

Strategies, analysis, and news for FX traders

CURRENCY TRADER

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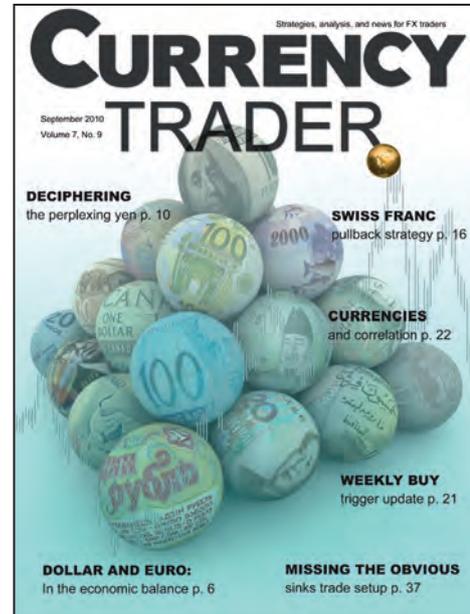
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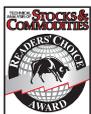
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Will sputtering U.S. economy torpedo the dollar?

The bloom recently came off the U.S. economic rose, but the implications for the dollar are mixed. Meanwhile, the Euro has its own problems.

BY CURRENCY TRADER STAFF

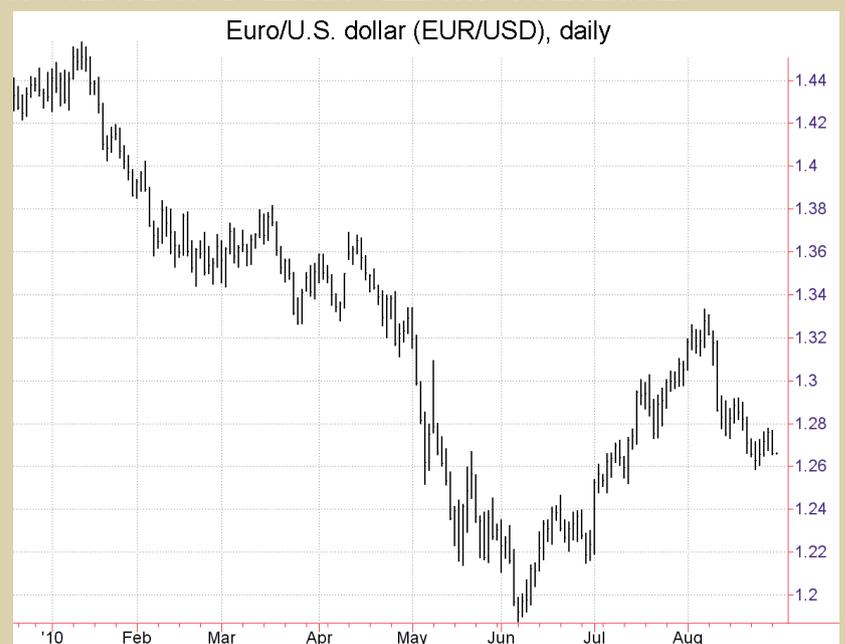
After racking up nearly six months of steady gains, the U.S. dollar tumbled vs. the Euro between early June and early August, with the Euro/U.S. dollar pair (EUR/USD) jumping 12 percent from a low of \$1.1876 to a high of \$1.3333 before pulling back (Figure 1). Several factors drove the move, including shifting economic growth perceptions and decreased anxiety over the Eurozone's sovereign-debt issues. In addition, analysts generally agree the EUR/USD pair was just plain oversold after the Dec. 2009 to June 2010 21-percent sell-off move from \$1.5100.

Over the summer new views emerged on the U.S. economy and the stance of the U.S. Federal Reserve. In late 2009 and early 2010, some Fed watchers had expected the central bank to hike interest rates in the second half of 2010, but now those expectations have generally been pushed forward another 12 months into the second half of 2011. A spate of unexpectedly poor economic news has emerged from the U.S., fueling speculation the second-quarter U.S. gross domestic product (GDP) figure will be revised lower.

Let's take a look at recent U.S. data — where the rough patches are and why they have emerged. Also, what are analysts saying about the Fed's and U.S. government's reaction to the slowdown? What, if anything, could be done to revive the sputtering economy?

And, finally, what does it all mean for the U.S. dollar? Where do trading opportunities lie in the final months of 2010 and what are the most important currency pairs traders need to watch?

FIGURE 1: EURO/DOLLAR: PULLBACK OR REVERSAL?



The plunge in the Euro vs. the dollar in 2010 ended in early June when concerns about European sovereign debt eased and favorable U.S. economic news began drying up.

Source: TradeStation

Shifting economic perceptions

Economists generally agree U.S. economic growth in Q4 2009 and Q1 2010 was inflated by the massive fiscal stimulus program, along with a surge in home sales partially driven by the now-expired tax credit for home buyers. Economic numbers were also buffered by factors such as the decennial census, which helped keep employment numbers from worsening — at least on the surface.

More recently, the bloom has definitely come off the economic rose.

"We've seen bad data in most of the [economic] series," says David Wyss, chief economist at Standard & Poor's. "We saw rising unemployment claims up to 500,000 in the latest week (Aug. 12). It suggests that we are losing the impetus we had."

The advance second quarter GDP reading was respectable at 2.4 percent, but most analysts now expect the actual number to come in much lower.

"Second-quarter growth could be cut in half based on all the information that has been reported," warns Jonathan Basile, economist at Credit Suisse. His firm now forecasts a downward revision of the Q2 GDP number to 1.2 percent.

Wyss calls the current recovery a "half-speed" one. "It's much slower growth that you'd expect," he says. "Usually deep recessions are followed by strong recoveries."

He also notes the peak-to-trough decline in GDP of 4 percent in the latest recession was the "worst since 1946." Also, the total job loss of 8.4 million was "the biggest job loss since before World War II," he adds.

Continued uncertainty

A common theme economists sound these days is "uncertainty." To both consumers and businesses the future still feels uncomfortably unpredictable, which breeds caution and inaction.

Of Fed Chairman Ben Bernanke's mid-July testimony before Congress, David Resler, chief U.S. economist at Nomura, says: "He referred to the unusual uncertainties we face. That is acting as a barrier to hiring, business expansion and a healthy economy. Consumers have uncertainty over whether they will have a job, and there is uncertainty about the affects of large structural reforms that will affect business and health care costs. It is leading to an almost paralysis of motion."

Credit Suisse's Basile points to the pivotal role small businesses play in the U.S. economy. "Small business is the key to the jobs recovery," he says. "They've been faced with different types of uncertainty: What kind of regulation is going to come out of Washington? How high are taxes going to be? How high are health costs going to be? When there is doubt, they do nothing," he says, adding, "There really needs to be some sort of policy response to help the economy."

"The next six to nine months will be uncomfortable for the U.S. economy," Mark Zandi, chief economist at Moody's Economy.com wrote in his Aug. 16 U.S. Macro Outlook. "The recovery is losing momentum — not an atypical development for this point in the cycle, but a disconcerting one given a nearly double-digit unemployment rate and eroding confidence among many households, businesses and investors."

Like Basile, Zandi voices concern about the policy side of the equation.

"Even more worrisome, there is no obvious policy response if the recovery does falter," he says. "The Federal

Reserve has few tools beyond resuming [quantitative easing](#), which [previously] had limited success. And it is unclear what Congress and the administration could do to provide a sizable near-term fiscal boost to the economy."

Nomura's Resler is critical of the steps the government has already taken. "History will say one of the biggest blunders of this Administration was moving too fast on big structural changes on health care and financial reform when the economy was still fragile," he says. "You don't do those things when doing so will aggravate uncertainty."

He adds: "I don't know anyone who starts rebuilding the house after a fire when there are still embers burning in the house, and that's what we've done."

Another cause for concern is signs of slowing manufacturing, which previously had been a strong point for the U.S. economy. In August, the Philadelphia Fed Index showed an unexpected plunge of 7.7, which was the first time since July 2009 the manufacturing sector in the Philadelphia

Federal Reserve region contracted, according to Briefing.com.

Also, although the latest New York Fed manufacturing index showed a slight gain, it revealed orders are contracting, according to Basile.

"We are seeing signs of orders slowing in regional data," he says. "It could become a national story, and that's troubling because manufacturing has been strong." The orders index fell from 10.13 to -2.71.

Basile says that the ISM index (especially the new orders component) and jobless claims will be key numbers to monitor regarding the health of the recovery because "they are leading indicators."

Revised forecast

Wyss forecasts overall 2010 GDP growth in the U.S. at 2.8 percent, with 2011 slipping to 2.5 percent. Breaking it down on a quarter by quarter basis, Nomura's Resler expects the final second-quarter 2010 number to be revised down to 1.6 percent, third quarter to come in at 1.9 percent and fourth quarter at 2.2 percent.

"It's not bad, but is it good enough to gain traction in the labor market?" asks Credit Suisse's Basile. "The Administration has to find ways to encourage job creation. Something needs to be done, because doing nothing is not an option when it comes to jobs in this country."

And he sees little reason to wait. "If the patient is sick, why not give the medicine right away? If you get sicker, it is going to take longer for you to get better."

Wyss agrees the "U.S. needs to see some make-up growth," but he also notes the deficit quandary the government is in: "Baby Boomers are retiring; government spending is going to be going up, because of entitlement spending," he says. "The Federal government deficit is almost 10 percent of GDP and we don't have any real plan to get out of that mess."



What does it all add up to? “An extended period of sluggish growth,” Wyss says. “Don’t expect us to bounce back from this one. It requires changes in American behavior, which includes paying our own way. Also, major changes in fiscal policy are needed to get in balance, but also to prepare for the major wave of retiring Baby Boomers that are retiring,” he says.

Dollar action

The EUR/USD rally that began in early June coincided with data revealing the “U.S. economy had taken a turn for the worse,” says Michael Woolfolk, managing director at BNY Mellon.

“Through July, the soft patch in the U.S. economy has been playing the main role [in dollar weakness]. Also, Fed expectations have been pushed back,” adds Vassili Serebriakov, Wells Fargo currency strategist.

Forex.com chief currency strategy Brian Dolan points out the other side of the coin. “On the Euro side, it was a relief rally — short-covering as the worst fears of the sovereign debt crisis passed.”

On a longer-term basis, Wyss expects to see a bearish trend dominate the dollar. “The trade deficit is still too big,” he says. “Also, foreign countries are getting nervous about the percentage of assets held in dollars — primarily China, but OPEC countries are feeling nervous, too.”

Wyss’s less-than-rosy bottom line: “The dollar is going down in the long run. Take your vacation to Paris now.”

Aug. 8 marked a turning point in recent dollar action. The day marked a swing high on the daily EUR/USD chart and a renewed period of U.S. dollar strength as of late August.

Dolan refers to the \$1.3333 high scored on Aug. 8 as “a pretty significant reversal.” Looking ahead, he believes the level will stand as a “multi-month high” for the pair.

Dolan believes weaker-than-expected Eurozone economic numbers will keep pressure on the Euro. “The third quarter will see slower activity and the fourth quarter will likely see an even further slowing in European economic activity,” he says.

Another factor in the recent dollar rally was weakness in U.S. equities. The still-jittery financial system has not wholly shaken the reflex — ingrained so deeply in the 2008-2009 financial crisis — to pour funds into the dollar when equity market stumbles (Figure 2). What’s good for the stock market is bad for the dollar, and vice versa, Woolfolk notes.

“There has been a negative correlation between the Dow and the U.S. dollar and the yen,” he says. “While that negative correlation began to derail partially in July, it has come back into alignment, and we expect it to continue through Labor Day.”

Over the next several weeks to several months Serebriakov sees “a steady dollar against most majors,” but a “weaker dollar against commodity currencies and most emerging-market currencies.” He highlights the Australian, Canadian and New Zealand dollars, along with the Indian rupee, Korean won, Chilean peso, and Brazil real as currencies with potential to strengthen vs. the U.S. dollar.

“The dollar will not turn around until we have a strong U.S. economy and a stronger job market, and that probably won’t happen until next year,” he says. Serebriakov has a year-end target between \$1.2800-1.3200 for the Euro/dollar.

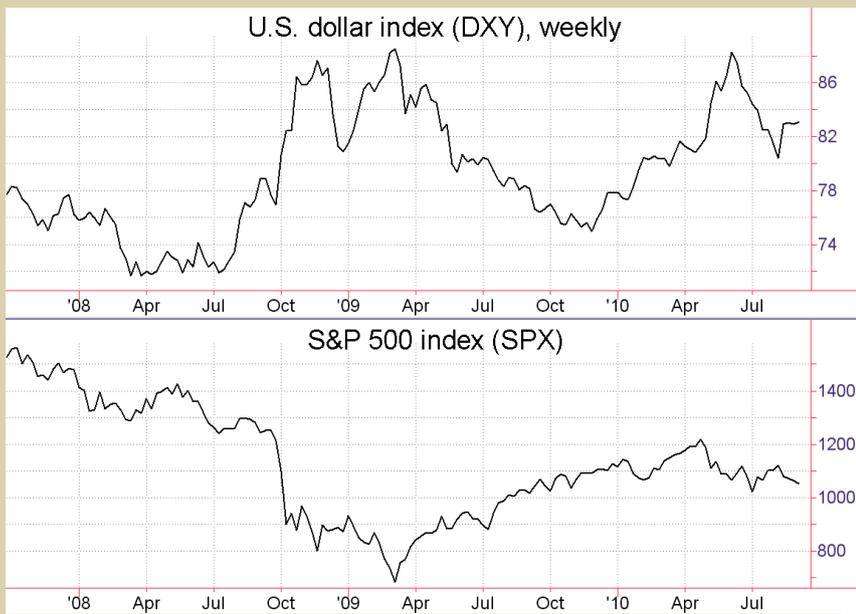
Dolan sees potential for additional U.S. dollar strength

vs. the Euro over the next several months — a view based more on Eurozone weakness than any bullish dollar fundamentals. He says a “withdrawal of fiscal stimulus and moves towards austerity measures” are factors likely to weigh on Eurozone growth prospects. Dolan believes a move down to \$1.1800/1.1500 is possible, with a year-end target around \$1.2200.

“Look to sell on remaining strength in the \$1.3000 area,” he says. Shorting the Euro against “higher-yielding and better-performing nations, such as Euro/Canada, Euro/Aussie, and Euro/Swiss,” is another possibility.

Woolfolk says “you aren’t going to be getting a great move on a buy-and-hold position [in the dollar].” He advises trading “in roughly the opposite direction of the stock market. During periods of extreme risk aversion, when the stock market would be sold — that’s the time to buy the U.S. dollar. When the stock market is rallying, sell the dollar vs. the Euro, sell the dollar vs. sterling Canada,” he says. ☐

FIGURE 2: U.S. STOCKS AND DOLLAR



Although the relationship broke down somewhat in late 2009 and the first half of 2010, the inverse correlation between U.S. stocks and the U.S. dollar showed evidence of strengthening in July and August.

Source: TradeStation

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The mystery of the rising yen

The most important lesson might be the about the prospects of the Brazilian real.

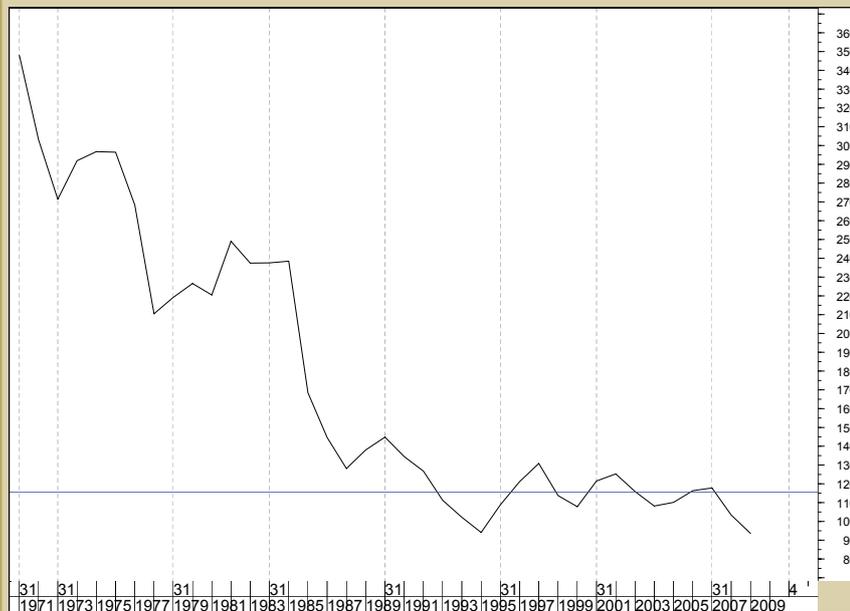
BY BARBARA ROCKEFELLER

Talk of the Japanese government intervening to halt the rising yen became increasingly heated as the summer of 2010 has progressed. Japanese politicians demanded official action to preserve export competitiveness (and the jobs of voters). Old hands will remember that from August 2003 to March 2004 the Japanese spent ¥35 trillion, or about \$316 billion, intervening to halt the rise of the yen. The threat, in other words, is not an empty one — and yet hardly any forex analysts expect outright intervention.

Why the yen is strong in the first place is quite a mys-

tery, especially since Japan's place in the world is undergoing a rapid change. In the second quarter of the year, China surpassed Japan as the second largest economy in the world. This says more about China than it says about Japan, but it is also noteworthy that the Japanese economy contracted 5 percent in 2009 and is expected to grow by only 1 percent or so in 2010. How far Japan has changed from the 1980s, when the Imperial Palace was worth more than California and every other book in the business section of the local bookstore was about how Japan Inc. would soon rule the world.

FIGURE 1: DOLLAR/YEN YEARLY AVERAGES 1971-2009



Although most of the yen's long-term appreciation vs. the dollar (shown here as a dollar/yen downtrend) occurred in the 1970s and 1980s, the yen is currently approaching its historic low of 79.75.

Source for all figures: Chart — Metastock; data — Reuters and eSignal

Yen history

The yen has been among the strongest currencies for two decades, despite Japan suffering a stock market crash from which it has never recovered, the lowest interest rates and the weakest GDP in the G7, and a demographic time bomb about to go off in the next three to five years. Now yen strength has reached a near-crisis level, already under the average of about ¥90 expected in the most recent quarterly Tankan survey of major manufacturers. Big Japanese corporations have hedged for that outcome, but not beyond it. They will experience losses if the yen reaches ¥85 or ¥80.

Figure 1 shows the dollar/yen's long-term downtrend since 1971, most of it occurring in the 1970s and 1980s and the yen sticking closer to 110 since 1990. Today, the consensus forecast is for the dollar/yen to slide below its historic low of 79.75 (from April 1, 1995), possibly

as low as 65 or 70. Figure 2 is a chart of monthly prices dating back to 1985, with two channels: one from the 1990 high and the heavier channel from the 1998 high. Neither channel goes much below 80 by year-end 2010, but traders are nonetheless willing to accept a forecast of 65 or 70 without raising an eyebrow.

Figure 3 shows the EUR/JPY, with the Euro “created” out of its legacy currencies for the years before it actually came into existence in 1999. Current forecasts have the EUR/JPY pair falling back below 100, having visited 88 almost 10 years ago in October 2000. Again, nobody raises an eyebrow.

Why is that true? If you reflect on the overall environment in Japan, it’s pretty grim. Domestic investors seek opportunities and yield elsewhere, while foreign investors are not thick on the ground in Japan. This suggests an oversupply of yen and a falling value, not a rising one. Offsetting the inferior return-on-capital is the classic balance-of-trade argument — that any country maintaining giant trade surpluses must have an overvalued currency. In the perfect world of economic modeling, that currency should rise to equilibrate trade. This sounds reasonable — except in practice, FX traders seldom respond to trade data. We’ll revisit this idea later, though.

One of a kind

Japan is unique. First, no country has ever experienced a stock market crash like Japan’s. The bursting of the Japanese stock market bubble at the end of 1989 cost the nation about \$16 trillion, or three times GDP. It set the stage not only for an imploding real estate bubble, a banking crisis, and ensuing deflation, but a mindset among Japanese citizens that the glory days — when Japan was poised to take

FIGURE 2: CHANNEL PROJECTIONS



The two price channels indicate the USD/JPY pair is unlikely to failing to trade much below 80 by year-end 2010.

FIGURE 3: MONTHLY EURO/YEN



Current forecasts have the EUR/JPY pair returning below 100, having traded as low as 88 in October 2000.

FIGURE 4: THE NIKKEI'S LONG ROAD DOWN


The Nikkei stock index has consistently made lower highs and lower lows since its 1989 crash. Despite the presence of world-class companies, foreign investors account for only about 26 percent ownership of total shares outstanding in Japan.

the Number One spot from the U.S. — are over and never to return. This has an effect on everything from politics to the decline of entrepreneurial activity and the falling birth-rate.

The Nikkei has consistently made lower highs and lower lows since the crash (Figure 4). A recent Merrill Lynch survey shows 27 percent of investment managers are underweight Japan, meaning their investment in Japanese equities is not proportionate to the size of the Japanese economy.

We can make three deductions. First, never has buy-and-hold been so soundly disproven. Second, aside from limited periods, Japanese savers who put money in equities have been on the losing end since the bubble burst. This encourages additional saving and a preference for safer hands, such as government bonds. Third, even the presence of world-class companies isn't enough to draw in global investors, who account for only about 26 percent ownership of total shares outstanding. To be fair, it's only about 12 percent foreign ownership in the U.S., but at the same time the U.S. equity market is far bigger, so the dollar amount is higher; also, the U.S. has a large number of foreign company listings while Japan has fewer all the time, despite efforts to lure listers.

The next big factor is the ongoing deflationary recession that started in 1992-93 when Japan was hit with a banking crisis, about three years after the 1989 stock market crash. Banks were bought by the government, merged with oth-

ers, and forced to change credit and other practices, including a breakup of too-cozy industrial-financial links. But since the crisis, bank lending has never risen much above an annual rate of 1 to 2 percent. This is evidence that when a financial crisis prods an economy into deleveraging, it can be a permanently slippery slope.

The 1990s were called the "lost decade" but really it's been a case of the lost double-decade. Core CPI has been negative every year since 1998. The broader measure, the GDP deflator, has averaged -1.2 percent since 2000. Japan is caught in a Keynesian liquidity trap. This is a society with a low propensity to consume and a high propensity to save, so traditional incentives, even giving consumers checks that must be spent before they expire, failed to boost spending. The classic anal-

ogy is "pushing on string," and thus the savings mentality became a structural impediment. This may be about to change.

On the horizon

In the effort to substitute government spending for household spending, Japan spent trillions on infrastructure and research subsidies, much of it wasteful, resulting in the biggest public debt of any developed country, equal to about 190 percent of GDP. Japan's debt has not been below 60 percent of GDP, the golden rule of the EMU's Stability Pact, since 1980. To be fair, most of the debt is shorter-term, averaging 5.2 years. Politically, the current government gained office in part because of promises to reduce the debt, a move that would be fatal to any country without such a giant population of savers (more than 90 percent of all Japanese government debt is held domestically).

But Japan may soon face a debt rollover problem of epic proportions. With a rapidly aging population and disposable real income flat or falling for more than a decade, Japan stopped being a country of savers. The household rate of savings has fallen from more than 11 percent in the early 1990s to only about 3.5 percent today. Yes, the U.S. savings rate now exceeds Japan's! One-quarter of Japan's population is above the age of 65 and the birthrate is one of the lowest in the world — only 1.37 per woman, or far under the 2.1 it takes to maintain a population level. As we know, immigration is negligible. Accordingly, as retirees

cash in, the pool of savers who demand government bonds is falling. The state pension fund, which is the biggest in the world, became a net seller of government bonds in 2009. Worse, about 70 percent of the social security budget goes to old-age pensions, and the number of persons in the workforce supporting the social security budget is falling from four retirees per worker in 2000 to two retirees per worker by 2025.

An ordinary country with debt at 190 percent of GDP would have to pay returns of 8-10 percent, like Greece, for example. Instead, Japan has the lowest rate of return of all the developed countries, only 0.1 percent on overnight money and 0.94 percent for the 10-year Japanese Government Bond (JGB), or 1.68 percent under the U.S. T-note rate. Capital continues to flow out of Japan seeking yield, with investment trusts (mutual funds) sending ¥2.8 trillion (about \$32.9 billion) abroad in January-June 2010, up 65 percent year-over-year, according to Reuters. Institutional investors are doing the same, with life insurers increasing holdings of foreign securities by ¥200 billion in January-July to ¥1.2 trillion.

But foreigners are buying more yen-denominated securities than Japanese are selling. Overseas investors bought ¥5.5 trillion in Japanese equities, bonds, and money market instruments in the January-July period. This includes Chinese purchases of about ¥1.7 trillion, far more than ¥255.7 billion the year before, and representing confirmed reserve diversification.

With yields so low, why are both private and public entities buying Japanese securities? A central reason has to be they believe in the ever-rising yen, too.

In the classic Economics 101 way, the traditional Japanese trade surplus suggests the yen is undervalued. In the crisis year of 2009 Japan experienced a trade deficit, but that was quickly reversed and, as of June 2010, the surplus widened 41.1 percent from a year earlier to ¥686.96 billion. Exports are typically in double-digit territory, with Asia (and especially China) supplanting the U.S. as the chief buyer. In June, while exports to the U.S. rose 21.1 percent to ¥914.5 billion and exports to Europe rose 9 percent to ¥611.2 billion, exports to Asia rose 32 percent to ¥3.30 trillion — more than double the U.S. and Europe combined. China alone took ¥1.1 trillion.

But a country that regularly posts a huge trade surplus may have something more than an undervalued currency — it may also have an overwhelming competitive advantage. In the case of Japan, competitive advantage is a combination of superior quality (autos), location (near those

Asian buyers) and the ability to hold down labor costs. Japan is the only country that ever reports a drop in total net compensation to workers in the monthly numbers. Japanese companies can get away with it largely because of deflation and not because of “lifetime employment,” which became a historical oddity during the 1990s.

We might imagine the Japanese trade surplus is a “reason” for traders to sell the yen in anticipation of the inevitable equilibration effect, but we have no evidence traders think this way or have that expectation. In fact, the [purchasing power parity](#) thesis that underlies the trade/exchange rate equilibration idea has repeatedly been shown not to work. For one thing, not all goods and services are tradable. The playing field is not flat as exporters get unfair subsidies or other advantages and importers face unfair restrictions.

Still, if we look at the classic purchasing power parity basis, *The Economist* magazine’s “Big Mac” estimate had the yen overvalued by about 28 percent at the end of January when the rate was ¥121 to the dollar, suggesting it “should” be 87.10. The average of July and August happens to be 86.9, which is spooky but not terribly helpful. It suggests the dollar/yen rate is in equilibrium, and thus Japan should be losing its trade advantage with the U.S. and that U.S. exports to Japan and Japanese exports to the U.S. should even out in upcoming periods. No sane forecaster believes that.

In fact, former Ministry of Finance official Eisuke Sakakibara, who styles himself “Mr. Yen,” opined the U.S. would not cooperate in intervention to halt the yen’s rise because it wouldn’t suit the U.S.’ own efforts to promote exports. Without U.S. approval and perhaps participation, Japanese intervention wouldn’t work. While the U.S. does indeed have export-promotion programs, it has never officially embraced any export policy commitment that pertains to the level of the dollar. What Sakakibara really means is that if politicians are so touchy about the Chinese yuan being “manipulated” and undervalued, the environment is hardly right for the U.S. to help another country with a giant trade surplus.

Sakakibara also said it was overall dollar weakness driving up the yen — that a rate of ¥80 to the dollar is really more like ¥60 or ¥70 today, given the relative rates of deflation and inflation in the two countries.

This provocative comment inspired Bank of New York Mellon economist Michael Woolfolk to examine the data with care. He used the national CPI series for the U.S. and Japan to adjust nominal changes in the exchange rate.

He found that over the 15 years ending June 30, 2010), U.S. CPI has averaged 2.4 percent year-over-year and Japanese CPI has averaged -0.1 percent year-over-year. Taking the difference between the two, he found that in real terms, the yen has depreciated against the USD by 32.1 percent. Woolfolk wrote in an email to BoNY clients: “Consequently, the JPY would need to be 32.1 percent stronger today in nominal terms to equal its purchasing power in 1995. This puts USD/JPY at 64.35, at the center of Sakakibara’s range of 60 to 70. Alternatively, USD/JPY at 85 today would be comparable to USD/JPY at 125.20 in 1995.”

Responding to trade data

As mentioned, traders don’t respond to trade data these days. They name the U.S. trade deficit as a reason to sell dollars when they are in the mood to sell dollars, but it’s difficult to recall any trader saying he was buying or selling yen because the trade surplus was growing.

Nonetheless, professional traders are fully aware of the trade imbalance, even if it’s a background factor. They are also aware that non-price factors inhibit exchange rate equilibration to the point of snuffing it out. Because traders cast a skeptical eye on purchasing power parity and trade imbalances, what is really going on that gives them such a strong bias to buy yen? We are talking about a full-bore preference for the yen far beyond bouts of risk aversion and *carry-trade* unwinding.

Behind the preference for the yen may be the lurking suspicion that at some point in the not-too-distant future, Japan will run out of domestic savers and will have to raise foreign capital to fund its giant deficits. To date it has just printed money and played ring-around-the-rosie — the debt is bought by savers and banks. Inducing foreigners to buy Japanese bonds is going to be the sales job of the century. Of necessity, yields will rise and — despite the universally acknowledged willingness of the citizens to eat dirt before they would allow a sovereign default — rise a lot. Any failure to manage this process could be disastrous for any Japanese administration. The current government has committed to starting the process of winding down the deficit, but has yet to publish a roadmap. No wonder attentiveness to intervention seems lacking — the government has bigger fish to fry.

Japan West?

The deeper implication of the yen story is the question of

whether the U.S. is becoming like Japan. We usually refute the idea because wages are inelastic downward in the U.S., the U.S. consumer is tireless in his materialistic greed, and the voters would never allow the Army Corps of Engineers to pave over rivers (would they?). Besides, the U.S. is a far more open society — we have too much immigration and Japan has almost none. Our demographic time bomb is farther off in the future, as U.S. population growth is still rising, creating not only workers to pay for retirees but also demand for housing.

But it’s not an unrealistic possibility the U.S. could become more Japan-like, complete with deleveraging, deflation or disinflation, permanently low interest rates, unsustainably high deficits, and a rising currency. Population growth and high ownership of public debt by foreigners are important differences from the Japanese model, but they do not necessarily make it impossible for the fragile recovery to slide down into a deflationary recession that is less than a double dip but worse than a mere L-shaped recovery.

What could cause such a thing? As a general rule, it takes a shock to crumple a weak recovery back into recession. Shocks comes in all colors and stripes, but another stock market decline would qualify, as would another Flash Crash,

a terrorist attack, a political event, and so on. If a new round of gloom and pessimism develops, we could end up with the ridiculous situation of U.S. T-note yields falling below 2.5 percent while the dollar continues to rise, a violation of a key rule of FX forecasting — that money flows to the currency with the highest real return. But money also flows to the safe-haven U.S. even as it’s recession in the U.S. that causes fear. An abnormally strong currency has already happened in Japan despite fairly awful conditions — why not the U.S.?

The real lesson

The only trading recommendation to come out of this is not about either the yen or the dollar, but rather about emerging-market currencies. There the standard logic still applies: buy the currency whose country has a trade surplus and relatively high interest rates.

We can therefore deduce that more capital will flow to Brazil and other emerging markets. This is quite a distance from whether the Japanese Ministry of Finance will intervene against the too-strong yen. 📍

Behind the preference for the yen may be the suspicion that at some not-too-distant point Japan will run out of domestic savers and will have to raise foreign capital to fund its giant deficits.

For information on the author, see p. 4.

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Swiss swing

Inside day plays pivotal role in pullback setup.

BY CURRENCY TRADER STAFF

“An inside look at a dollar/yen pattern” and “The pattern behind the pattern” (*Currency Trader*, November and December 2009) analyzed a pullback pattern in the U.S. dollar/Japanese yen pair (USD/JPY) that initially centered around the price action after inside days (days with a lower high and higher low than the preceding day). More detailed research, however, revealed the inside-day component was largely irrelevant to the pattern’s performance.

The inside day recently came into focus in analyzing the U.S. dollar/Swiss franc (USD/CHF) pair — again, in the context of a potential long-side pullback setup. The high-

lighted bars in Figure 1 mark the conclusions of two daily timeframe patterns with the following components:

Pattern 1 (highlighted blue)—

1. yesterday’s high is below the previous day’s high;
2. yesterday’s low is above the previous day’s low;
3. today’s low is at least .0050 below yesterday’s low;
4. today’s close (based on the New York forex session) close is in the bottom third of the day’s range.

Pattern 2 (highlighted green)—

1. the high two day’s ago is below the high three days ago;
2. the low two day’s ago is above the low three days ago;
3. yesterday’s low is below the low two day’s ago;
3. today’s low is at least .0050 below yesterday’s low;
4. today’s close (based on the New York forex session) close is in the bottom third of the day’s range.

As formulas, the patterns are:

Pattern 1—

1. $high[1] < high[2]$;
2. $low[1] > low[2]$;
3. $(low[1] - low) \geq 0.0050$;
4. $(close[0] - low[0]) / (high[0] - low[0]) \leq .33$.

Where 0, 1, and 2 refer to the current bar, one bar ago, and two bars ago.

FIGURE 1: RECENT PATTERN SIGNALS



Blue dots mark the conclusion of pattern 1, the green dot marks the one instance of pattern 2.



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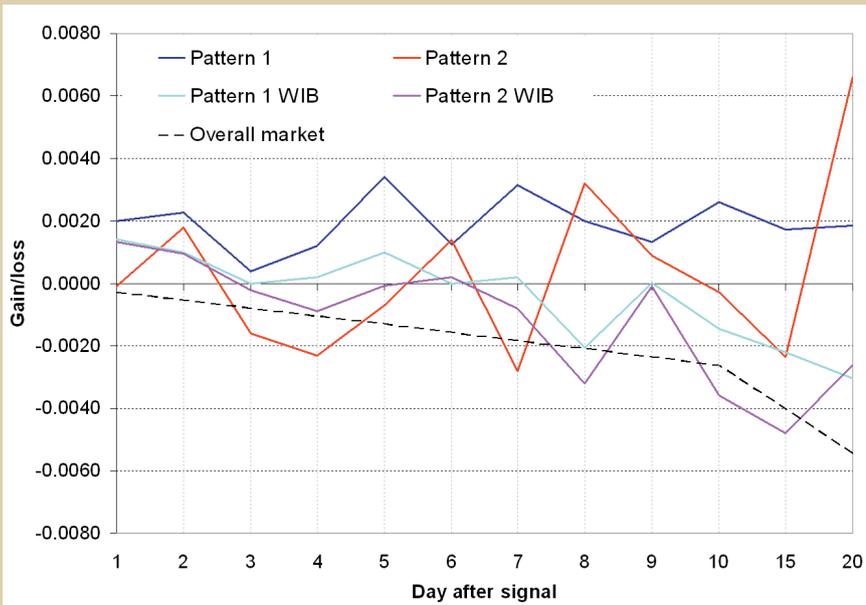
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FIGURE 2: PATTERN PERFORMANCE



The versions of the patterns without the inside-day component fared poorly, following the downward trajectory of the market's overall bias during the review period.

Pattern 2—

1. high[2] < high[3];
2. low[2] > low[3];
3. low[1] < low[2];
4. (low[1] – low[0]) >= 0.0050;
5. (close[0]-low[0])/(high[0]-low[0]) <= .33;

In both cases, the first two rules define the inside-day component. Pattern 1 is the same in principle and logic to pattern 1 except that the inside day component occurs one bar earlier — two days before the pattern's final day instead of one day before it. Most of the marked bars in Figure 1 are followed by upward movement over the next few bars.

What's happened after the patterns over time? Figure 2 shows the median close-to-close changes in the USD/CHF pair for the two patterns from the closing price of each pattern's last day to the closes of the subsequent 10 days, as well as 15 and 20 days later, between Aug. 16, 2000 and Aug. 16, 2010. During this 10-year period there were 78 instances of pattern 1 and 41 of pattern 2. Also shown are the results for both patterns without the inside-bar component ("WIB") and the average close-to-close moves for all one- to 10-day (and 15- and 20-day) periods in the analysis window.

The USD/CHF pair's overall bias over 20-day time horizons during this period was down, as evidenced by the downtrending black dashed line in Figure 2. Figure 3 reveals a major downtrend dominated the first half of the analysis period, while direction in the second half was mixed. After pattern 1 (dark blue line in Figure 2) price exhibits a minor upside bias that appears to peak at day 5. Performance after pattern 2 was haphazard. Returns flitted day to day above and below breakeven territory.

FIGURE 3: ANALYSIS PERIOD



A major downtrend dominated the first half of the review period, while trading was more mixed in the second half.

TABLE 1: PATTERN SUMMARY

Day:	1	2	3	4	5	6	7	8	9	10	15	20
Pattern 1	0.0020	0.0023	0.0004	0.0012	0.0034	0.0013	0.0031	0.0020	0.0013	0.0026	0.0017	0.0018
Pattern 2	-0.0001	0.0018	-0.0016	-0.0023	-0.0007	0.0014	-0.0028	0.0032	0.0009	-0.0003	-0.0023	0.0066
Pattern 1 WIB	0.0014	0.0010	0.0000	0.0002	0.0010	0.0000	0.0002	-0.0021	0.0000	-0.0015	-0.0022	-0.0030
Pattern 2 WIB	0.0013	0.0010	-0.0002	-0.0009	-0.0001	0.0002	-0.0008	-0.0032	-0.0001	-0.0036	-0.0048	-0.0026
Overall market	-0.0003	-0.0005	-0.0008	-0.0010	-0.0013	-0.0016	-0.0018	-0.0021	-0.0024	-0.0026	-0.0040	-0.0054

Pattern 1 appears to have some bullish potential, but pattern 2's performance is sub-standard. In addition, pattern 2 only triggered 41 times in 10 years — far too infrequently.

The most important aspect of Figure 2 is the much more consistently negative performance after the WIB versions of the patterns — only slightly less bearish than the market's average performance. This suggests the inside-bar component of the pattern is not incidental in this case — it's actually part of what's enabling pattern 1, at least, to defy the market's downside bias. Table 1 details the performance of the patterns in Figure 2.

Given the sub-par performance of pattern 2, let's look at pattern 1 in a little more detail.

More context

The top half of Table 2 details the performance of pattern 1, showing the total point gain or loss, median and average closing moves, maximum individual gains and losses, [standard deviation](#), and winning percentage at every daily interval. The bottom half of the table shows the numbers for the WIB version of the pattern.

The superior performance of the inside-bar version is apparent at every interval except, perhaps, day 1, where the WIB version had a higher total gain (0.2606 vs. 0.1127). However, there were 393 instances of the WIB version of pattern 1 vs. only 78 for the inside-day version, which means the WIB version's per-trade profitability was actually much lower than the inside-day version — a fact reflected in the day 1 median and average gains.

One anomalous aspect of pattern 1's performance is the peak in total gains at day 3 (0.1689), despite this day having the lowest winning percentage (51.28) and the smallest median gain (.0004). The average gain hints at the answer: at .0022, it is the highest of all the days, suggesting a small number of large gains provided the extra overall return. The high median gain (.0034) and winning percentage (59.74) at day 5 suggest greater consistency at this interval, despite the lower overall total profit.

TABLE 2 INSIDE-DAY EFFECT

	1	2	3	4	5	6	7	8	9	10	15	20
Total	0.1127	0.1236	0.1690	0.1606	0.1471	0.1410	0.1180	0.0604	0.1561	0.1224	0.0572	-0.0073
Med	0.0020	0.0023	0.0004	0.0012	0.0034	0.0013	0.0031	0.0020	0.0013	0.0026	0.0017	0.0019
Avg	0.0014	0.0016	0.0022	0.0021	0.0019	0.0018	0.0015	0.0008	0.0020	0.0016	0.0008	-0.0000
Max loss	-0.0307	-0.0292	-0.0400	-0.0418	-0.0412	-0.0663	-0.0809	-0.0890	-0.0926	-0.0998	-0.0743	-0.0802
Max gain	0.0300	0.0442	0.0440	0.0446	0.0420	0.0472	0.0478	0.0701	0.0570	0.0735	0.0831	0.0768
StD	0.0102	0.0120	0.0158	0.0158	0.0177	0.0202	0.0220	0.0250	0.0262	0.0283	0.0321	0.0369
Win %	57.69%	58.97%	51.28%	58.97%	59.74%	55.84%	55.84%	53.25%	53.25%	51.95%	52.63%	50.67%
Total	0.2606	0.0264	0.0084	-0.1756	-0.3248	-0.5981	-0.8273	-1.0225	-0.8166	-1.0886	-1.7999	-2.8537
Med	0.0014	0.0010	0.0000	0.0002	0.0001	0.0000	0.0002	-0.0021	0.0000	-0.0015	-0.0022	-0.0031
Avg	0.0007	0.0001	0.0000	-0.0004	-0.0008	-0.0015	-0.0021	-0.0026	-0.0021	-0.0028	-0.0046	-0.0074
Max loss	-0.0522	-0.0876	-0.0756	-0.1121	-0.1001	-0.0803	-0.0902	-0.0951	-0.1234	-0.1140	-0.1253	-0.1326
Max gain	0.0311	0.0442	0.0517	0.0519	0.0602	0.0654	0.0589	0.0701	0.0570	0.0735	0.0831	0.0969
StD	0.0094	0.0126	0.0157	0.0180	0.0203	0.0225	0.0243	0.0259	0.0275	0.0292	0.0339	0.0394
Win %	54.45%	54.08%	49.49%	50.77%	51.66%	49.62%	50.13%	47.83%	49.87%	47.31%	47.95%	44.99%

Pattern 1's performance including the inside-day (top) was far superior to its performance without it (bottom).



Market conditions

Pattern 1 was unoptimized; the level of the close (bottom third of the day's range) and the low-to-low decline (.0050) were representative of several initially observed patterns. Other settings can and should be explored to investigate the setup's trading potential.

One bit of additional research revealed some useful information for further study. The frequency of signals (and their success) in the summer of 2010 was rather unique. The pattern's performance was comparable, but slightly worse, over the 36 signals from August 2005 through the end of 2009. But performance in the second half of the 10-year analysis period was far superior to the period as a whole — winning percentages were closer to 70 percent than 60 percent and per-trade profitability was higher. Performance from 2000 to mid-2005 was very mixed, and mostly unprofitable.

Also, the 2010 signal frequency was repeated only one other time in the analysis period — summer/fall, which happened to be a similar market environment: a fairly narrow range consolidation (Figure 4). These suggesting the pattern could benefit from filters that accept or reject trades based on the recent market environment.

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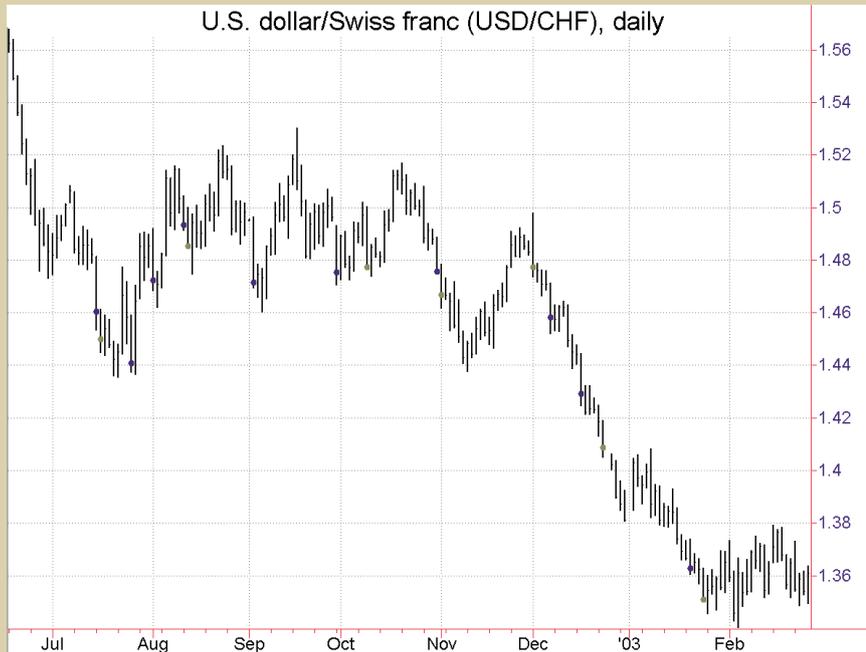
Winning percentage

A final interesting piece of analysis has to do with winning percentage. Figure 3 compares pattern 1's winning percentages to the average "winning percentage" (i.e., the odds of a higher close) for all one- to 10-day, and 15- and 20-day, intervals in the 2000-2010 review period.

Despite its early advantage (except for day 3), the odds of a higher close after pattern 1 are actually lower than the pair's overall odds after day 5 (day 6 and 7 were about even, with the pattern's odds approximately .20 percent lower). While this may in part be explained by the natural pullback that would occur after an up move — especially in a market with an overall downward bias — it is somewhat surprising the overall market posted higher closes more than 50 percent of the time.

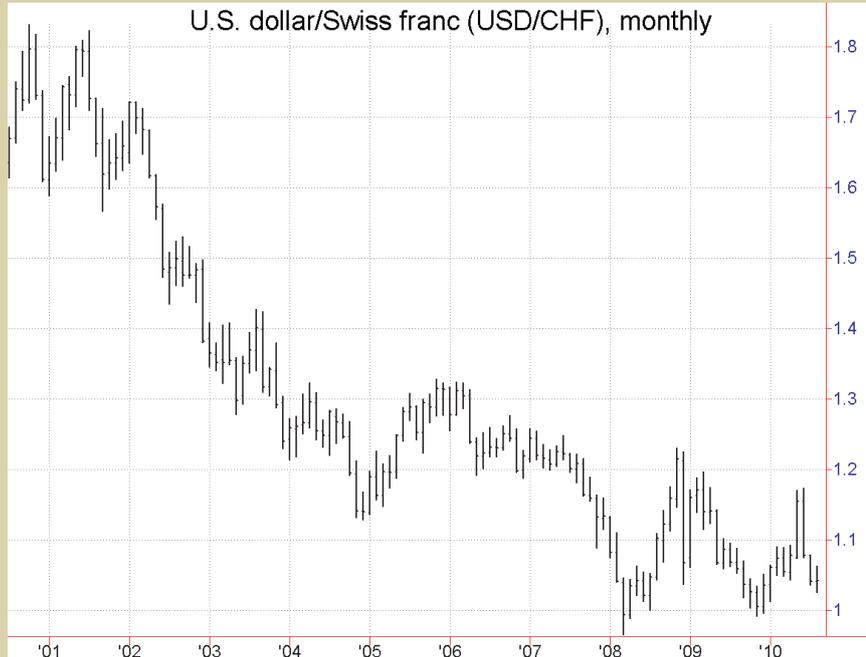
Surprising, but not unexplainable: There were more up moves than down moves, but the down moves were simply larger. This, of course, would suggest a benefit to finding a complementary short side pattern to take advantage of these moves. 📌

FIGURE 4: SIGNAL FREQUENCY



Like the period of frequent trades shown in Figure 1, this cluster of signals from 2002 also occurred during a consolidation.

FIGURE 5: WINNING PERCENTAGE



The odds of a higher close after pattern 1 were often lower than the USD/CHF pair's overall odds of a higher close during the analysis period.



A review of the performance of an entry setup described in the October 2008 issue.

In the nearly two years since the publication of the Spot Check article “Dollar / yen weekly low pattern” (*Currency Trader*, October 2008), the U.S. dollar / Japanese yen pair (USD / JPY) has zigzagged some 24 percent lower, from around 105.00 to 85.00 — closer than its been in a long time to its all-time low below 80.00.

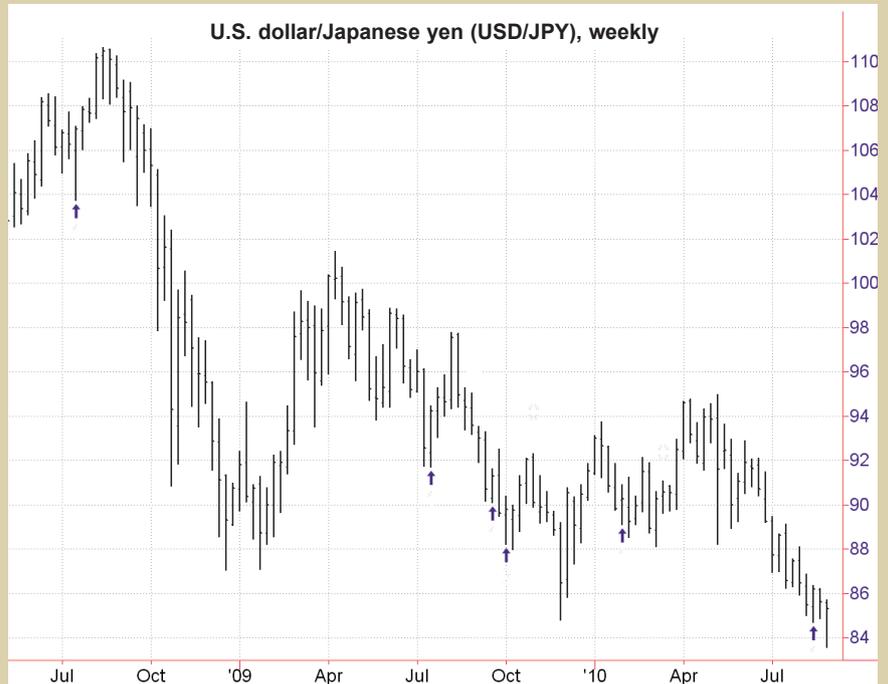
The relatively uncommon pattern outlined in the article (45 instances in 30 years) was defined as:

1. This week’s low is lower than last week’s low.
2. This week’s low is at least 1.25 lower than the low two weeks ago.
3. Last week’s low is below the lows of three and four weeks ago.
4. This week’s close is above last week’s close.
5. This week’s close is in the upper 20 percent of the week’s range.

The pattern basically describes a weekly low that has been preceded by selling but closes strongly (higher than the previous week and a close high within the current week’s range). The pattern’s other components designed to eliminate many of the situations in which price might be rallying within a downtrend and would thus be likely to revert to the downside.

The article noted that, overall, the yen’s one- to-eight-week moves were volatile and without directional bias between September 1978 and September 2008. The weekly

FIGURE 1: PATTERN SIGNALS: JULY 2008-AUGUST 2010



The weekly buy setup has appeared six times over the past two years, most recently the week ending Aug. 13.

lows identified by the pattern were followed by (after some initial weakness) more-bullish-than-usual price action four to seven weeks after the pattern’s conclusion.

Subsequent monitoring of the pattern and experimentation with different exit and short-selling setups suggested removing the high-close component produced almost twice as many trade opportunities, that while slightly less profitable on average, produced much more profitability over time and had a better than 60-percent chance of a favorable move over a six-week horizon.

Figure 1 shows six instances of the more relaxed pattern definition that have occurred since July 2008, while Table 1 shows the profit or loss at the close six weeks later and the largest up move (LUM) and largest down move (LDM) during each trade’s life. (The exception is the final trade, which was marked to market at the end of its second week.)

Of the five trades that extended to six weeks, two would have ended up profitable and three would have lost money. However, as Figure 1 and the LUM and LDM numbers in the table indicate, in three of these five trades, the pair had more upside movement than downside, suggesting an exit rule would need to be designed to capture available profits. (Note the big upswing after the July 2009 signal that was not captured.) All five trades had gains of 1 percent or more, and four had gains of at least 2 percent. 📌

TABLE 1: DOLLAR/YEN WEEKLY LOW PATTERNS

Date	Entry price	P/L after 6 weeks	LUM	LDM
7/18/08	106.956	1.84	3.69	-0.90
7/17/09	94.218	-0.63	3.56	-1.14
9/18/09	91.277	-1.18	1.25	-3.29
10/2/09	89.785	-0.14	2.54	-1.79
1/29/10	90.265	0.29	1.88	-2.13
8/13/10	86.185	-0.81	0.03	-2.60

Only two of the five completed trades as of Aug. 27 were profitable after six weeks, although four of five had open price gains of 2 percent or more during the life of the trade.



Currencies, curves, and correlations

Searching for long-term predictive relationships between currencies, yield curves, and equity markets is an exercise in futility.

BY HOWARD L. SIMONS

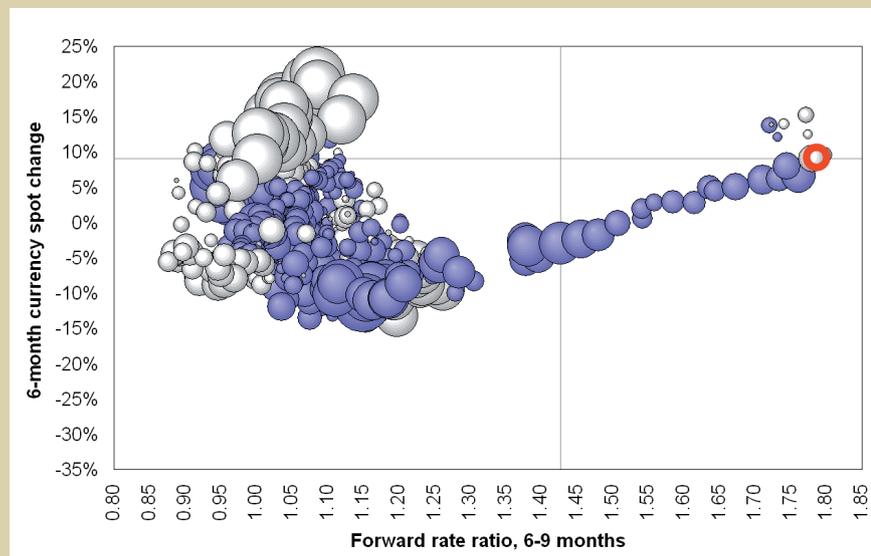
Two debates never seem to cease when it comes to the relationship between currencies and the U.S. stock market. The first, almost always stated improperly, is whether a “strong” or “weak” dollar is good or bad for U.S. stocks. The reason this question is stated improperly is, despite the presence of instruments such as the dollar index, the dollar does not trade as a whole so much as it trades as a series of currency pairs. The second question is whether large- or small-capitalization stocks benefit more or less from “dollar” strength or weakness.

We can add a third dimension to these questions by asking whether there is any general relationship between a country’s money market yield curve, the percentage change in its currency’s spot rate, and its prospective equity returns. The experience of the post-March 2009 rally led many to believe the exaggerated steep yield curves as measured by the forward rate ratio between six and nine months ($FRR_{6,9}$), which is the rate at which we can lock in borrowing for three months starting six months from now divided by the nine-month rate itself, drove equity markets higher.

We will examine the relationship between the $FRR_{6,9}$ and percentage change in the spot rate for five of the six components of the U.S. dollar index (DXY) and the dollar index itself against the prospective six month-ahead total returns for the underlying stock indices, as calculated by Morgan Stanley Capital International in local currency terms. For reference, the index’s components are the Euro (57.6 percent), Japanese yen (13.6 percent), British pound (11.9 percent), Canadian dollar (9.1 percent), Swedish krona (4.2 percent), and Swiss franc (3.6 percent). However, the history for the components of the Swedish krona is too short to be included in this analysis. The other five will provide us with insight into whether currency and $FRR_{6,9}$ moves affect equity returns.

Also, we will examine the correla-

FIGURE 1: SIX-MONTH-AHEAD U.S. STOCK CHANGES



The $FRR_{6,9}$ for the USD literally went off the chart in 2009 as U.S. short-term rates were pushed down toward zero percent.

tion of returns between the dollar [carry trade](#) into each of the six components of the dollar index against the total returns for both the large-capitalization Russell 1000 index and the small-capitalization Russell 2000 index since the January 1999 advent of the Euro. This will provide us with an insight into the question of which currencies affect large- and small-capitalization U.S. stocks and when.

Curves and currencies

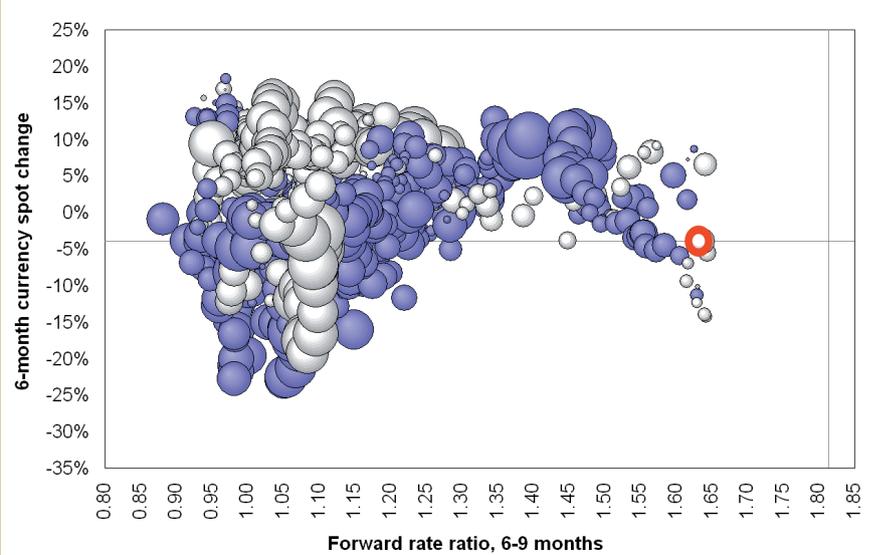
If we map six-month-ahead equity market returns in local currency terms against $FRR_{6,9}$ levels and six-month-ahead changes in currency spot rates, do distinct patterns emerge?

In Figures 1-7, which show six-month-ahead stock changes as a function of currency change and yield curve, blue bubbles indicate positive equity market changes, white bubbles indicate negative equity market changes, and the diameter of a bubble indicates the magnitude of change. The red circles mark the value combination for the week ending July 2, 2010. The values for the $FRR_{6,9}$ and the change in the currency spot rate from January 8, 2010 are located with gray crosshairs. All charts are displayed on an equal scale for comparative purposes.

Figure 1 shows the $FRR_{6,9}$ for the USD literally went off the chart in 2009 as U.S. short-term rates were pushed down toward zero percent. At no point since 1991 had this segment of the [LIBOR](#) curve been so steep. The USD suffered accordingly after the March 2009 [quantitative easing](#) began. We should expect the prospective change for the U.S. stock market to have been biased higher based on liquidity alone, and this appears to have been the case. However, the USD $FRR_{6,9}$ peaked right at the end of 2009 and began to flatten as Eurozone credit stress led to an increase in short-dated LIBOR. Global

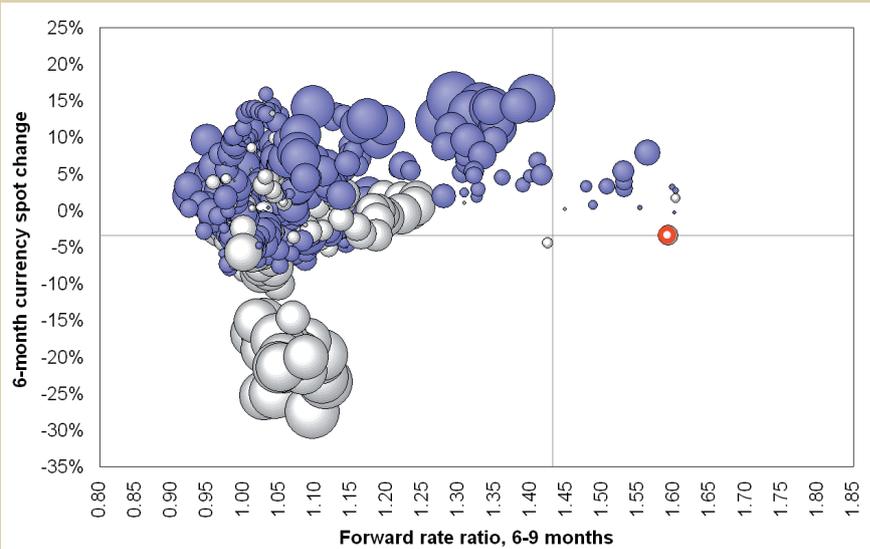
bourses peaked at the end of April 2010 for reasons unrelated to money-market yield curves.

FIGURE 2: SIX-MONTH-AHEAD SWITZERLAND STOCK CHANGES



The CHF $FRR_{6,9}$ steepened as francs were created to finance the purchase of Euro-denominated bonds.

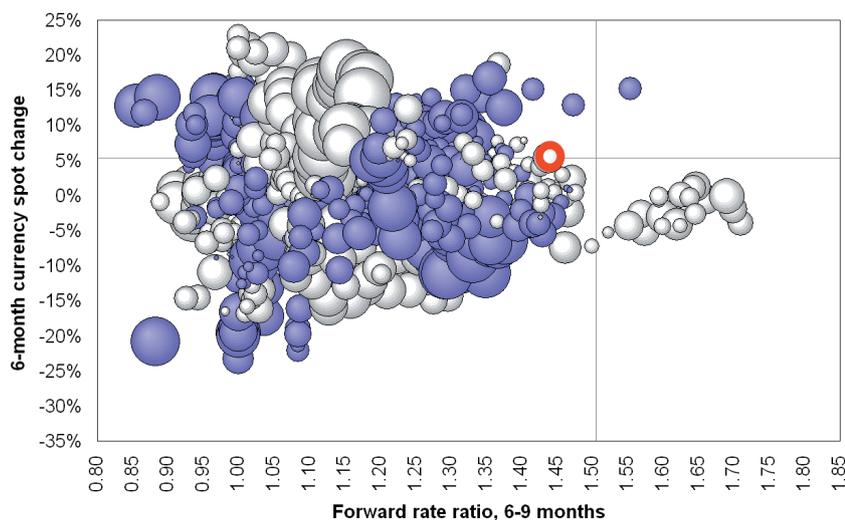
FIGURE 3: SIX-MONTH-AHEAD CANADA STOCK CHANGES



The combination of a steeper yield curve and a stronger CAD was bullish for Canadian equities on an absolute basis until the global market peak at the end of April.



FIGURE 4: SIX-MONTH-AHEAD JAPAN STOCK CHANGES



The $FRR_{6,9}$ has been steeper before, but each case coincided with negative prospective equity returns. Previous periods of a stronger JPY have led to both rising and falling prospective equity market returns.

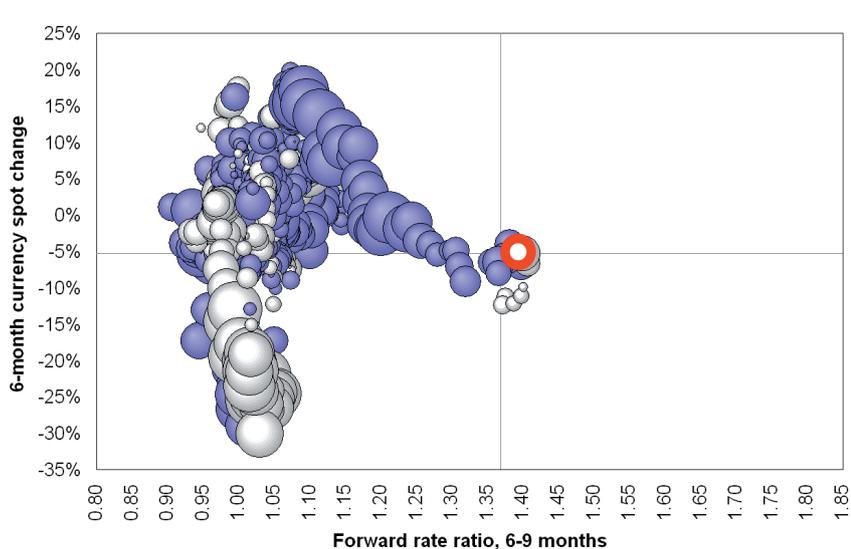
The USD strengthened on a relative basis for the first half of 2010 as the USD $FRR_{6,9}$ flattened. It would be a stretch to say the USD strengthened on an absolute basis given its 13.3 percent decline against gold on a total return basis, but this subject can and will be debated for years.

The Swiss $FRR_{6,9}$ also remained extraordinarily steep following its quantitative easing in March 2009, although it had been steeper briefly in December 2003 and in May 2004 (Figure 2). The Swiss National Bank's response to the Eurozone's travails was to intervene massively and unsuccessfully against the CHF by buying Euro-denominated bonds. The intervention succeeded, as they always do, in losing SNB capital and ultimately making Switzerland a poorer place. The CHF $FRR_{6,9}$ steepened as francs were created to finance this exercise in imbecility.

The Canadian LIBOR curve also spent most of 2009 (and indeed the first half of 2010) steepening. As all previous observations of a strongly rising CAD have been accompanied by rising prospective equity market returns, the combination of a steeper yield curve and a stronger CAD was bullish for Canadian equities on an absolute basis until the global market peak at the end of April (Figure 3). Between April 26 and June 30, 2010, Canadian equities declined 13.14 percent in USD terms as opposed to U.S. stocks declining 14.77 percent. A small triumph, as all relative value comparisons always are.

The JPY combination, as is so often the case for this always-exceptional currency, has no distinct pattern (Figure 4). Its $FRR_{6,9}$ has been steeper before (multiple periods in 1999, 2000 and

FIGURE 5: SIX-MONTH-AHEAD UK STOCK CHANGES



The $FRR_{6,9}$ for the UK was not as steep as the others during 2009, which is surprising given the British attempt to debase the pound against the euro.

2006), but each of these periods coincided with negative prospective equity returns. Previous periods of a stronger JPY have led to both rising and falling prospective equity market returns. We have to classify the present mix as indeterminate in outlook.

The $FRR_{6,9}$ measures for both the U.K (Figure 5) and the Eurozone (Figure 6) were not as steep as the others during 2009. This is surprising given the British attempt to debase the pound (see “No man is an island, but the UK is,” *Currency Trader*, August 2010). “Flat” is a relative term, however, as both measures were the steepest on record up until that point. We have little to go on from such exaggerated values, but we can observe the dominance of positive prospective equity market returns emerging from previous periods of currency strength.

The general combination of steep LIBOR curves and strengthening currencies leading to positive equity returns should not be surprising. A country flooding itself with liquidity and able to draw capital from elsewhere is a country with a positive financial market environment.

The Japan exception can be explained by the country’s long post-1991 history as the principal funding currency for carry trades.

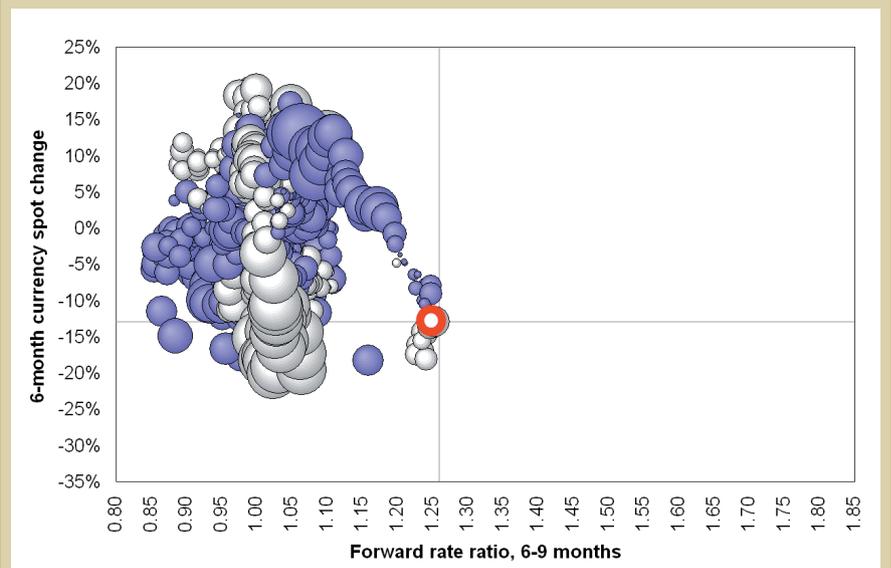
The dollar has been a funding currency relatively recently in its history, and yielded less than the yen from August 24, 2009 through March 5, 2010. If U.S. interest rates continue to remain sufficiently low to keep the dollar carry trade open, and they have so far, we should expect the forward-looking prospects for U.S. equities to enter a long period of Japan-like torpor.

Capitalization and correlations

Much of the difference between the Russell 1000 and 2000 indices can be attributed to different sector weightings between the two indices. If we re-index the total return streams between the

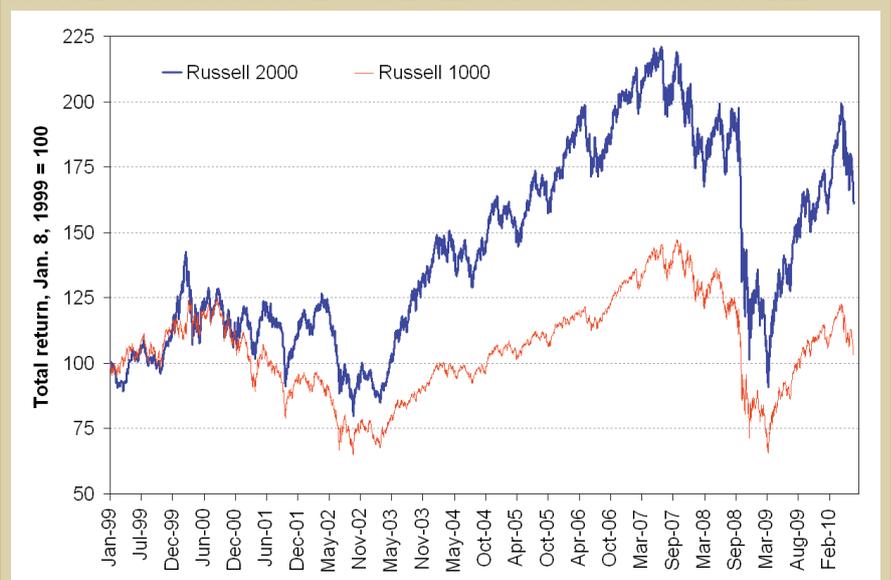
two indices to the January 1999 advent of the Euro, we see just how much more volatile the Russell 2000 is in both

FIGURE 6: SIX-MONTH-AHEAD EUROZONE STOCK CHANGES



As was the case with the UK, the Eurozone $FRR_{6,9}$ was not as steep as the others in 2009. However, both measures were the steepest on record up until that point.

FIGURE 7: COMPARATIVE TOTAL RETURN PATHS FOR RUSSELL



Re-indexing the total return streams for the Russell 1000 and 2000 to the January 1999 advent of the Euro reveals just how much more volatile the Russell 2000 is.

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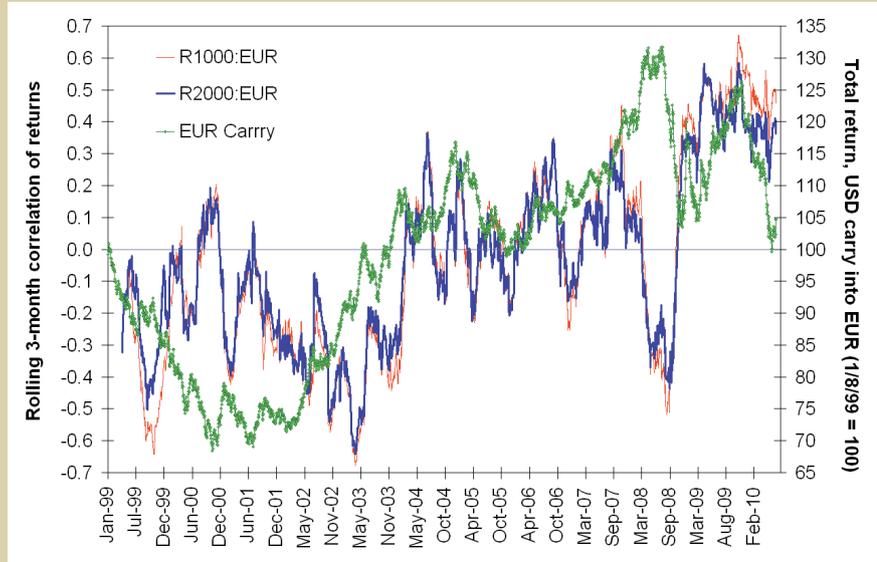
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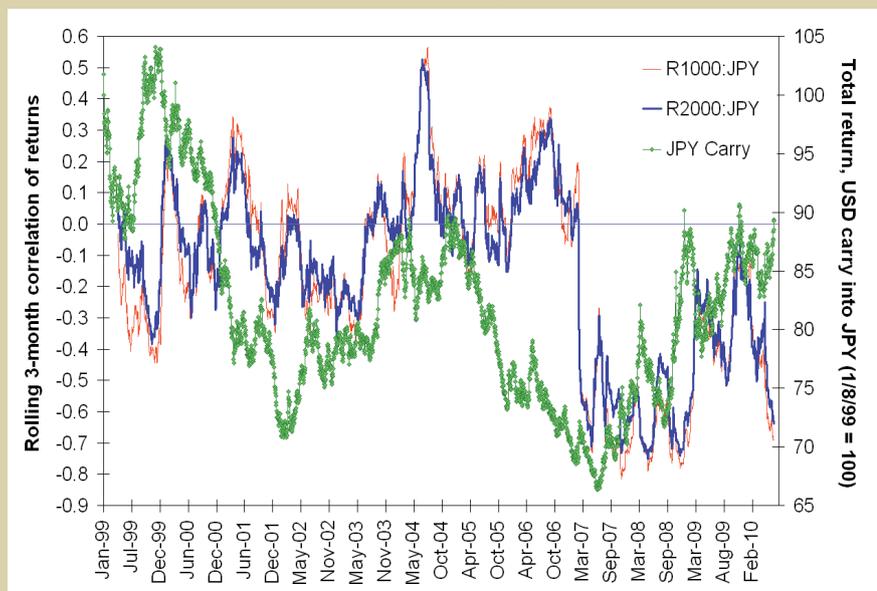


FIGURE 8: CORRELATION OF RETURNS, U.S. EQUITIES VS. EURO



The correlations of returns since the 2008 financial crisis moved to all-time highs in November 2009 against both Russell indices, but more so against the Russell 1000.

FIGURE 9: CORRELATION OF RETURNS, U.S. EQUITIES VS. YEN



For the yen, the correlation of returns has been negative since March 2007, the period just after the first rumblings of the financial crisis were noticed. The distinction between the Russell 1000 and Russell 2000 indices has been small throughout the history of the series.

directions (Figure 7). This is one of those cases when a commonly held belief is true.

But how much of this difference is linked to the three-month rolling correlations of returns with currencies? For each of the following charts the correlations for the Russell 1000 and 2000 series are in red and blue and marked with a ‘r’ in the legend box, while the currency carry trade’s return index is in green. Total returns are used instead of spot rates to reflect the actual opportunity cost of swapping out of the dollar and into a currency trade as opposed to swapping out of dollar deposits and into equities.

In the case of the Euro, the correlations of returns since the 2008 financial crisis moved to all-time highs in November 2009 against both Russell indices, but especially against the Russell 1000 (Figure 8). Nothing since the advent of the Euro in January 1999 even compares to it on the positive side; on the negative side, the correlation was more extreme during the latter stages of the 2001-2003 bear market. This is consistent with the statement that excess liquidity drives stocks and the Euro higher. The break in the Euro during the first half of 2010 created financial system stresses that lowered both the correlation of returns and the absolute value of the stock indices.

If we repeat the exercise for the yen, the correlation of returns has been negative since March 2007, the period just after the first rumblings of the financial crisis were beginning to be noticed (Figure 9). As the dollar carry trade into the yen turned profitable for seven months beginning in August 2009, the response

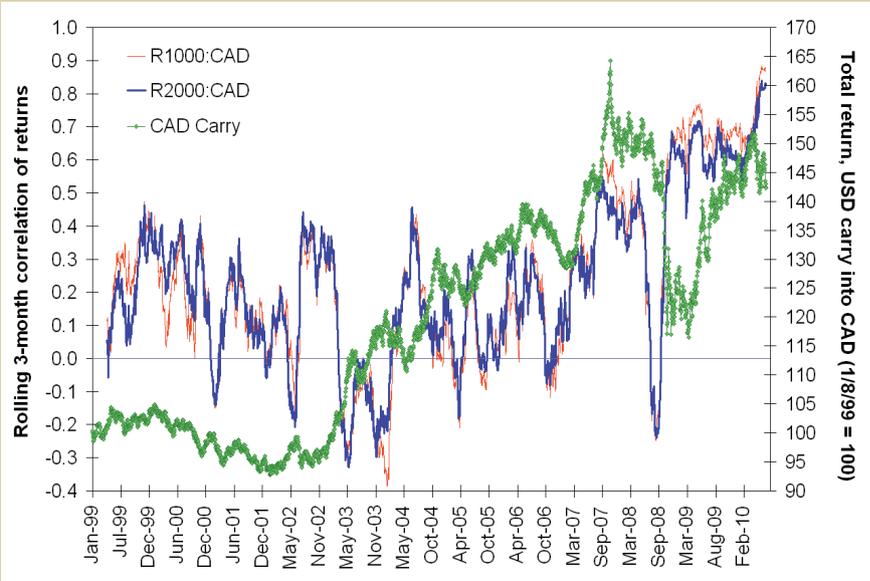
was a negative correlation of returns by both Russell indices. The restoration of Japan to its “rightful” place as the cheapest currency to borrow has done little to affect the correlation of returns. The distinction between the Russell 1000 and Russell 2000 indices has been small throughout the history of the series.

Now let’s look at the Canadian dollar (Figure 10). Here years of correlation oscillating around zero were replaced by a rapid drop during the financial crisis, followed by a recent ascent to record high correlation of returns by mid-2010. However, the capitalization differential remains small across the history; at best we can say here the correlation of returns against the Russell 1000 reaches greater extremes of high and low values, but the importance of this claim is difficult to discern.

The British pound has maintained a positive correlation of returns against U.S. stocks, the Russell 1000 in particular, even while the GBP broke in 2009 as a result of British quantitative easing (Figure 11). The pattern is somewhat opposite of the one seen for Japan; here the dollar carry to the pound decreased over time while it increased over time for the yen. Still, the correlation of returns for the dollar carry into the GBP reached record highs by June 2010, with the Russell 1000 showing slightly higher values.

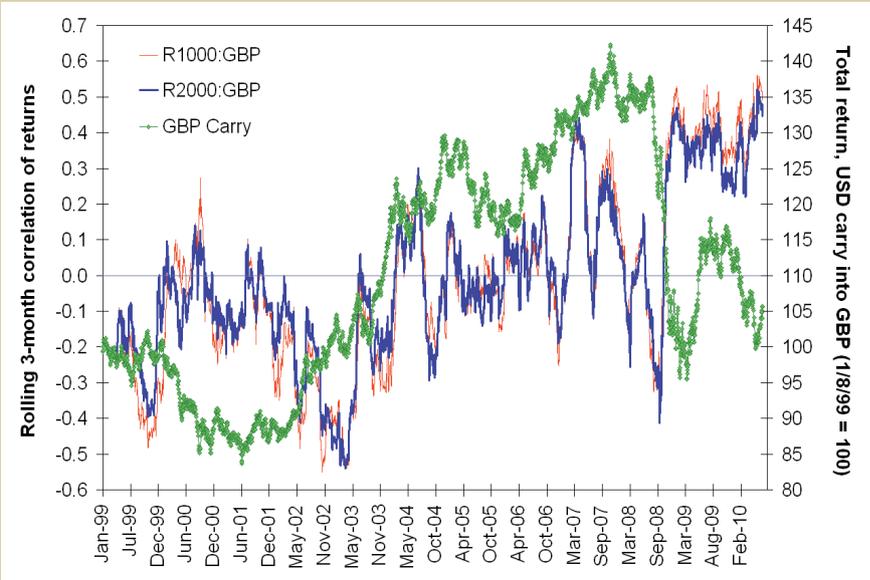
The Swiss franc chart shows some real extremes in correlation of returns: In the 18 months between the spring of 2008 and the fall of 2009, the correlations moved from levels near their all-time lows to all-time highs, with the Russell 1000 once again showing the most extreme value (Figure 12). In addition, the dollar carry into the CHF reversed directions after the U.S.

FIGURE 10: CORRELATION OF RETURNS, U.S. EQUITIES VS. CAD



In the case of the Canadian dollar, the capitalization differential remains small across the history. At most we can say the correlation of returns against the Russell 1000 reaches greater extremes of high and low values, but the importance of this claim is debatable.

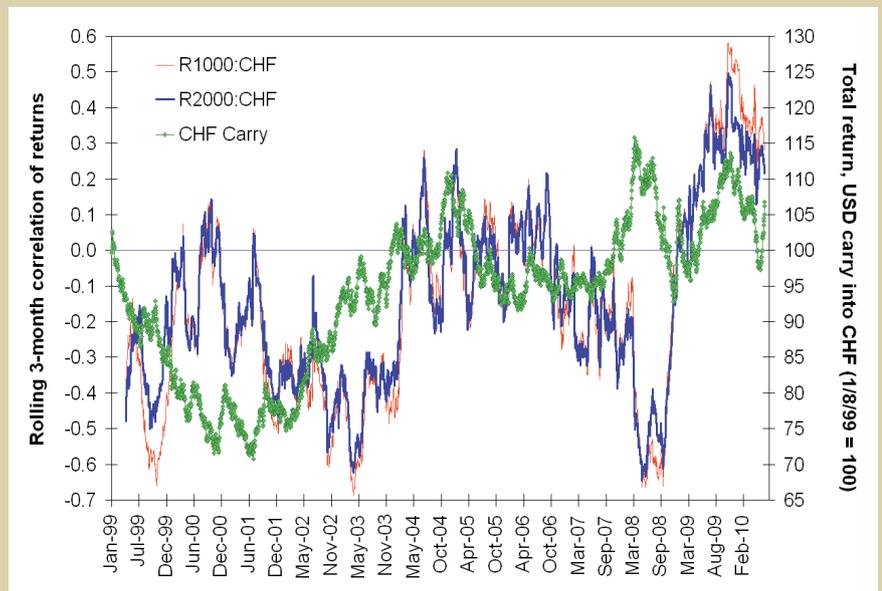
FIGURE 11: CORRELATION OF RETURNS, U.S. EQUITIES VS. GBP



The British pound has maintained a positive correlation of returns against U.S. stocks, the Russell 1000 in particular, even when the GBP broke in 2009 as a result of British quantitative easing.

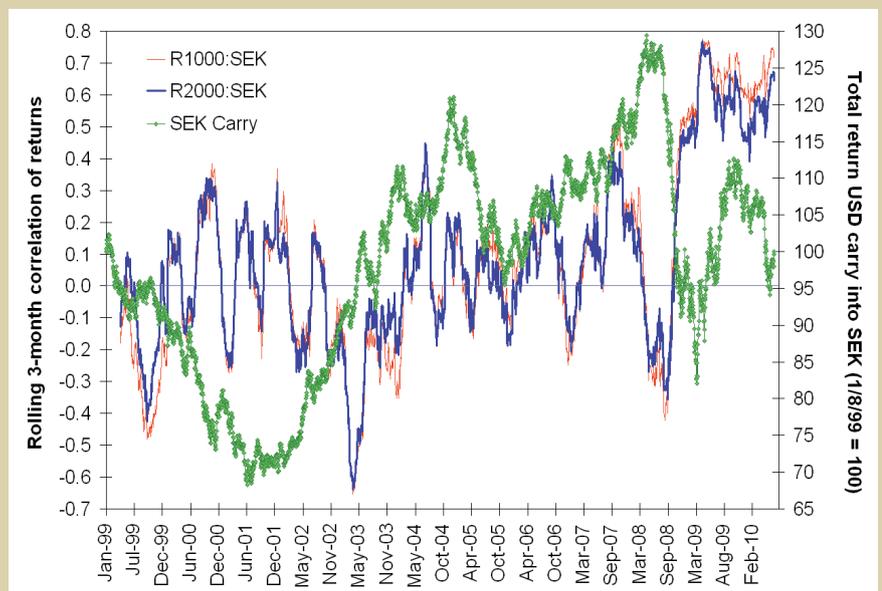


FIGURE 12: CORRELATION OF RETURNS, U.S. EQUITIES VS. FRANC



In the 18 months between spring 2008 and fall 2009 correlations moved from levels near their all-time lows to all-time highs, with the Russell 1000 once again showing the most extreme values.

FIGURE 13: CORRELATION OF RETURNS, U.S. EQUITIES VS. KRONA



The Swedish krona's patterns of carry and correlation look resemble the British pound's — a surprise, given the British attempt to drive the pound lower while the Swedish Riksbank managed to keep the krona in a relatively tight band against the Euro.

matched and then exceeded the Swiss in the quantitative easing game after March 2009. The carry into the franc reversed again during May-June 2010 as the CHF rallied against the EUR. Walls of money can do strange things to market relationships.

Finally, we come to the Swedish krona (Figure 13). Its

patterns of carry and correlation look rather like those seen for the British pound; this is somewhat surprising given the British attempt to drive the pound lower while the Swedish Riksbank managed to keep the krona in a relatively tight band against the Euro.

The why, not the what

The single most important conclusion a trader can garner from the information above is a search for long-term predictive relationships between currencies, yield curves, and equity markets will fail. Markets move in fashions, and trading fashions are no more permanent than clothing fashions.

Second, in a world that demands a trading rule for every observation, here the observation is the value: The "why" is far more important than the "what." The reason why correlations between currencies such as the Euro and Canadian dollar and U.S. equity markets moved to record highs in 2009 was the common impact of the dollar carry trade.

The opposite held for the yen. Both the yen and the dollar were haven currencies during times of increased financial risk because of their roles as funding currencies in carry trades. The unwinding of the yen carry trade and its replacement by the dollar carry trade by late August 2009 distorted long-term relationships.

Finally, stay away from the quick-and-dirty answers on capitalization. It is easy for someone to say a weak dollar is good for large-capitalization U.S. stocks, but the effect is not particularly strong, nor is it particularly stable. In sum, nothing in the data above indicate you can treat one market as causal to the other. Currencies and equities are

affected by a common factor, liquidity, at the same time but with disparate impact.

This means you can trade currencies or you can trade equities, both as separate markets, but you should not use one to trade the other. 📌

For information on the author, see p. 4.

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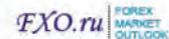
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The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields. Note: Average volume and open interest data includes both pit and side-by-side electronic contracts (where applicable).

Market	Sym	Exch	Vol	OI	10-day move / rank	20-day move / rank	60-day move / rank	Volatility ratio / rank
EUR/USD	EC	CME	286.0	234.3	-1.10% / 23%	-3.80% / 75%	5.85% / 95%	.19 / 32%
JPY/USD	JY	CME	117.5	131.5	0.72% / 32%	2.12% / 50%	7.96% / 77%	.18 / 22%
GBP/USD	BP	CME	104.0	132.7	-1.15% / 33%	-2.68% / 80%	6.95% / 54%	.12 / 0%
AUD/USD	AD	CME	94.8	100.4	-0.11% / 0%	-1.74% / 50%	8.76% / 97%	.22 / 18%
CAD/USD	CD	CME	80.2	88.6	-1.31% / 62%	-3.26% / 100%	0.08% / 2%	.60 / 92%
CHF/USD	SF	CME	37.7	55.3	1.32% / 54%	1.31% / 20%	13.19% / 100%	.16 / 27%
MXN/USD	MP	CME	22.2	93.3	-3.43% / 100%	-4.07% / 100%	-1.20% / 27%	.67 / 97%
U.S. dollar index	DX	ICE	18.9	26.3	0.72% / 17%	2.68% / 75%	-5.92% / 84%	.16 / 18%
NZD/USD	NE	CME	7.6	22.2	0.34% / 0%	-3.09% / 53%	5.86% / 93%	.27 / 13%
E-Mini EUR/USD	ZE	CME	3.6	3.5	-1.10% / 23%	-3.80% / 75%	5.85% / 95%	.19 / 32%

Note: Average volume and open interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity is based on pit-traded contracts.

LEGEND:

Volume: 30-day average daily volume, in thousands.

OI: 30-day open interest, in thousands.

10-day move: The percentage price move from the close 10 days ago to today's close.

20-day move: The percentage price move from the close 20 days ago to today's close.

60-day move: The percentage price move from the close 60 days ago to today's close.

The "% rank" fields for each time window (10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the % rank for the 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, it shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, it shows how the most recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100% means the current reading is larger than all the past readings, while a reading of 0% means the current reading is smaller than the previous readings.

Volatility ratio/% rank: The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The % rank is the percentile rank of the volatility ratio over the past 60 days.

BarclayHedge Rankings

Top 10 currency traders managing more than \$10 million as of 7/31/10, ranked by July 2010 return

	Trading Advisor	July Return	2010 YTD Return	\$ Under Mgmt. (Millions)
1.	Dacharan Capital (High Exposure)	19.44%	80.13%	100.0
2.	QFS Asset Mgmt (Currency Ltd)	5.56%	3.30%	210.0
3.	Grant Capital Partners	5.55%	21.03%	10.0
4.	Silva Capital Mgmt (Cap. Partners)	4.92%	6.52%	17.2
5.	Henderson Global Currency	4.64%	-7.10%	130.0
6.	IKOS FX Fund	4.26%	21.32%	918.7
7.	DynexCorp Ltd. (Currency)	3.75%	1.09%	50.5
8.	Gables Capital Mgmt (Global FX)	3.63%	7.97%	15.3
9.	Ortus Capital Mgmt. (Currency)	3.59%	13.07%	1451.0
10.	Overlay Asset Mgmt. (Emerging Mkts)	3.22%	-0.16%	13.0

Top 10 currency traders managing less than \$10M & more than \$1M as of 7/31/10, ranked by July 2010 return

1.	D2W Capital Mgmt (Radical Wealth)	10.80%	80.88%	1.2
2.	Greenwave Capital Mgmt (GDS Beta)	2.90%	-0.48%	8.0
3.	Basu and Braun (Everest Mgd.Accts)	2.89%	12.23%	1.1
4.	Greenwave Capital Mgmt (GDS Alpha)	2.63%	1.68%	8.0
5.	Millennium Global Currency (USD)	2.31%	0.83%	2.4
6.	Vaskas Capital Mgmt (Global FX)	1.56%	-12.04%	3.3
7.	Quant Trading (FX Quant 11)	1.39%	-2.47%	4.4
8.	BEAM (FX Prop)	0.78%	3.93%	1.7
9.	Wealth Builder FX Group	0.20%	-5.03%	4.3
10.	Trident Asset Mgmt. (Gl. Currency)	-0.01%	0.61%	7.0

Based on estimates of the composite of all accounts or the fully funded subset method.

Does not reflect the performance of any single account.

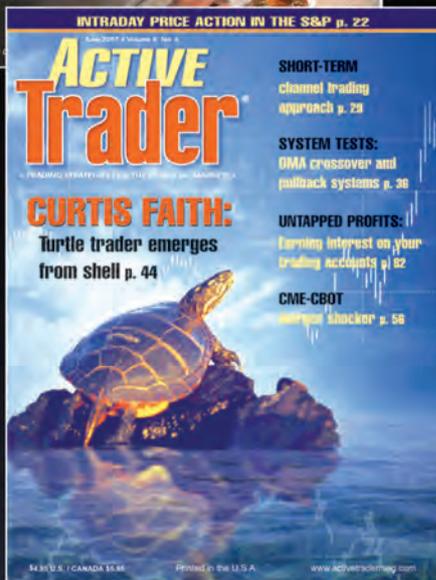
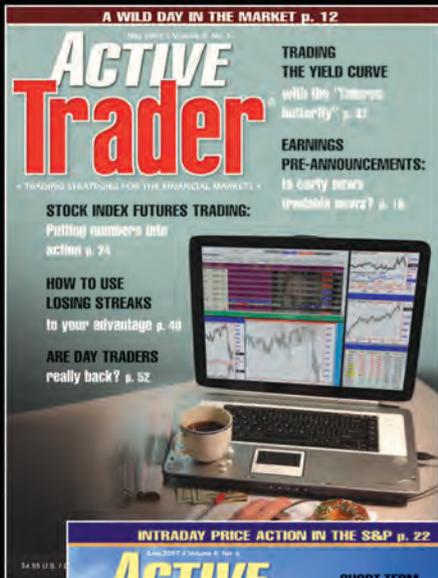
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Rank	Currency	Aug. 27 price vs. U.S. dollar	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	Japanese yen	0.01182	3.01%	6.68%	5.35%	0.01196	0.01053	7
2	Thai baht	0.03188	2.69%	3.74%	5.34%	0.03193	0.02891	11
3	Swiss franc	0.973815	2.30%	12.76%	4.78%	1.0087	0.853	3
4	South African rand	0.13665	0.85%	6.25%	5.47%	0.1393	0.1204	4
5	Singapore dollar	0.73757	0.56%	3.89%	3.75%	0.743	0.691	10
6	Brazilian real	0.56786	0.55%	4.93%	3.02%	0.5882	0.5076	12
7	Indian rupee	0.021365	0.40%	1.04%	-1.52%	0.02263	0.02018	17
8	Great Britain pound	1.554305	0.39%	7.96%	1.99%	1.6877	1.4235	6
9	Taiwan dollar	0.03121	0.16%	0.73%	-0.06%	0.03201	0.0303	13
10	Hong Kong dollar	0.128575	-0.14%	0.18%	-0.19%	0.129	0.1281	15
11	Chinese yuan	0.147055	-0.30%	0.42%	0.39%	0.14760	0.1458	14
12	Australian dollar	0.887545	-1.23%	7.19%	-0.37%	0.9405	0.8069	5
13	Russian ruble	0.03249	-1.61%	1.42%	-2.62%	0.03497	0.03077	9
14	Euro	1.271005	-1.83%	3.64%	-6.55%	1.5144	1.1891	2
15	Canadian dollar	0.94678	-2.08%	1.04%	0.03%	1.0068	0.9005	16
16	Swedish krona	0.133499	-2.38%	5.92%	-4.62%	0.148	0.1227	1
17	New Zealand dollar	0.704095	-3.66%	5.42%	1.17%	0.7635	0.6561	8



GLOBAL STOCK INDICES

	Country	Index	Aug. 27	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Canada	S&P/TSX composite	11,879.72	1.39%	1.11%	1.29%	12,321.80	10,634.80	11
2	India	BSE 30	17,998.41	-0.44%	7.99%	7.31%	18,475.30	15,330.60	9
3	Singapore	Straits Times	2,938.74	-1.36%	7.27%	5.94%	3,043.28	2,560.15	5
4	Switzerland	Swiss Market	6,183.10	-1.47%	-1.94%	-8.96%	6,990.70	5,935.00	14
5	Brazil	Bovespa	65,585.00	-1.63%	5.63%	-2.44%	71,989.00	55,339.00	4
6	Hong Kong	Hang Seng	20,597.35	-1.79%	6.00%	-2.18%	23,099.60	18,971.50	10
7	Australia	All ordinaries	4,404.10	-2.43%	0.11%	-6.19%	5,048.60	4,194.40	8
8	Mexico	IPC	31,755.35	-2.87%	-0.94%	-0.03%	34,223.90	27,705.90	13
9	UK	FTSE 100	5,201.60	-3.06%	0.12%	-3.78%	5,833.70	4,776.50	1
10	Germany	Xetra Dax	5,951.17	-4.13%	0.24%	4.16%	6,386.97	5,263.11	12
11	France	CAC 40	3,507.44	-4.34%	-0.51%	-6.95%	4,088.18	3,287.57	7
12	U.S.	S&P 500	1,064.59	-4.42%	-3.49%	-4.58%	1,219.80	991.97	6
13	Japan	Nikkei 225	8,991.06	-5.33%	-6.73%	-11.61%	11,408.20	8,807.41	15
14	South Africa	FTSE/JSE All Share	26,738.91	-6.05%	-2.59%	-1.06%	29,499.70	24,944.83	3
15	Italy	FTSE MIB	19,817.46	-6.34%	0.95%	-7.05%	24,559	18,045	2

NON-U.S. DOLLAR FOREX CROSS RATES

Rank	Currency pair	Symbol	Aug. 27	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Franc / Canada \$	CHF/CAD	1.028555	4.47%	11.61%	4.74%	1.0629	0.8989	3
2	Yen / Real	JPY/BRL	0.02082	2.54%	1.66%	2.26%	0.02127	0.01838	8
3	Pound / Canada \$	GBP/CAD	1.641675	2.52%	6.85%	1.95%	1.8004	1.4894	5
4	Aussie \$ / New Zeal \$	AUD/NZD	1.2605	2.52%	1.68%	-1.69%	1.3233	1.1931	14
5	Pound / Aussie \$	GBP/AUD	1.751245	1.64%	0.72%	2.37%	1.9561	1.6328	17
6	Aussie \$ / Canada \$	AUD/CAD	0.93743	0.87%	6.09%	-0.41%	0.9895	0.8643	4
7	Euro / Canada \$	EUR/CAD	1.342445	0.25%	2.58%	-6.58%	1.6041	1.2502	1
8	Euro / Aussie \$	EUR/AUD	1.432035	-0.61%	-3.31%	-6.06%	1.7262	1.377	9
9	Franc / Yen	CHF/JPY	82.385	-0.71%	5.72%	-0.48%	91.549	76.36	11
10	Aussie \$ / Real	AUD/BRL	1.56296	-1.76%	2.15%	-3.30%	1.6978	1.4954	6
11	Pound / Franc	GBP/CHF	1.59613	-1.87%	-4.26%	-2.66%	1.744	1.5778	20
12	Euro / Pound	EUR/GBP	0.817725	-2.21%	-4.00%	-8.37%	0.9411	0.8065	10
13	Euro / Real	EUR/BRL	2.238235	-2.37%	-1.24%	-9.29%	2.7412	2.1772	2
14	Pound / Yen	GBP/JPY	131.495	-2.56%	1.25%	-3.16%	154.096	127.065	15
15	Canada \$ / Real	CAD/BRL	1.667275	-2.61%	-3.72%	-2.90%	1.8244	1.6003	18
16	Aussie \$ / Franc	AUD/CHF	0.91141	-3.44%	-4.94%	-4.92%	1.0079	0.8854	19
17	Aussie \$ / Yen	AUD/JPY	75.105	-4.13%	0.53%	-5.45%	88.048	46.508	13
18	Euro / Franc	EUR/CHF	1.302675	-4.22%	-8.27%	-10.98%	1.5243	1.2968	12
19	Euro / Yen	EUR/JPY	107.53	-4.71%	-2.83%	-11.27%	138.473	105.404	7
20	Canada \$ / Yen	CAD/JPY	80.1	-4.95%	-5.27%	-5.02%	94.1955	79.617	21
21	New Zeal \$ / Yen	NZD/JPY	59.57	-6.47%	-1.16%	-3.93%	69.5573	59.1643	16



GLOBAL CENTRAL BANK LENDING RATES

Country	Interest Rate	Rate	Last change	Feb-10	Aug-09
United States	Fed funds rate	0-0.25	0.5 (Dec. 08)	0-0.25	0-0.25
Japan	Overnight call rate	0.1	0.2 (Dec. 08)	0.1	0.1
Eurozone	Refi rate	1	0.25 (May 09)	1	1
England	Repo rate	0.5	0.5 (March 09)	0.5	0.5
Canada	Overnight funding rate	0.75	0.25 (July 10)	0.25	0.25
Switzerland	3-month Swiss Libor	0.25	0.25 (March 09)	0.25	0.25
Australia	Cash rate	4.5	0.25 (May 10)	3.75	3
New Zealand	Cash rate	3	0.25 (July 10)	2.5	2.5
Brazil	Selic rate	9.5	0.75 (April 10)	8.75	8.75
Korea	Overnight call rate	2	0.5 (Feb. 09)	2	2
Taiwan	Discount rate	1.25	0.25 (Feb. 09)	1.25	1.25
India	Repo rate	5.75	0.25 (July 10)	4.75	4.75
South Africa	Repurchase rate	6.5	0.5 (Mar. 10)	7	7



Unemployment		Period	Release date	Rate	Change	1-year change	Next release
AMERICAS	Argentina	Q2	8/23	7.9%	-0.4%	-0.9%	11/22
	Brazil	July	8/26	6.9%	-0.1%	-1.1%	9/23
	Canada	July	8/6	7.9%	0.1%	-0.6%	9/10
EUROPE	France	Q1	6/3	9.5%	0.0%	0.8%	9/2
	Germany	July	8/31	6.9%	0.0%	-0.7%	9/30
	UK	April-July	8/11	4.5%	0.0%	-0.4%	9/15
ASIA and S. PACIFIC	Australia	July	8/12	5.2%	0.0%	-0.6%	9/9
	Hong Kong	May-July	8/17	4.3%	-0.2%	-1.1%	9/16
	Japan	July	8/27	5.2%	-0.1%	-0.4%	10/1
	Singapore	Q2	7/30	2.3%	0.1%	-0.9%	10/29

GDP		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	Q1	6/18	-0.6%	14.8%	9/17
	Brazil	Q1	6/8	-2.7%	15.2%	9/3
	Canada	Q2	8/31	0.7%	6.7%	11/30
EUROPE	France	Q2	8/13	0.7%	6.7%	11/30
	Germany	Q2	8/13	2.3%	4.9%	11/12
	UK	Q2	7/23	1.1%	1.6%	Delayed
AFRICA	S. Africa	Q2	8/24	-4.4%	-4.7%	11/30
ASIA and S.PACIFIC	Australia	Q1	6/2	0.6%	2.7%	9/1
	Hong Kong	Q2	8/13	0.4%	6.5%	11/12
	India	Q2	8/31	19.1%	8.8%	11/30
	Japan	Q2	8/16	0.1%	0.4%	11/15
	Singapore	Q2	8/27	7.8%	18.8%	NLT 11/26

CPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	July	8/13	0.8%	11.2%	9/15
	Brazil	July	8/6	0.0%	4.6%	9/9
	Canada	July	8/20	0.5%	1.8%	9/21
EUROPE	France	July	8/13	0.3%	1.7%	9/14
	Germany	July	8/10	0.3%	1.2%	9/9
	UK	July	8/17	-0.2%	3.1%	9/14
AFRICA	S. Africa	July	8/25	0.6%	3.7%	9/29
ASIA and S.PACIFIC	Australia	Q2	7/28	0.6%	3.1%	10/27
	Hong Kong	July	8/20	1.3%	1.3%	9/21
	India	July	8/31	2.3%	11.3%	9/30
	Japan	July	8/27	-0.5%	-0.9%	10/1
	Singapore	July	8/23	1.3%	3.1%	9/23

PPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	May	6/11	1.0%	15.2%	9/3
	Canada	July	8/30	0.1%	1.0%	9/29
EUROPE	France	June	7/29	0.1%	3.4%	9/30
	Germany	July	8/19	0.5%	3.7%	9/17
	UK	July	8/6	5.0%	0.1%	9/10
AFRICA	S. Africa	July	8/26	1.3%	7.7%	9/30
ASIA and S. PACIFIC	Australia	Q2	7/26	0.3%	1.0%	10/25
	Hong Kong	Q2	6/14	1.7%	4.0%	9/13
	India	July	8/16	10.2%	10.0%	9/14
	Japan	July	8/11	-0.1%	-0.1%	9/10
	Singapore	July	8/27	-1.2%	1.3%	9/29

As of Aug. 31 2010 LEGEND: Change: Change from previous report release. NLT: No later than. Rate: Unemployment rate.



CPI: Consumer price index
 ECB: European Central Bank
 FDD (first delivery day): The first day on which delivery of a commodity in fulfillment of a futures contract can take place.
 FND (first notice day): Also known as first intent day, this is the first day on which a clearinghouse can give notice to a buyer of a futures contract that it intends to deliver a commodity in fulfillment of a futures contract. The clearinghouse also informs the seller.
 FOMC: Federal Open Market Committee
 GDP: Gross domestic product
 ISM: Institute for supply management
 LTD (last trading day): The final day trading can take place in a futures or options contract.
 PMI: Purchasing managers index
 PPI: Producer price index

Economic release (U.S.)	Release time (ET)
GDP	8:30 a.m.
CPI	8:30 a.m.
ECI	8:30 a.m.
PPI	8:30 a.m.
ISM	10:00 a.m.
Unemployment	8:30 a.m.
Personal income	8:30 a.m.
Durable goods	8:30 a.m.
Retail sales	8:30 a.m.
Trade balance	8:30 a.m.
Leading indicators	10:00 a.m.

September 2010

29	30	31	1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	1	2

The information on this page is subject to change. Currency Trader is not responsible for the accuracy of calendar dates beyond press time.

- 1 U.S.:** August ISM manufacturing report
Australia: Q2 GDP
- 2 France:** Q2 employment report
ECB: Governing council interest-rate announcement
- 3 U.S.:** August employment report
Brazil: Q2 GDP
LTD: September U.S. dollar index options (ICE); September forex options
- 4**
- 5**
- 6**
- 7 Japan:** Bank of Japan interest-rate announcement
- 8 U.S.:** Fed beige book
Canada: Bank of Canada interest-rate announcement
- 9 U.S.:** July trade balance
Australia: August employment report
Brazil: August CPI
Germany: August CPI
Mexico: August PPI and Aug. 31 CPI
UK: Bank of England interest-rate announcement
- 10 Brazil:** August PPI
Canada: August employment report
Japan: August PPI
UK: August PPI
- 11**
- 12**
- 13 Hong Kong:** Q2 PPI
LTD: September U.S. dollar index futures (ICE); September forex futures.
- 14 U.S.:** August retail sales
France: August CPI
Hong Kong: August PPI
UK: August CPI
FND: September U.S. dollar index futures
- 15 UK:** July employment report
FDD: September U.S. dollar index futures (ICE); September forex futures
- 16 U.S.:** August PPI
Hong Kong: June-Aug. Employment report
- 17 U.S.:** August CPI
Germany: August PPI
- 18**
- 19**
- 20 Hong Kong:** Q2 GDP
- 21 U.S.:** August housing starts and FOMC interest-rate announcement
Canada: August CPI
Hong Kong: August CPI
South Africa: Q2 employment report
- 22**
- 23 U.S.:** August leading indicators
Brazil: August employment report
Mexico: August employment report and Sept. 15 CPI
- 24 U.S.:** August durable goods
- 25**
- 26**
- 27**
- 28**
- 29 Canada:** August PPI
South Africa: August CPI
- 30 France:** July and August PPI
Germany: August employment report
India: August CPI
South Africa: August PPI

October

- 1 U.S.:** August personal income and September ISM manufacturing report
Japan: Aug.-Sept. employment report and CPI
- 2**
- 3**
- 4**
- 5 Japan:** Bank of Japan interest-rate announcement
- 6**
- 7 Australia:** September employment report
Brazil: September CPI
Mexico: September PPI and Sept. 30 CPI
UK: Bank of England interest-rate announcement
ECB: Governing council interest-rate announcement
- 8 U.S.:** September employment report
Brazil: September PPI
Canada: September employment report
LTD: October U.S. dollar index options



KEY CONCEPTS

Carry trades involve buying (or lending) a currency with a high interest rate and selling (or borrowing) a currency with a low interest rate. Traders looking to “earn carry” will buy a high-yielding currency while simultaneously selling a low-yielding currency.

London Interbank Offered Rate (LIBOR): A benchmark short-term interest rate established daily by the British Bankers’ Association. It represents the rate at which banks can borrow funds in the London interbank market.

PIIGS: Portugal, Ireland, Italy, Greece, and Spain.

Purchasing power parity: The idea that an exchange rate should reflect the level that results in the same price (in the two currencies) for a product purchased in two countries. For example, if a certain automobile costs 50,000 British pounds in Great Britain, it should cost 25,000 U.S. dollars in the United States if the current British pound/U.S. dollar rate (GBP/USD) is 2.0000.

Quantitative easing is a tool a central bank uses to attempt to stimulate the economy when cutting interest rates is not feasible — such as when rates are already at or near zero. Through quantitative easing, the central bank purchases assets (e.g., treasuries, mortgages, securities) from financial institutions to pump money into the financial system. Quantitative easing is often referred to as “printing money.” Critics contend the practice runs a high risk of creating high inflation, among other drawbacks.

True range (TR): A measure of price movement or volatility that accounts for the gaps that occur between price bars. This calculation provides a more accurate reflection of the size of a price move over a given period than the standard range calculation, which is simply the high of a price bar minus the low of a price bar. The true range calculation was developed by Welles Wilder and discussed in his book *New Concepts in Technical Trading Systems* (Trend Research, 1978).

True range can be calculated on any time frame or price bar — five-minute, hourly, daily, weekly, etc. The following discussion uses daily price bars for simplicity. True range is the greatest (absolute) distance of the following:

1. Today’s high and today’s low.
2. Today’s high and yesterday’s close.
3. Today’s low and yesterday’s close.

Average true range (ATR) is simply a moving average of the true range over a certain time period. For example, the five-day ATR would be the average of the true range calculations over the last five days.

Variance and standard deviation: Variance measures how spread out a group of values are — in other words, how much they vary. Mathematically, variance is the average squared “deviation” (or difference) of each number in the group from the group’s mean value, divided by the number of elements in the group. For example, for the numbers 8, 9, and 10, the mean is 9 and the variance is:

$$\{(8-9)^2 + (9-9)^2 + (10-9)^2\} / 3 = (1 + 0 + 1) / 3 = 0.667$$

Now look at the variance of a more widely distributed

set of numbers: 2, 9, and 16:

$$\{(2-9)^2 + (9-9)^2 + (16-9)^2\} / 3 = (49 + 0 + 49) / 3 = 32.67$$

The more varied the prices, the higher their variance — the more widely distributed they will be. The more varied a market’s price changes from day to day (or week to week, etc.), the more volatile that market is.

A common application of variance in trading is standard deviation, which is the square root of variance. The standard deviation of 8, 9, and 10 is: sq. rt. $0.667 = .82$; the standard deviation of 2, 9, and 16 is: sq. rt. $32.67 = 5.72$.



EVENTS

Event: The Forex, Futures & ETFs Expo Las Vegas 2010

Date: Sept. 23-25

Location: Caesars Palace, Las Vegas

For more information: Go to www.moneyshow.com

Event: SEC Customer Protection Rule one-day seminar

Date: Sept. 29

Location: Bayards, New York City

For more information: www.fmwonline.com

Event: Bollinger Bands Seminar

Date: Oct. 9-10

Location: Sheraton Gateway Hotel at LAX, Los Angeles

For more information:

<http://bollingerbands.com/seminar/>

Event: The First Qatar Traders Expo

Date: Oct. 17-18

Location: J.W. Marriott, Qatar

For more information: www.metradensexpo.com

Event: CME Group’s Global

Financial Leadership Conference

Date: Oct. 18-20

Location: Ritz-Carlton Beach Resort, Naples, Fla.

For more information: www.gflc.com

Event: FXstreet.com International Traders Conference

Date: Oct. 20-22

Location: Barcelona, Spain

For more information: www.traders-conference.com

Event: Sydney Trading & Investing Seminars & Expo

Date: Oct. 29-30

Location: Sydney

For more information:

www.tradingandinvestingexpo.com.au

Event: Las Vegas Traders Expo

Date: Nov. 17-20

Location: Caesars Palace, Las Vegas

For more information: Go to www.moneyshow.com



Overlooking an obvious aspect of the yen's behavior sinks trade.

TRADE

Date: Wednesday, Aug. 18, 2010 (9:27 a.m. CT).

Entry: Long the U.S. dollar/Japanese yen pair (USD/JPY) at 85.34.

Reason for trade/setup: This paper trade had three catalysts. First, and most importantly a weekly buy setup triggered the week ending Aug. 13, implying favorable odds of higher prices over the next several weeks (see "Strategy recap"). Second, the market has been consolidating, and everyone is expecting another sharp drop to challenge the all-time low below 80.00. That will likely happen, but probably not before a fake-out move to the upside. Finally, continued trouble in the equity market (which has been building) should drive the dollar higher, as has been the pattern for the past two years.

Initial stop: 84.43, .29 below the Aug. 11 low.

Initial target: 86.35, just below the Aug. 13 high.

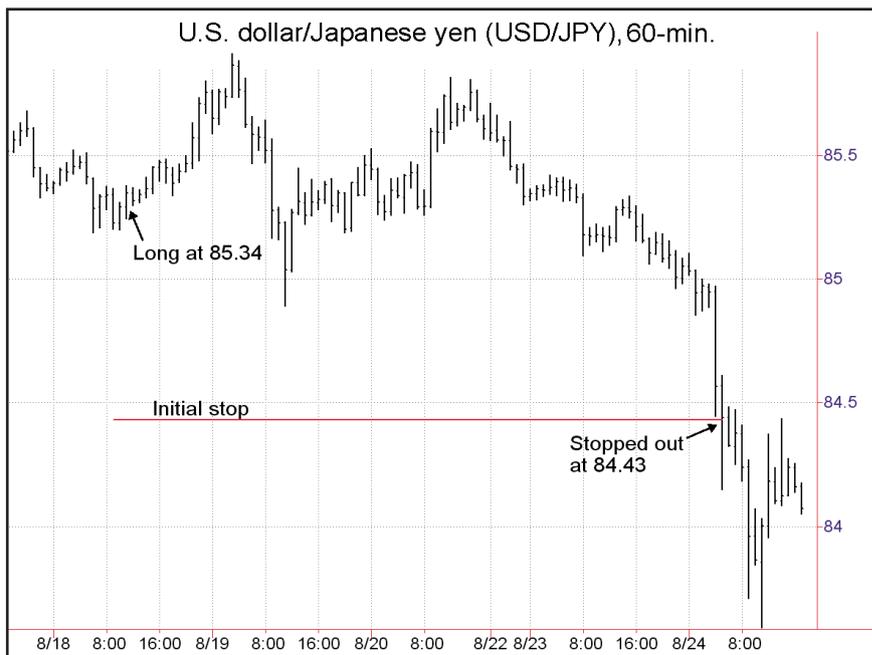
Secondary target: 87.94, a little below the July 28 high.

RESULT

Exit: 84.43

Profit/loss: -.91.

Outcome: After a few more days of sideways movement (and only a couple of brief pushes into positive territory) the position was stopped out on Aug. 24 when the dollar/yen broke made its first move out of the consolidation — to the downside.



Source: TradeStation

This trade's Achilles heel was the third reason for the position: the expected benefit from stock-market weakness. Right or wrong, sharp sell-offs in the global equity markets have, more often than not, resulted in U.S. dollar rallies since the 2008-2009 financial crisis pushed the safe-haven effect into high gear. Just one problem: the Japanese yen has been an even bigger beneficiary of financial turmoil; it was, in fact, the only major currency that outperformed the dollar during the financial crisis. This was an embarrassingly major oversight. When equity markets around the world sold off sharply on Aug. 24 (after a 10-day decline), the dollar rallied robustly — except against the yen. While the dollar lost nearly 1.5 percent vs. the yen that day, it gained more than .75 percent vs. the British pound, .9 percent vs. the Euro and Canadian dollar, and more than 1 percent vs. the Australian dollar. 📌

Note: Initial trade targets are typically based on things such as the historical performance of a price pattern or a trading system signal. However, because individual trades are dictated by immediate circumstances, price targets are flexible and are often used as points at which to liquidate a portion of a trade to reduce exposure. As a result, initial (pre-trade) reward-risk ratios are conjectural by nature.

TRADE SUMMARY

Date	Currency pair	Entry price	Initial stop	Initial target	IRR	Exit	Date	P/L		LOP	LOL	Trade length
								point	%			
8/18/10	USD/JPY	85.34	84.43	86.35	1.11	84.43	8/24/10	-0.91	-1.07%	0.57	-0.91	4 days

Legend – IRR: initial reward/risk ratio (initial target amount/initial stop amount). LOP: largest open profit (maximum available profit during lifetime of trade). LOL: largest open loss (maximum potential loss during life of trade).