

# Black Swan Capital Currency Snapshot

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## Dollar Weakness Inevitable, “They” Say. Hmmm ... ?

It seems the consensus argument is the US dollar MUST go lower given the nationalization of banking institutions and bailouts. But, that hasn't necessarily been the historical reality. Below is an excerpt from a [piece by Stephen Jen & Spyros Andreopoulos of Morgan Stanley](#):

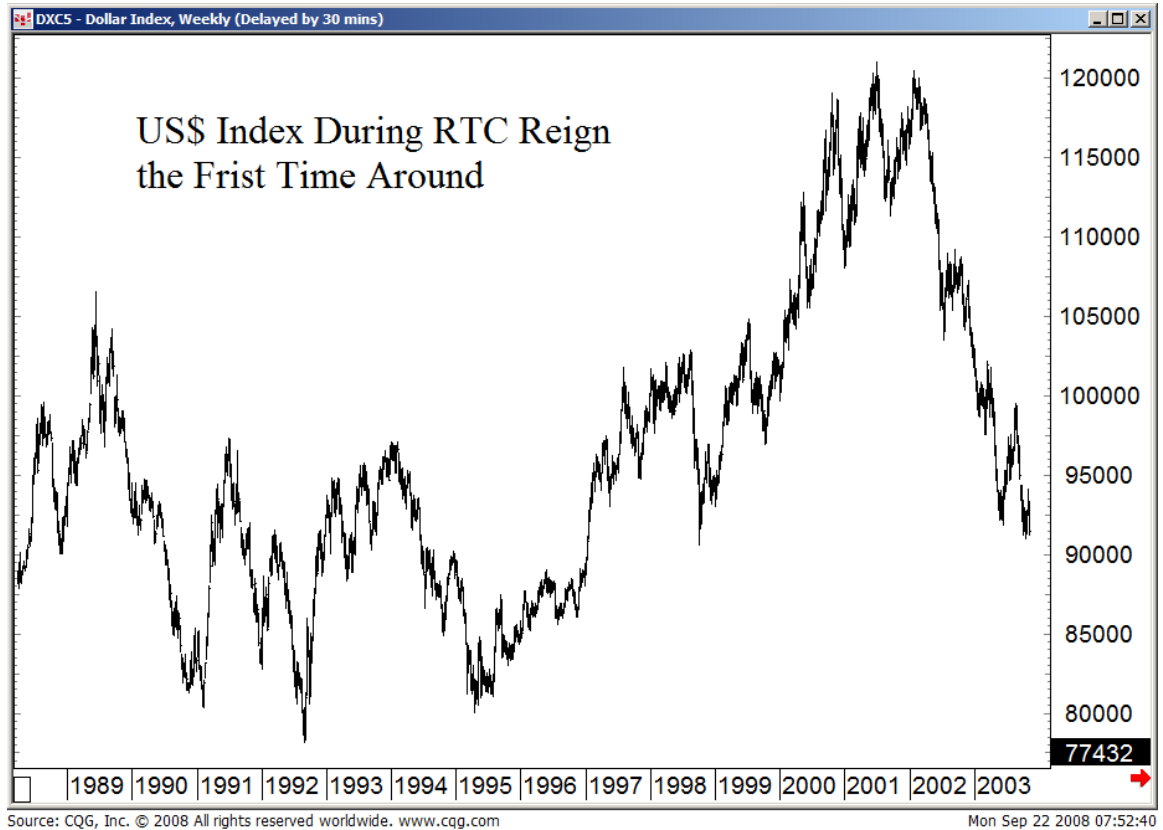
“Conventional wisdom has it that, as a government fiscalises the contingent liabilities of nationalised banks, the currency of the country in question should depreciate. More generally, banking crises are, very often, accompanied by balance of payments (or currency) crises. The US, being a country with still out-sized ‘twin deficits’ (fiscal and external deficits), will likely see the dollar weaken because of the Treasury and the Fed’s decision to effectively nationalise some of the large financial institutions, so the argument goes. **An inconvenient fact, however, is that nationalisation of banks, historically, did not tend to lead to further currency weakness.** In fact, very often the financial sector and the currency in question reach a trough just as the government takes steps to address the banking crisis. Thus, currency weakness tends to precede, not follow nationalisation.”

Below are some examples cited [our charts added] of banking crisis past and currency impact from Jen and Andreopoulos:

“**The S&L Crisis** and its bail-out spanned a protracted period of time. The dollar index did continue to fall from 1986 – the beginning of the S&L Crisis – until 1989 or so. (In 1986, the FSLIC (Federal Savings and Loan Insurance Corporation) – the deposit insurance scheme funded by the thrift industry but guaranteed by the government – first reported being insolvent (incidentally, the main reason why 1986 is remembered as the beginning of the S&L Crisis). The RTC (Resolution Trust Corporation) was established in 1989, and by 2003, the RTC had ‘resolved’ US\$394 billion worth of non-performing assets of US savings and loans. (The total cost of the clean-up of the US S&L Crisis reached US\$153 billion, in ‘current’ terms equivalent to some 2.6% of US GDP in 1991. This

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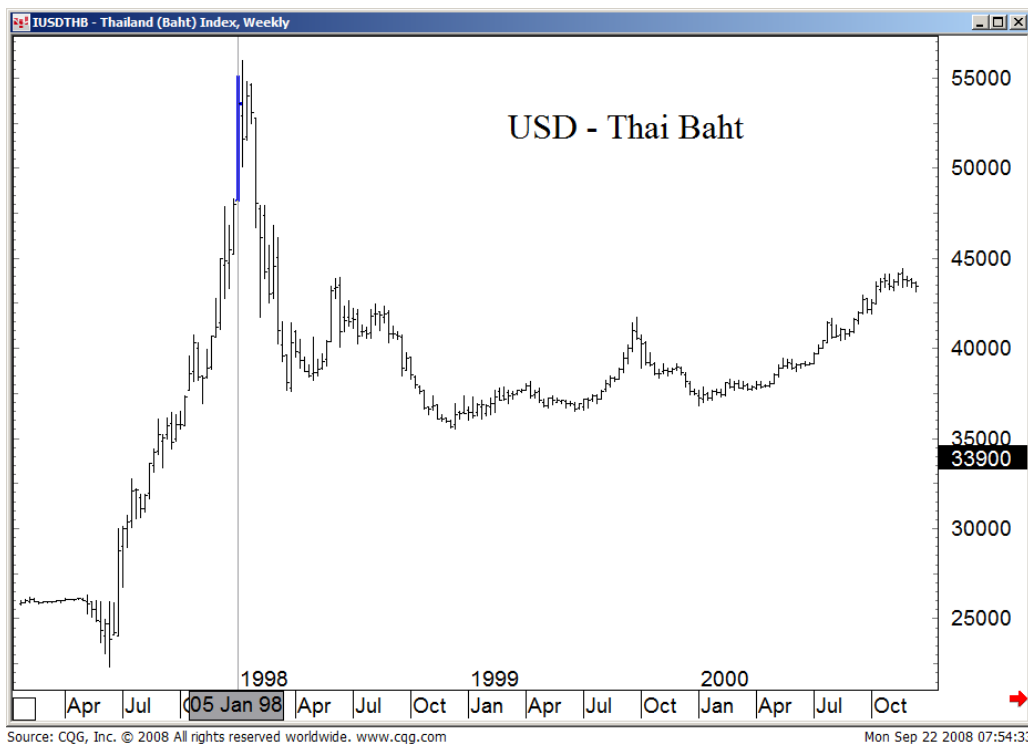
translates to US\$375 billion in 2008 dollar terms.) The dollar index essentially moved sideways in the early 1990s. The dollar did falter in 1994/95, but that was attributed more to the inflation scare than to the S&L Crisis.”



“Similarly, **Japan’s** government did not explicitly address its banking crisis until 1998-99 and again in 2002-03. After each episode, USD/JPY actually collapsed toward 100, i.e., JPY strengthened in the ensuing quarters.”



“Finally, in the case of **Thailand**, the banking crisis did indeed lead the currency crisis. But bank bail-outs did not take place until 1998, and USD/THB drifted in the 36-42 range between 1998 and 2000 – significantly below the peak of 56 reached in January 1998.”



And of course, we've watched the Euro - US dollar fall from 1.60 to the euro to about 1.39 during most of this ugly process in the US so far. No doubt, the past crises and

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currency reaction cited above represents a small sample size. But it does at least give us pause to sell the dollar in a knee-jerk fashion with expectations of a new low in the future, despite what appears to be at least a decent correction shaping up, as we indicated on Friday, and playing out at least among the European pack this morning.



The chart above represents the **Euro futures contract traded at the Chicago Mercantile Exchange**. Based on sentiment figures as evidenced in the Commitment of Traders report, the market was getting very bearish on the euro...

Commitment of Traders Report 16 Sep 2008:

Euro bullish: 32%  
Euro bearish: 68%

So, US peak in the banking crisis seems to have coincided with a much needed oversold rally in the euro (overbought correction in the dollar). Does it mean the dollar is toast—new lows dead ahead? Maybe!

However, if the overarching theme of money moving to the center is still in play—which means more deleveraging, global growth waning, and commodity prices falling—it still may be dollar supportive despite the ugly role of US government as bad debt buyer of last resort. Mr. Hampered Market is a strange place.

Regards,

Black Swan Capital

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