Black Swan Capital
Currency Currents

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Key News

- If the European climate turns nasty, the ECB could suffer from exposure. (Telegraph)

Quotable

"[ECB] Credibility undermined: First, the ECB had to make a climb-down on its collateral rules by accepting Greek government bonds irrespective of their credit rating. While justified as an exceptional step, it seems clear that the ECB will not be able to deny similar treatment to any other member state getting into trouble. Second, the decision to buy government bonds in the 'dysfunctional' secondary market was a big step, as can be seen by the open controversy it created in the ECB Council. While these purchases do not violate the Maastricht Treaty, which only rules out direct lending to governments or bond purchases at auction, they clearly help governments finance their deficits at lower rates than otherwise. Third, by continuing to provide banks with unlimited liquidity at various maturities, the ECB keeps even the weakest players afloat and thus slows down the necessary consolidation and recapitalisation in the banking sector.

"…Amazingly, though, while the gold price and currency markets have been sensitive to these concerns [about all central banks], bond markets appear to be lulled in by liquidity, carry and roll-down that seems to springs eternal. But this is not new: bond markets also took years to take on board the Great Inflation of the 1970s and the big disinflation of the 1980s and 1990s. The famed bond vigilantes are fast asleep, again".

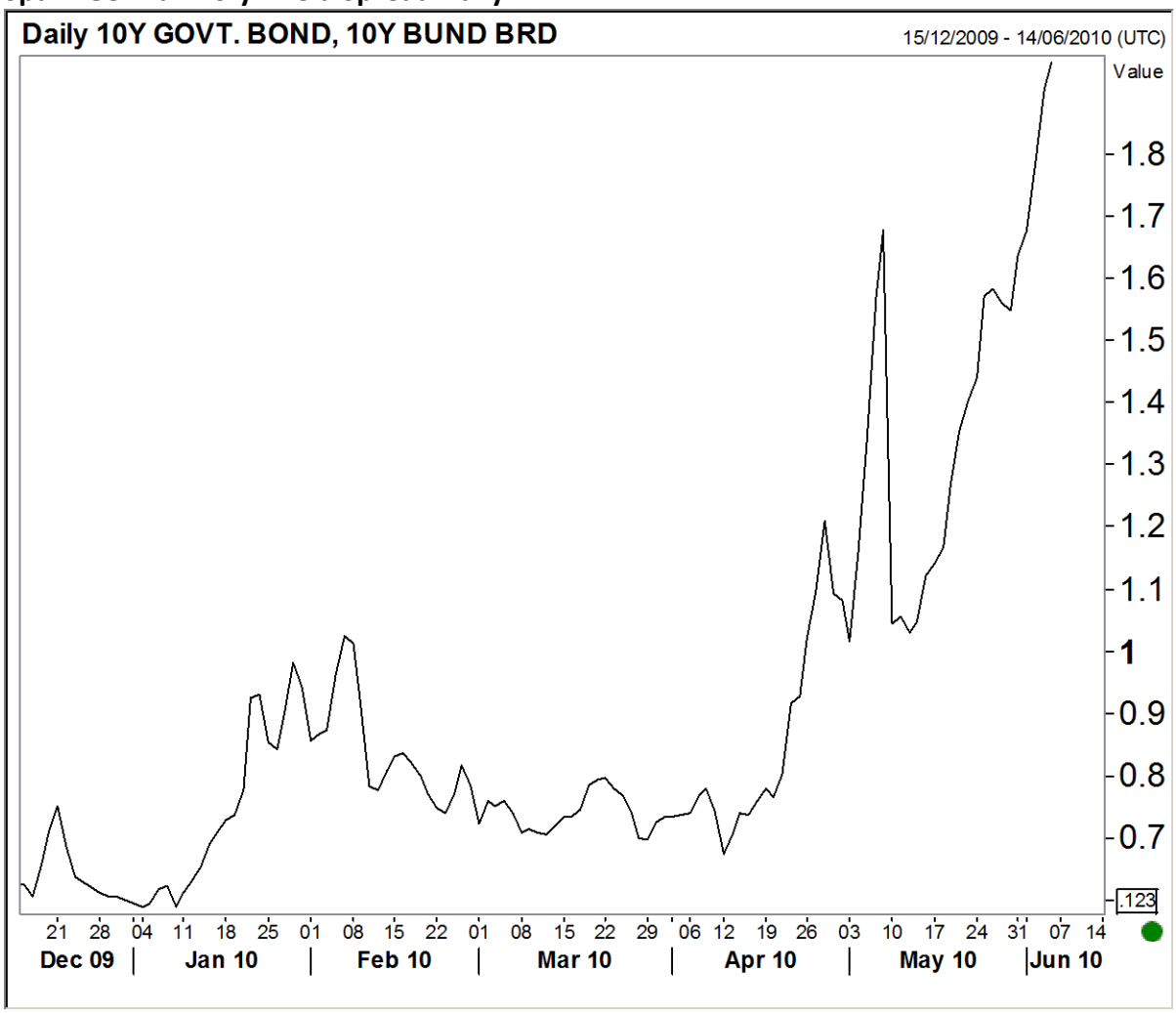
Joachim Fels

FX Trading – Sooner or later it all comes out in the wash

On Wednesday, I had an opportunity to present a webinar to discuss my current views about the euro. One of the key PowerPoint pages summarized reasons for my continued concern about the euro, includes the comment that the market has still not priced in the risk of breakup, i.e. bond yields relative to Germany are still too low for the countries facing huge debt problems, that will either be worked off/restructured/defaulted upon.

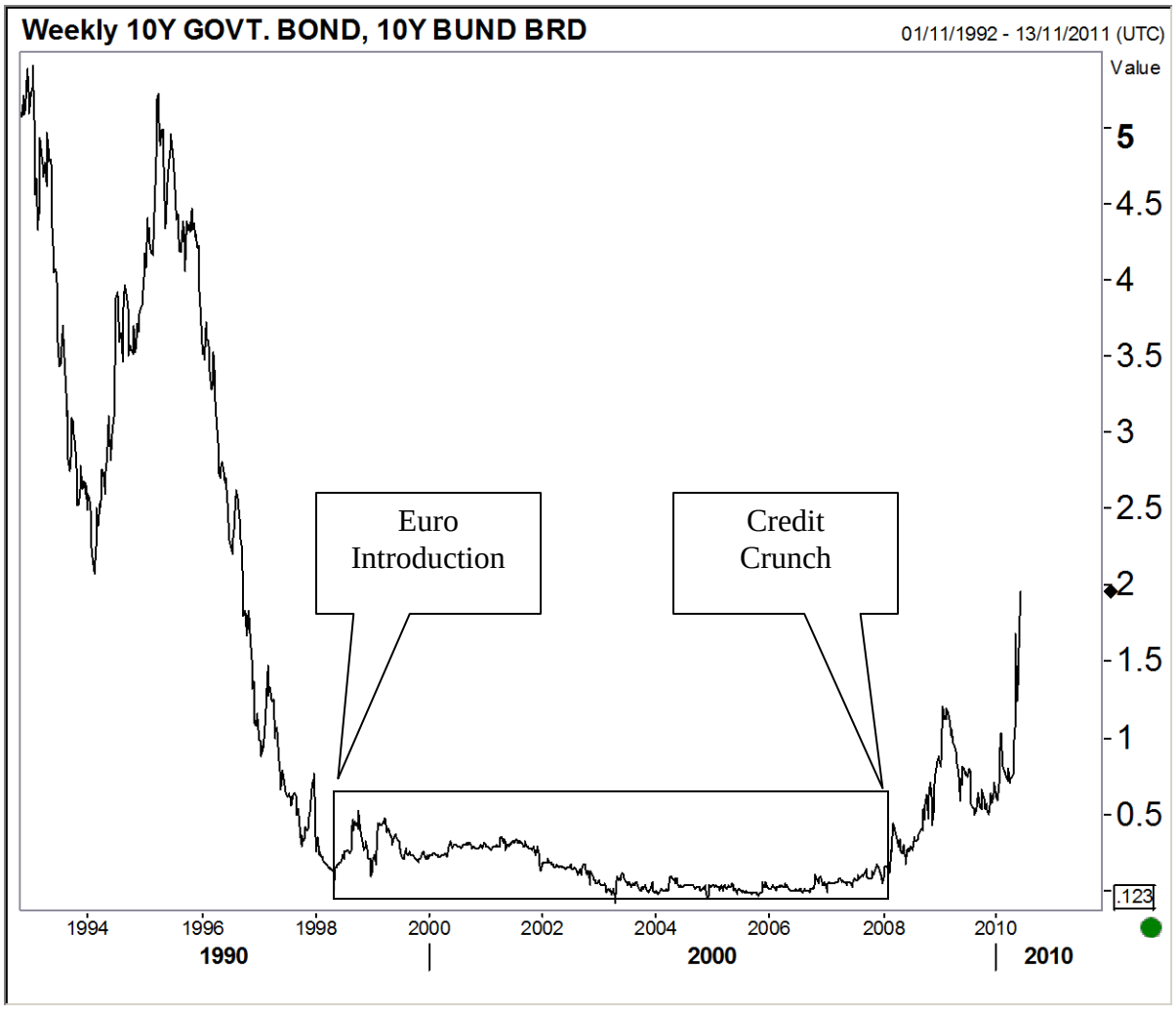
By looking at the current yield spread now between Spain and Germany, one would say the market is starting to do just that -- price in the risk in a big way:

Spain-German 10-yr Yield Spread Daily:



But what is most telling, is when we step back and look at a long-term chart of this relationship, going back to the time before the introduction of the euro as a single currency…

Spain-German 10-yr Yield Spread Weekly:



Key point to draw from the chart above:

- Before introduction **the market priced in the real differences** between Spain and German country financial conditions; and

Thus, the introduction of the euro shows the inherent artificiality of the entire system—for 10-years the monetary union tried to ignore the market and create its own rules.

But, Mr. Market can only be denied for so long. Low cost credit was used primarily for consumption (party hardy buying those German exports) instead of capital goods (building efficiencies to compete with Germany). And now this period, bookended by the Credit Crunch, is over. Mr. Market is on to the game. Sea change events in the global economy are almost always triggered by the abuse of credit.

So, it is interesting to watch all of government politicos—the Western world over—pretend that this problem was purely a problem caused by the market and lack of regulation. It is to laugh!!!

Politicos impose their will and create huge market inefficiencies, by basically buying votes with artificially low interest rates, then turn around and have the gall to say "the market failed us." What a joke! And they wonder why voters are lining up all over the world to throw their so-called "leaders" out of office.

So, let's boil this down to a yes or no question to help determine whether or not we think the European Monetary System will soon be history (the title of a major presentation I gave about two-years ago which brought some laughter to the audience):

Do governments collectively have the ability to continue to deny Mr. Market?

Our answer is no! Governments have shot their monetary wads. We agree with our Quotable from Joachim Fels—central banks have lost all the credibility they once had. So the levers of market intervention have been severely weakened—and we are thankful for that.

Take a moment and look back on the long-term Spain-German yield spread chart above. Think about all this paper generated by all these members of the eurozone at very high prices (issued at very low interest rates). Now think about the fact that there are many institutions and central banks sitting on all that paper that is becoming increasingly less valuable by the day. Then ask yourself another question: Is the European banking system a train wreck waiting to happen?

The term we keep using is "systemic risk." Instead of defining that, let me share with you what an old accounting professor I had many years ago said on a regular basis during class:

"Sooner or later it all comes out in the wash."

Now, I finally understand what he meant!

Happy non-farm payroll Friday to you.

P.S. Scotch lovers unite! I want to thank all my fellow scotch drinkers for the overwhelming and nice responses we received from my missive on Wednesday about my love for scotch and father-in-law's promise to step up to the 15-year Glenfiddich. One of our readers wrote to say: skip the 15-year, the 18-year is so much better. I shared that very astute observation with my father-in-law. So far, I haven't heard back from him. ☺

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We've been getting the same question a lot over the last few days: is it too late to profit from the euro crash; and what about the Aussie ... or yen?

And our answer is:

No.

We've done well in 2010. And we expect to do even better as the halfway point approaches.

For good measure, I've included our year-to-date track record and profit curve here, reflecting through Thursday, May 20.

Here's the bottom line…

We think the Euro is going to par with the dollar – 1:1 – or maybe even lower.

If you've been waiting on the sidelines, now is time to jump in.

If you're not sure how to implement a currency trading strategy, we've got you covered. And we offer a 30-day 100% money-back guarantee if this isn't for you. After that we prorate your refund on a weekly basis if it's not working for you.

This is speculative trading and is not for everybody. If you're cut out for this, jump over now and give it a try.

All the best,

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