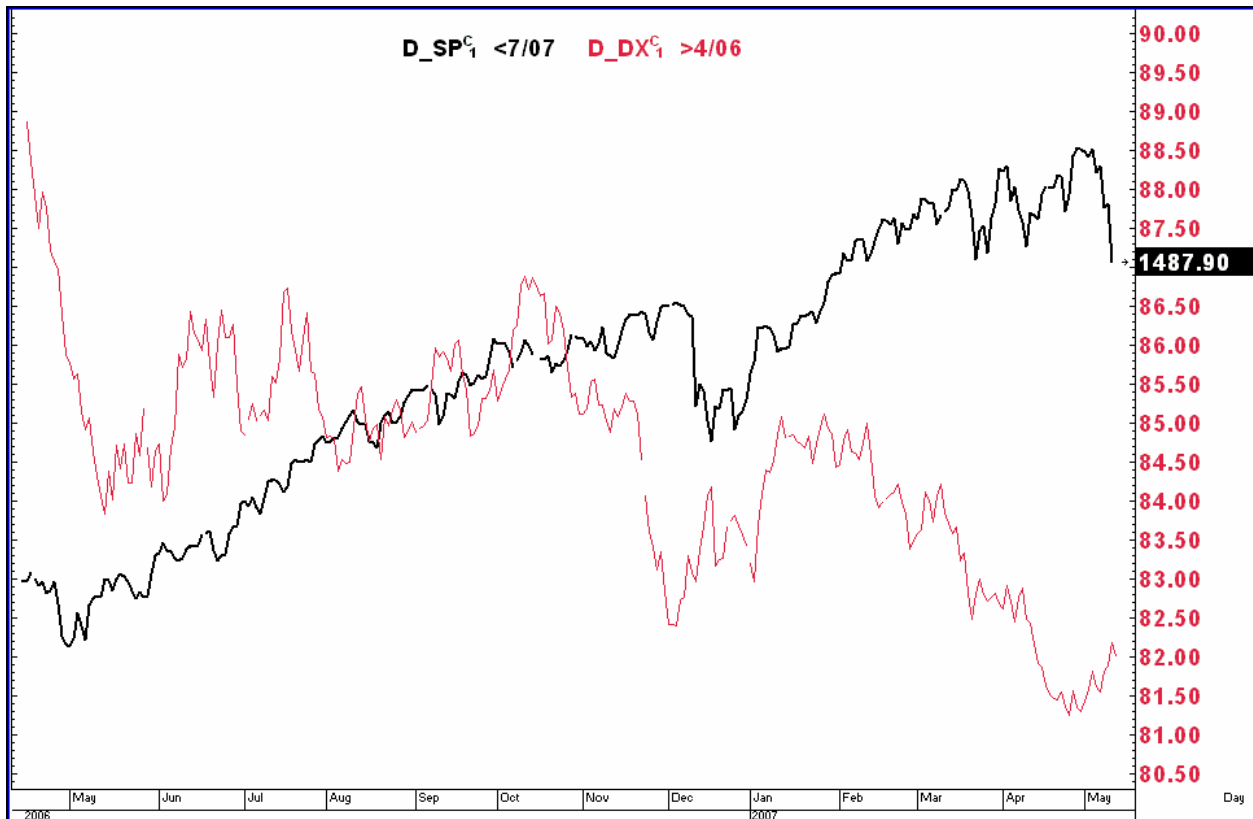
Doing the math, it means the \$ value of derivatives are about 8 times larger than stocks now, whereas in 1990 stocks were 6.5 times larger than derivatives. Hmmm!

Implications/guesses/comments:

- 1) There are too many derivatives in the world
- 2) The parceling out of those derivatives into smaller bundles for all to play the game doesn't seem to be reducing risks as "experts" expected.
- 3) They have never faced a serious test in this cycle
- 4) They have become increasingly complicated to price
- 5) Ratings agencies (S&P and Moody's) preferred fees to due diligence
- 6) Private equity is more interlinked to derivatives than most realize
- 7) Stress testing a derivatives portfolio can be tricky if you don't know whether or not the counterparty (maybe one of the 3,000 hedge funds) will be in business
- 8) One wonders why stock prices aren't a lot higher given that massive amount of leverage i.e. liquidity manufactured across the globe
- 9) Tied to point #7: It sets the stage for a massive global deflation, though everyone seems to think inflation is the problem. (If we accept that inflation is too much money chasing too few goods, then why isn't it higher with so much money generated since 1990? Maybe the massive deflationary pump of billions of new labor market entrants and overcapacity is stronger than experts realize.) A debt default is deflationary. And it leads to forced savings, which adds deflationary pressures in a world driven by "drunken sailor spending."
- 10) There could be much, much further to go "on the downside" as funds rush for the rapidly narrowing exits.
- 11) We want to pull the cover over our heads and go back to bed when we contemplate the potential for a real market cleansing. We use the words "real market cleansing" because we think the relative stimulus from central banks through rate cutting, in a world where \$415 trillion in credit craters, ain't going to have much impact.

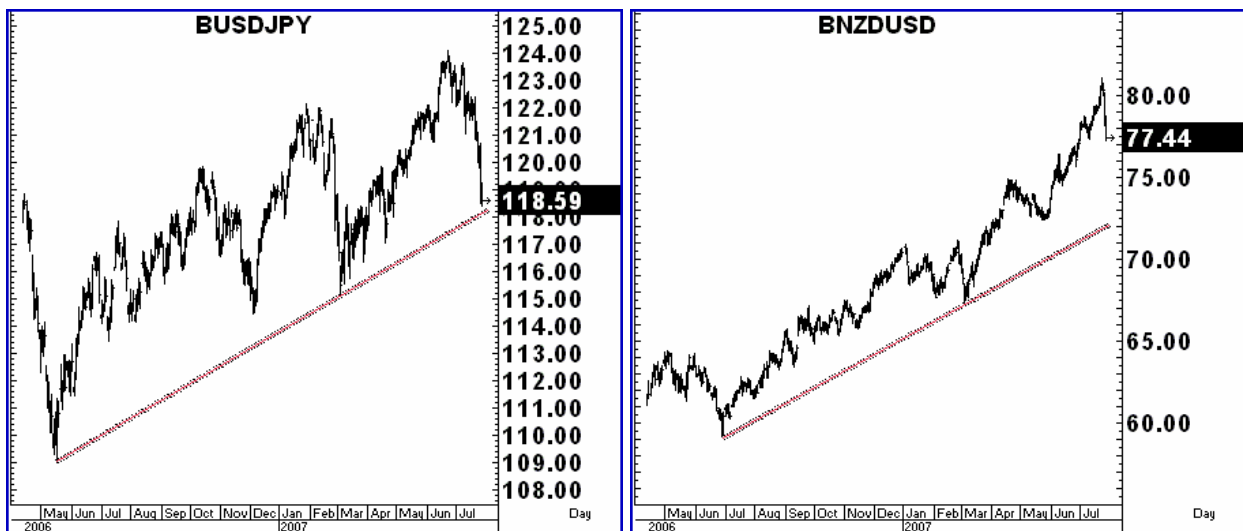
So, if your friend turns to you today, or anytime in the near future, and says this: "You know something, there are going to be some real bargains in the market soon!"—we suggest its time to find a new friend.

Below is a chart of the S&P 500 index (black) vs. US\$ Index (hot pink). If the dollar catches the mother of all safe haven bids, as the wall of real money assets invested outside the US comes crashing back, this gap could shrink dramatically...



It doesn't matter that the warts are growing in the US causing this problem. What matters is where the money goes. So, if short-term treasury paper becomes the recipient of relatively more of the money running for hiding places, the dollar goes higher—simple as that we think.

And of course, we finally are witnessing some unwinding of the ubiquitous yen carry trade. Our favorite play in the unwinding world is short NZDJPY. Below \$-yen and NZ\$-\$ charts going back to Mar '06:



Contagion is a powerful thing—it triggers fear. And when fear flows, the idea of the “rational man” vanishes and self-preservation moves back to the top of the list.

On that lovely note, be careful out there and try to enjoy your weekend.

**Currency Currents** is strictly an informational publication and does not provide individual, customized investment advice. The money you allocate to options should be strictly the money you can afford to risk. While every effort is made to evaluate the actual experience of subscribers, all performance figures must be considered hypothetical, and past results are no guarantee of future performance.

Jack Crooks  
Black Swan Capital

**Currency Currents** is strictly an informational publication and does not provide individual, customized investment advice. The money you allocate to options should be strictly the money you can afford to risk. While every effort is made to evaluate the actual experience of subscribers, all performance figures must be considered hypothetical, and past results are no guarantee of future performance.