PARAMETER-LESS FX STRATEGY P. 16

Strategies, analysis, and news for FX traders

CURRENCY TRADER

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Latin currency quilt

Latin America is currently a mixed FX bag, with a few bright spots surrounded by unsettled currency outlooks.

BY CURRENCY TRADER STAFF

While developed nations continue to battle sluggish economic growth or recession, emerging markets are poised to once again outperform in 2013. Credit Suisse pegs 2013 global gross domestic product (GDP) at 3.3%, but expects developed economies to average 1.1% GDP growth this year — far below the 5.5% GDP pace for emerging markets.

There are three major emerging market "zones" for FX traders to monitor: non-Japan Asia, Latin America, and EEMEA (Eastern Europe, Middle East, and Africa). Fueled by China, Asian economies remain the strongest performers, with Credit Suisse forecasting a 6.8% GDP pace for emerging Asia in 2013. Latin America is second on the list at a 3.6% pace, followed by the EEMEA countries at a 2.9% pace.

Latin America has often been a destination for speculative forex money chasing higher yields. Those returns are still present, but increased central bank currency intervention has cooled interest in some currencies, including the Brazilian real (BRL). Right now, the Latin region appears to be something of a mixed bag. With myriad potential economic reforms in the pipeline, Mexico could be the star performer, while Brazil has been disappointing on the economic side. And Argentina's currency outlook remains risky, with an illegal so-called "parallel" market already developing for foreign exchange trade there.

Big picture

The increased interdependency of the global economy in recent years has not left Latin America unaffected, and the region has certainly been impacted by downturns in other areas of the international economy.

"The region is basically trying to figure out what's going on in China and Europe," says Eugenio Aleman, senior economist at Wells Fargo Securities. "Brazil has been particularly affected by the European crisis and the Chinese slowdown." Brazil is both a major raw commodity exporter to China and a big exporter of diesel automobiles and auto engines to Europe.

In recent years, Latin currencies have been notably driven by the swings in global risk appetite and risk aversion. During times of risk appetite, global money managers have pushed into Latin American markets, but bouts of risk aversion have triggered quick exits. However, although that phenomenon still exists, it may be lessening now.

"We are clearly in an environment where external events matter very much," says Clyde Wardle, senior EM FX strategist at HSBC Securities. "But it also seems apparent that sensitivity to those events is less than it was. For instance, even in the last couple of weeks (*as of March 27*), which saw downward pressure on emerging market currencies, it seemed the bulk of that was in the emerging Europe and Middle East region. In Latin America, the Chilean peso and the Mexican peso continued to do quite well (*Figure 1*)."

Another factor supporting Latin American currencies is the sustained loose-money policies by many global central banks. "You have central banks in the developed world still pursuing quantitative easing," says Dr. Francisco Larios, chief emerging-market economist at Decision Economics, Inc. "There's a monetary policy push in developed countries that benefits flows into the [Latin] economies." Larios also notes that although commodities have come off their post-crisis peaks, they remain at relatively high levels. "On average, commodity prices are still above levels when the Lehman crisis happened," he says.

The expected 2013 economic growth rates for Latin American countries is mixed. Nomura categorizes Venezuela in a recession, with a -1% GDP rate. Meanwhile, it estimates Argentina at 4%, Brazil at 3.5%, Chile at 5.5%, Columbia at 4.2%, and Mexico at 3.5%.

"There are some countries in the region that have been doing extremely well, where growth has been clearly above average," Lario says. "Peru has been booming and it is growing at a very, very fast pace. It is growing Asian style."

Larios describes Peru's "policy stability and low inflation" as a primary growth catalyst. "Most evident is a lot of investment in mining and infrastructure, but there's also a lot of construction going on," he says.

In his 2013 *Latin American Outlook*, Alfredo Coutino, director Latin America at Moody's Analytics, noted Peru continued to outperform most other Latin American nations in 2012 thanks to its mining boom and solid macroeconomic fundamentals. That growth decelerated in early 2012, but "timely fiscal stimulus and low interest rates" resulted in a quick rebound in domestic demand that offset the impact of the sluggish world economy. "Fiscal and monetary policies will remain accommodative in 2013, with the economy growing at a solid 5.8% after an estimated 6.3% in 2012," he wrote.

Mexico

Although in years past Brazil has been the shining star of the Latin region, more recently Mexican fundamentals have impressed many analysts. The country has been implementing major reforms designed to increase productivity and overall growth.

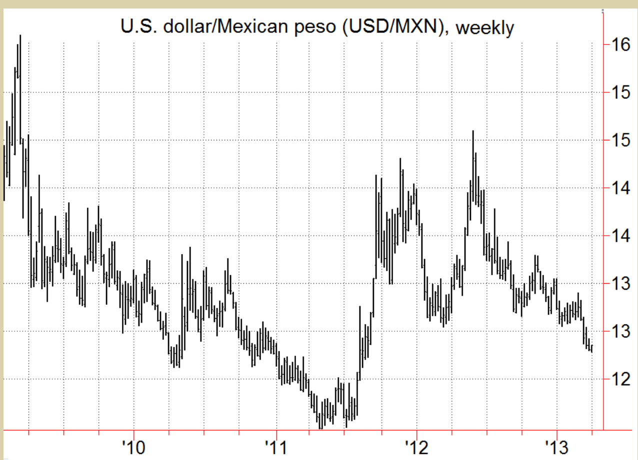
Through March 25, the Mexican peso (MXN) had gained 4.3% vs. the U.S. dollar on the year, and many analysts remain positive about the currency. "I keep thinking the Mexican peso is in for a good run," Larios says. The currency has pushed to its strongest levels vs. the U.S. dollar since summer 2011 (Figure 2).

"Mexico has been our top pick for this year for the currency outlook," Wardle says. "We think there are a number

FIGURE 1: LATIN RESILIENCY

While some emerging European and Asian currencies were getting hit in early March, some Latin American currencies, including the Mexican peso, held their strength.
Source: TradeStation

FIGURE 2: NEARING TWO-YEAR MILESTONE



In March the USD/MXN pair dropped to its lowest level since late summer 2011.
Source: TradeStation

of positive factors. It stands to benefit from some structural reforms. There are two key reforms, fiscal and energy, which the market expects to be passed by the end of this year — it could result in ratings upgrades."

Several reform developments emerged after President Pena Nieto took office in December. The so-called "Pacto por Mexico" defines specific, time-based goals for the country, including structural reforms to increase the Mexican energy sector's competitiveness and initiate changes to make the state-controlled energy company, Pemex, more efficient and profitable.

Unlike many developing countries that have been threatened with or subjected to credit downgrades in recent years, Mexico is on the upswing. "With reforms, we and most investors consider Mexico a strong candidate for an 'A' rating. However, this could largely depend on the scope and strength of the reforms passed," HSBC analysts wrote in a research note.

Aleman agrees that "Mexico is still one of the brightest spots," but he nonetheless voices some concerns about a potential economic slowdown south of the border this year because of a weaker export picture to the U.S. He forecasts 2013 Mexican GDP at 2.7% but concedes he "might be on the low side of consensus." He notes Mexican exports jumped 17.1% in 2011, but increased by only 6.2% in 2012. "That's a very big slowdown," he says, adding, "There's a big slowdown in construction, which was one of the big drivers of the domestic expansion."

In early March the Mexican central bank slashed its benchmark interest rate from 4.5% to 4%. However, the Mexican peso actually rallied on the news, as the central bank widely announced that this was a one-time monetary policy cut and not the start of a new easing cycle. The central bank cut rates in response to a dramatic slowing of inflation. The fourth quarter 2012 GDP deflator increased by 0.7% on a year-over-year basis, which was the lowest reading ever recorded.

"Prices were very weak in the fourth quarter," Aleman says. "The deflator has never dropped below 3% before. It was a very weak pricing environment in the fourth quarter."

The forex market viewed the March action as a "one-and-done interest rate cut," Wardle says. "It fits with our medium-term positive view of the currency. We still see more room to rally; we see 12.15 by year-end."

FIGURE 3: DOLLAR/REAL

Many analysts expect the Brazilian central bank to take steps to keep the nation's currency in a well-defined range vs. the U.S. dollar.
Source: www.advfn.com

Brazil

Brazil is the largest economy in Latin America, but last year's GDP numbers were on the low side for this erstwhile economic powerhouse. In 2012, GDP came in at 0.9% — a sharp contrast to the 7.5% pace of 2010 or the 6.1% pace from 2007, Aleman notes.

However, analysts expect Brazil's economy to pick up. "We should see GDP growth in the 3.5-4.% range later this year," Larios says.

As testament to the greater impact and importance that Asia has to the region, Larios notes that Brazil's biggest trading partner is now China. But Brazil also has strong ties to the Eurozone and the recession there has taken its toll in Latin America. Aleman notes in 2012 the commodity price slowdown and contraction in the Chinese and European economies hit Brazil's manufacturing sector.

Nonetheless, Brazil could be on the verge of a new interest-rate tightening cycle. The central bank's official selic rate is currently at 7.25%, but several market watchers see potential for rate hikes as early as this April. "Inflation is starting to turn higher, and they are always very concerned it could re-accelerate," Aleman says.

Credit Suisse forecasts a total of 1.25% in rate increases in 2013, potentially starting with a 0.25% hike in the selic rate at the central bank's April 16-17 meeting.

"The market is gearing up for rate hikes," Wardle says. "Given where they've come from, their tolerance for inflation has gone away." HSBC expects the selic rate to jump to 8.75% by year-end, with a 0.50% hike anticipated for the May meeting, a 0.5% jump in July, 0.25% in August, and a 0.25% hike in October.

Regardless of higher rate expectations Brazil's central bank is also expected to wield a heavy hand in the forex market, which will keep currency appreciation to a minimum despite higher interest rates. Slower growth could also weigh on the currency late in the year. "We're less constructive on Brazil medium-term," Wardle says. "Once the focus turns back to the lack of growth, we could see dollar/real at $2.15 by year-end."

The BRL gained 1.7% year to date vs. the dollar through March 25, but most market watchers still expect Brazilian government to keep a tight hold on the currency's range in the months ahead (Figure 3). According to Wardle, central-bank intervention is more prevalent in Latin America than other emerging market nations, but what differentiates the Brazilian central bank from most others in its region is that "Brazil is intervening on both sides of the market, while other central banks tend to be primarily dollar buyers," he says.

As a result, Wardle expects the real to remain in a fairly tight range, which he pegs at 1.95-2.05. "The most recent intervention, just a few weeks ago, was them buying dollars around 1.95," he says.

Argentina

Credit Suisse forecasts Argentina's GDP at 3% for 2013. Argentina's peso (ARS) has posted the biggest declines vs. the U.S. dollar in the first quarter among the Latin currencies, and many see risk for additional weakness ahead. The peso fell 3.8% through March 25 vs. the dollar.

"The Argentine economy had serious difficulties expanding in 2012, with growth slowing down from an impressive 8.9% in 2011 to only 2.0% in 2012 after the external sector collapsed due to both weakness in the global economy as well as by political decisions taken by the Kirchner administration," wrote Wells Fargo economists in a research note.

Analysts warn of a potential devaluation in Argentina's currency this year. Currently there is a so-called "parallel market" for exchanging the peso into U.S. dollars, which sprang up in response to governmental capital controls that included the inability to purchase U.S. dollars. To meet demand for U.S. currency, the illegal exchange market developed, with a wide spread to the official exchange rate of 5.1 pesos to the dollar. The parallel market is currently about 8.6 pesos to the dollar. "People are scared and they think the government will try to take their money with higher taxes or higher appropriations," Aleman says. "The government is running out of money to finance its expenditures, and the economy is very weak."

Larios says there's a perception the government is very interventionist. "There is a complete lack of confidence in their published inflation numbers," he says. "There is much more inflation than they really report. It is really unraveling. There's a complete lack of transparency — it's a completely flawed way to manage a macro economy. They may be forced to devalue their currency."

Chile

The Chilean peso (CLP) climbed 1.3% vs. the U.S. dollar year-to-date through March 25. Credit Suisse forecasts 4.9% GDP growth for Chile in 2013. The CLP is currently trading around 473 pesos to the dollar (Figure 4). However, there is risk for central bank intervention to try to weaken the currency.

"We are close to 2008 and 2011 levels, where we have seen intervention in the past," Wardle says. "If we broke 470 the probabilities of some kind of intervention would increase."

The peso has gained early in 2013 due to a strong domestic growth picture and relatively high interest rate, according to Wardle. The Chilean central bank lending rate stands at 5%. "Investors get a nice return and the economy is in good shape from a fiscal and debt perspective," Wardle says.

Chile also benefits from its copper deposits. Roughly 55% of the country's exports are copper, with much of that supply heading to China. "The rebound in China is expected to be a positive for commodity prices more generally," Wardle notes.

However, Wardle adds not to look for anything dramatic out of Chile. "We could see 490 by year-end, with modest weakness throughout the year," he says. "The CLP is unlikely to strengthen much more at these levels, with the threat of intervention."

FIGURE 4: CHILEAN PESO

The CLP's sustained strength has some analysts speculating about the risk of central bank intervention to weaken the currency vs. the dollar.

Source: www.advfn.com

Confidence fairies, the Cyprus incident, and the sovereignty puzzle

Little Cyprus is a bigger story than many people think.

BY BARBARA ROCKEFELLER

A big, insolvent bank in Cyprus was put into bankruptcy over the weekend of March 23-24, and bondholders, shareholders, and uninsured depositors will take a big loss. The bankruptcy is part of a wider plan to recapitalize the country's banks, which will continue to receive emergency liquidity from the European Central Bank (ECB). If Cyprus had not put the bank into liquidation, the ECB was going to withhold short-term lending, because it cannot lend to insolvent banks.

In addition to money taken from the failed bank amounting to about €4-5 billion, Cyprus will receive €10 billion in bailout funds from the troika (Eurogroup, ECB and IMF) to stave off sovereign default. If Cyprus had defaulted, it would have had to leave the Eurozone.

That's the Cyprus incident in a nutshell. Cyprus is the fifth Eurozone member to undergo a sovereign debt crisis and apply for a bailout, joining Greece, Ireland, Portugal, and Spain. The Cypriot banking problem arose from having invested in Greek bonds, among other non-performing assets, including about €30 million in Greek real estate. Cyprus' banks were undercapitalized and Greek losses were disastrous. Unlike Greece, though, Cyprus' public finances had only recently gone into the tank. In fact, Cyprus balanced its budget twice in recent years (2007 and 2008). The International Institute of Finance reports that Cypriot government debt declined from 70% of GDP in 2003 to 49% by the end of 2008.

So far, so good. The situation in Cyprus is just the unhappy collateral damage from the Greek debt crisis and restructuring. Not a big deal. A bank failed, the country borrowed from the troika to avert sovereign default, and the economy will have to contract for some years before fully recovering. This is what is happening in Ireland and Portugal, and Ireland has already returned to the private bond market, if in a limited way.

Not so fast.

In the process of arriving at the bankruptcy and bailout resolution, all the parties involved behaved very, very badly. They variously made statements and took actions that violated the spirit of Eurozone solidarity, the letter of contract law, and confidence in the management capability of the Eurozone, especially the ECB. In a single week, the Eurozone did tremendous damage to years of confidence-building.

U.S. economist Paul Krugman invented the term "confidence fairies" to ridicule the idea that when an accepted authority pronounces something to be so, the markets believe it, even when the statement is manifestly not true and logically unlikely to be true. The Eurogroup and the ECB, not to mention the IMF, are exactly that kind of authority. When, for example, ECB chief Mario Draghi makes a strong policy statement, everyone believes it fully, even when he doesn't disclose exactly how the policy will be implemented.

Confidence might be measurable only with great difficulty, but no trader would dismiss confidence out of hand as fiction. Only an ivory-tower economist who has never traded would invent the term "confidence fairies." Authority figures can inspire confidence with mere words, and they can lose that ability if they blunder. That is precisely what the Eurogroup, ECB, and IMF have done in the Cyprus incident. It bodes ill for the Euro.

The time line

As noted, the crisis in Cyprus differs little from the banking crisis in other Eurozone countries, including Ireland, Portugal, and Spain. The insolvent banks held a large percentage of government bonds that would have to be sold in the event of a bank failure. The state acquiring the non-performing assets of failed banks adds to the public debt, and rising public debt as a percentage of GDP ends up inspiring investors to demand higher yields. Ending the poisonous relationship of a failing banking system with public indebtedness is a primary goal of the upcoming pan-EMU banking regulator, which will define capital adequacy, offer deposit insurance, and generally make banking safe everywhere in the Eurozone.

In Cyprus, banks heavily invested in Greek bonds and real estate (among other losing assets) were sliding into bankruptcy. Cyprus formally applied to the ECB for a €17 billion bailout in June 2012. The ECB and other members of the troika dithered and delayed until Cyprus elected a new government on Feb. 24, 2013. It was not until the weekend of March 16-17 that the troika announced it would provide no more than €10 billion and Cyprus would raise the remainder by taxing bank depositors at a rate of 6.75% for accounts under €100,000 and 9.9% for accounts over €100,000. And because the Cypriot banks borrowing funds from the ECB were about to become insolvent and therefore ineligible to borrow from the ECB, the deadline for Cyprus to raise its share of the bailout was Monday, March 25. In other words, the troika gave Cyprus one week to fish or cut bait.

Before then, the Cypriot Parliament rejected the deposit tax proposal by a vote of 36 to zero, with 19 abstaining (and one absent). Cypriot Finance Minister Michael Sarris travelled to Russia the next day to seek better terms on an existing €2.5 billion loan, a new loan, a bank takeover, and/or a gas-exploration deal. He returned empty-handed, with Russia deferring involvement until it sees how the situation plays out. Going into the fateful weekend before ECB funding would disappear, the Cypriots had proposed a different deposit tax schedule to the troika, but the meeting was postponed for various reasons until 9 p.m. on Sunday, March 24, just 12 hours before the ECB deadline.

Critics noted this type of 11th-hour negotiation was becoming a tiresomely regular feature of the troika management style, and alarmists pointed out the next day the Eurozone could have a different membership roster. Forcing Cyprus into leaving the Eurozone (even if it kept the Euro for the sake of convenience) would be a full-blown crisis, because there are no exit criteria in any of the treaties and pacts, as noted in the Greek discussions since 2009.

Violation of the public trust

The first shock was the proposal to confiscate a percentage of the bank deposits, including those of ordinary people insured up to €100,000, to pay for Cyprus' share of the bailout. The troika members went along with this idea, making them complicit in confiscation. Historically, confiscation leads to capital flight, unless the sovereign imposes capital controls, which is exactly what Cyprus did a week later.

When the news hit the wires on March 16 the troika was proposing taxes on both insured and uninsured bank deposits, it was immediately obvious this was a basic violation of the contract between the depositor and the sovereign providing the deposit insurance.

Criticism focused on the Eurogroup, where the proposal reportedly originated. It took more than a week before German Finance Minister Wolfgang Schaeuble asserted it was the Cypriot government that preferred depositors (over shareholders) to take the loss. Earlier he had said taxing the smaller (insured) accounts was "not a German idea." In other words, it was Cyprus itself, not the Eurogroup, ECB or IMF, that proposed the depositor haircut, only two weeks after newly elected Cypriot president Nicos Anastasiades promised specifically not to do that.

To make matters worse, the Eurogroup explicitly stated it wanted Cyprus to shrink the size of its banking sector to Eurozone norms, from approximately eight to 3.4 times GDP. This is dictating a nation's business plan, so to speak. Acting as an offshore banking center accounted for about 50% of Cyprus' GDP.

Confiscation and contagion

Some analysts dismiss the Cyprus crisis as a mere squall. Cyprus is a standalone case and a very minor one at that, with fewer than 1 million citizens and a GDP representing 0.02% of the Eurozone total. Cyprus is about half the size of Connecticut and has GDP of only €18 billion, whereas Connecticut has GDP of $249 billion and a state budget of $46 billion. Cyprus is too small and such a special case that we can't expect contagion to other Eurozone countries from the crisis.

But for a sovereign nation to call for a tax on bank depositors, including insured accounts, is confiscation, and the issue of confiscation is very, very big. In practice, a tax is better than the bank going broke — depositors immediately know how much they're losing, whereas in a bankruptcy they stand in line for a long time and don't know until the last minute how much they have lost. The problem is not the method by which the depositor takes a loss, it's the confiscation aspect for those who trusted that deposit insurance was what it was advertised to be — a guarantee by the sovereign.

State confiscation is actually fairly rare. We have confiscation through eminent domain, where the state seizes real estate for some common good, which is more properly called "expropriation" because the original asset holder receives some compensation. In outright confiscation, there is no compensation. In practice, the compensation associated with expropriation is usually deemed insufficient and unfair, so telling the two apart is hard.

Outrageous state confiscations include the Nazis expropriating the property of Jews, Soviet Communists expropriating everything after 1918, and the U.S. government grabbing private land (most of it Native American) to build railroads. In the 19th century, the UK instituted its enclosure laws.

Today, the state confiscates the property of convicted drug criminals, the guns of those trading illegally in firearms, the real estate of anyone growing marijuana (in Connecticut), and other criminals, including anyone at airports carrying an illegal amount of shampoo. The U.S. government legally confiscated the property known as slaves (technically as war contraband) during the Civil War before freeing them, and confiscated gold in 1933 from those who failed to turn it in. But on the whole, the term confiscation applies to the property of criminals. An important point: When your shampoo bottle is illegally large, you should know that, and also that airport security is legally allowed to seize it.

State confiscation of bank accounts is so rare that only a few cases outside of war-time can be found — Austria and Czechoslovakia in 1920, Japan after WWII. In the seminal book by Carmen Reinhart and Kenneth Rogoff, *This Time is Different*, the words "confiscation" and "expropriation" do not appear in the index. The modern term is "capital levy" and it as been brought up only a few times over the past few decades as a solution to the sovereign debt problem. The state has to make a case that the capital levy serves an immediate public good, such as retiring public debt, and is a last-ditch measure. By announcing the capital levy ahead of time, depositors gain time to flee, calls to patriotism notwithstanding. The only really successful capital levy over the past century was in Occupied Japan — and it was imposed by the Occupation, not a Japanese government.

But when you have an insured bank deposit, you are not engaging in any illegal activity and have a reasonable expectation that it is, indeed, your money. When the state takes the stance that all the money in the country belongs to it and it will decide how much of it you get to keep, trust in government is lost.

To a certain extent, states with personal property taxes on things like cars and boats are engaging in a capital levy. A lawyer would say taxing bank deposits is not a difference in kind. An economist may add that when the Federal Reserve keeps interest rates artificially low for the benefit of the banks against the interests of savers, it's the same thing as a hidden capital levy. But ask a Cypriot whether some part of his funds were confiscated and there is no question of the answer.

In fact, the depositor tax violates many other rules and standards, both formal and customary.

Unequal treatment

In a bank bankruptcy, traditionally those who lose asset value are bondholders, equity shareholders, and uninsured depositors. The troika bailout would be of the Cypriot government, not the banks directly. In comparison, the ECB promised to directly bail out Spanish banks as long as Spain admitted ultimate sovereign responsibility.

That Spain has not formally asked for the bailout is irrelevant. What is relevant is unequal treatment, which arises purportedly from Eurogroup (German) unwillingness to use their taxpayer money to save Russian kleptocrats and other foreigners, whose deposits are some 40 to 50% of the total €68 billion in Cypriot deposits. French Finance Minister Pierre Moscovici says Cyprus is a "casino society," as indicated by a bank balance sheet of eight times GDP. But attracting foreign capital with good terms is a legitimate business model used by other small nations, including Luxembourg, whose banking sector is more than 20 times the country's GDP. Granted, it's hard to feel empathy for Russian oligarchs and mobsters — and Russia is not a member of the EMU — but discrimination against one nationality (or religion) is a terrible thing and often a slippery slope.

The press reports the Eurogroup told Cyprus it needs to reduce its banking sector to the EU average of 3.5 times GDP. This smacks of only previously glimpsed dictatorial powers at the Eurogroup, as in the case of the French effort to force Ireland to raise its corporate tax rate, since low Irish taxes were one of the key business investment magnets behind the Celtic economic miracle. Bottom line, it seems the Eurogroup was telling Cyprus to get out of the money laundering business (and out of bed with Russia) or get out of the Eurozone. This is patently unfair. How can the government know which deposits are from crime and laundering and which are legitimate?

If the Eurogroup or ECB wanted Cyprus to stop being an offshore banking center, it should have said so when Cyprus joined the EMU in 2008. Alternatively, upon accepting Cyprus as a member, it should have made special provision for the offshore banking activities to be fenced off from Eurozone rules and practices. The Eurogroup and ECB had another opening to separate domestic banking from offshore banking when Greece was defaulting, since the strong historical links to Greece were obviously well-known.

How could no one have seen this coming? To wait until the Cypriot banks were actually failing and then hold Cyprus hostage to a new standard is its own betrayal.

Capital flight

Advance talk of a tax had already triggered a withdrawal of about €1.7 billion of deposits from Cypriot banks in January. Because the banks were closed for the entire week after the deposit tax story broke, depositors could get money out of banks only at ATM's. When banks reopened on March 28, a full-scale run was averted by imposition of capital controls — limits on cash withdrawals and travellers' allowances, a ban on wire transfers, etc. These controls were initially slated to be in place for seven days, but no one doubts they will be extended to a month, or perhaps longer. When controls are relaxed, the estimate of capital outflows range from 10% to 50% of total deposits.

As for contagion, it is not well understood. Logically, depositors would look to the next bailout candidates (Spain, Italy) and assume the same kind of confiscatory tax could be used again. What is not clear is whether insured depositors will be exempt, or only the big accounts that are presumably better qualified to judge the solvency of the bank. In Spain, courts are now deciding whether depositors who bought into a form of hybrid note/CD are still insured depositors. The depositors feel they were cheated and didn't understand deposit insurance would not apply to the new security. The result is twofold — deeper evaluation of the solvency of small banks, which the average depositor is not qualified to conduct, and capital flight from the country.

For centuries, capital flight in the face of a capricious sovereign has been the result. The Eurogroup now appears "capricious." Other Eurozone members are already getting

FIGURE 1: EURO RESPONSE TO SOVEREIGN BANKING CRISES

The Euro rallied from 1.2068 in July 2012 to 1.3711 by Feb. 2, 2013. It has subsequently fallen back below 1.2900 as the Cypriot crisis has unfolded.

Source: Chart — Metastock; data — Reuters and eSignal

hit, or at least threatened; most bank shares across Europe are down. Moody's issued the following statement: "The losses are credit negative not only for Cypriot bank creditors, but also for other European bank creditors since this is a significant step toward limiting or removing systemic support for bank creditors across Europe." What Moody's is really saying is the ESM will not be used to rescue banks (that's the systemic thing), despite Draghi's promise to Spain last year.

The turning point of the Spanish sovereign debt crisis was Draghi's July 26, 2012 policy statement that "the ECB is ready to do whatever it takes to preserve the Euro." The Euro bottomed and rose from 1.2068 (July 23, 2012) to 1.3711 on Feb. 2, 2013 (Figure 1). The FX market was willing to wait until September before Draghi put his money where his mouth was in the form of the Outright Monetary Transactions (OMT) that called for unlimited purchases of sovereign debt. The yield on 10-year Spanish notes fell from 7.5% in July to below 5% by late December and, after a few days above 5% during "Cyprus Week," they fell back below 5%.

Many officials have denied any risk of contagion. France's Moscovici told Reuters "There's no reason to have doubts about the Eurozone based on the Cyprus case." The French have been serial expropriators, so perhaps this is not too surprising. But it's not true. For the ECB (and the IMF) to approve expropriation of the average citizen's savings, insured or not, is an immense blow to confidence in the Eurozone's ability to manage its economy and financial system.

And there is an organic connection between confidence and contagion, although no one currently expects a run on Italian or Spanish banks out of fear those governments would "pull a Cyprus." For one thing, Italian and Spanish politicians are too savvy. For another, they are presumably closer to being able to join the upcoming Eurozone-wide deposit insurance plan to be built into the new ECB-run bank regulator. That's the road of least resistance.

All the same, the European bank bailout process just got a whole lot nastier and uncertain. To be fair, those who place large amounts of money in any bank, offshore or not, in return for higher-than-normal returns must know they are taking a risk. In a way, the ECB is educating the depositor to start linking risk and return.

But no one would assert the Cyprus incident was the best way to do that. The idea of confiscation and sovereign betrayal linger. After all, Draghi's promise was to do whatever it takes to preserve the Euro, not to preserve banks or to protect depositors.

Reputation risk

The ECB is the single institution within the Eurozone with power and credibility. For the ECB to accept taxing depositors is to shoot itself in the foot, or maybe both knees. Michel Barnier, the EU commissioner responsible for the financial sector, has already called for accelerated talks on the pan-Eurozone banking regulator that was supposed to sponsor a pan-Eurozone deposit insurance plan.

Cyprus is like Greece in that its crisis is built on the core issue of tax evasion, along with crime supposedly being the primary source of the offshore funds. Germans and other northerners evade taxes, too, but the extent of tax evasion in the southern tier is shocking. Cyprus has the added component of money laundering by Russians and others, but the principle is the same — when you design a system to benefit crooks, you can't cry for help when you get into trouble, at least not with any credibility. The Eurogroup approach is, you made your bed, now lie in it.

But this hard-hearted stance violates another aspect of union — trust. Germany trusts the Netherlands to present fair and accurate financial accounts, but cannot trust Greece or Cyprus (or Italy or Spain). The logical deduction is that you shouldn't enter into a union with a party you don't trust, and likewise, the untrustworthy (who know they are untrustworthy) shouldn't count on aid and succor from those in the union they know do not trust them.

Before the Eurozone was launched, there was a big debate about whether Italy could and should join. After that (2001), letting Greece in was easy — but it should not have been. Cyprus should not have been allowed in at all (2008), but the precedent had been set with Italy and Greece: It's OK for countries to be in bed together without trust.

A banker would never make a loan to a counterparty it knows to be dishonest. It's the first rule in credit training — character is everything. It doesn't matter whether the borrower has a good business plan and repayment schedule, collateral up the wazoo, and fine management. If the counterparty is a crook, you don't do business with him. Willingness to repay comes before the ability to repay. Somehow politics, chiefly the ambition of EMU founders to compete with the U.S. and get the Euro to reserve currency status, blinded the Eurozone to the first principle of a successful union — trust.

Therefore, quite apart from the economic consideration that Greece would be far better off with the drachma than with the Euro, all this support for the continuation of the Eurozone in its present form is misplaced. Genuine credibility would come with the EMU booting out both Greece and Cyprus, or rather, letting their banks fail and sovereign default ensue. Because the Greek saga has now gone on too long without that outcome, maybe Cyprus will be or should be the test case. If the Eurogroup declines to expel Cyprus, it will be out of fear of contagion.

Bottom line, not only was the Eurozone designed badly in the first place — no pan-EMU taxing authority — it contains some unqualified parties, and the inability to deal with the resulting problems is a form of mismanagement. The only way the Euro can thrive is for markets to engage in "willful ignorance" — players declining to acknowledge a massive defect. So far this is exactly what has happened.

The most obvious lesson from the trust problem is that Turkey should count its blessings the Eurozone, led by France, refuses to let it enter. Trust would never be extended, whether for historical or religious reasons. Turkey would have to pay its share of dues and bailouts, but couldn't count on reciprocity, treaties be damned.

Russia game

Reports on Russian involvement in Cypriot banking and the Cypriot economy are difficult to untangle. Russians have a major financial investment in Cyprus, a lot of it capital flight from Russia's uncertainties but some of it perfectly legitimate. At one point it looked like the banking subsidiary of Gazprom would step forward, and Cyprus might also offer it an exploration license, but this talk has come to naught. Unfortunately, Cyprus is also a major trans-shipment point of arms for Syria from Iran. Presumably the U.S. and other NATO allies have a vested interest in not letting Russian influence get any bigger.

If the Eurogroup was playing a game of chicken with Cyprus — get out of the money laundering business or get out of the Eurozone — it chose a particularly ham-handed way to do it. With all the concern about contagion, some of it justified, it was a high-risk tactic. Another idea is the Eurogroup tried to extort Russia into funding the bailout but Russia refused to play. Talks between Eurozone and Russian officials were reported to be decidedly chilly. In a particularly murky episode, a European Parliament member from Germany, Georgios Chatzimarkakis, said what Russia really wants is Cyprus out of the Eurozone but still in the European Union.

It's ironic that if Cyprus were to leave the EMU and also chose a new (devalued) currency, it would probably fare pretty well (for one thing, tourism, a little over 10% of the economy, would boom). Maybe the Eurogroup secretly wants Cyprus to leave as a lesson to others. First, you're not good enough to be in our club. Second, it's not the end of the world. Some good economic consequences can arise from exiting the Eurozone, and the first of these is devaluation. No economist on the planet would argue otherwise, but rising revenue from devaluation is not the only goal of a nation.

The troika and the ECB in particular have made a horrible mistake. Under our current model of capitalism, it's OK to wipe out investors who misjudged the value of their assets. It's not OK to expropriate the savings of the hotel maid after telling her the deposits were state-insured.

The overall bias of the Cyprus drama is Euro-negative, but on past experience the market is always willing to give the Euro the benefit of the doubt. After all, Cyprus is economically irrelevant and its banking sector was indeed an unacceptable mess. Bottom line, Cyprus doesn't count unless it does, and we won't know that until we see contagion. This is a little like waiting to fire until you see the whites of the enemy's eyes.

It's not the market's way to judge things like contract law and EMU management capabilities, and since FX takes its tone from bonds (and bonds are OK), the stink in Nicosia has to be endured but not given much attention. Now we need to watch for capital flight, aka contagion. It's entirely possible the markets' ability to tolerate anxiety is so high the Cyprus incident will blow over quickly, whatever the outcome. But it's also possible it will fester until an authority figure, Draghi for instance, promises out loud that insured depositors everywhere in the Eurozone are safe from a capital levy. That would still leave plenty of wiggle room for imposing a tax on the uninsured.

Longer run, Cyprus without its offshore banking capability must fact a contracting economy, perhaps as much as 25%. This brings the sustainability of the Cypriot national debt into doubt — again. Both Cyprus and the troika blundered with the deposit tax idea, and while the current resolution appears to be in keeping with the usual banking sector restructuring process, economic problems are not solved — and the economy goes forward with a new higher level of uncertainty. The confidence fairies had their wings clipped.

Trading FX on a big-picture hypothesis is risky. For example, those who sell the dollar because of the twin deficits (trade and budget) take big losses on the occasions the dollar is favored as a safe haven. Losses were also in store for those who sold the dollar when the Fed introduced quantitative easing on the grounds that it would cause inflation. But during the financial crisis, the extra money supply went into reserves and investment in government notes and mortgage-backed securities, not into the real economy and therefore the multiplier effect didn't develop. No real economy multiplier, no inflation.

In this case, it looks like the Eurozone shot itself in the foot. The likelihood of contagion — capital flight — is not zero; the Euro "should" be sold. But be careful.

Barbara Rockefeller (www.rts-forex.com) is an international economist with a focus on foreign exchange, and the author of the new book The Foreign Exchange Matrix *(Harriman House).* *For more information on the author, see p. 4.*

Latest IMF figures show dollar still reigns in reserves

Dollar slips slightly as a percentage of total currency holdings, but developing countries are net buyers of the buck.

BY MARC CHANDLER

At the end of last March, the International Monetary Fund (IMF) reported the latest currency reserve figures for the fourth quarter of 2012. Overall currency reserves stood at $10.9 trillion at the end of last year, a $734.5 billion increase over the course of the year.

Most central banks provide the currency allocation of their reserves, but there are two notable exceptions: China, which regards the information as a state secret, and Taiwan, which is not a member of the IMF. These two nations account for the lion's share of the $4.85 trillion in unallocated reserves.

In percentage terms, the U.S. dollar's share of allocated reserves slipped to 61.9% from 62.1%. The Euro's share was unchanged at 23.9%, while the yen's share eased from 4.1% to 3.9%.

Looking at the changes in absolute amounts rather than percentages offers a more nuanced perspective of what took place. For example, the decline in the dollar's share of allocated reserves does not mean a single dollar was sold. On the contrary, central banks added $31.4 billion to their reserves in Q4 and $247 billion over the course of the entire year. Of the 2012 increase, $78.5 billion was accounted for by the high-income countries (what the IMF refers to as "advanced"). This means developing countries were net buyers of dollars — hardly diversifying away from the greenback.

After a $11.5 billion decline in Q3, allocated reserves held in Euros rose $20.6 billion in Q4 — their highest level since Q2 2011. Last year, the high-income countries bought $106 billion worth of Euros for reserves. However, developing countries sold almost $45 billion of Euros over the course of 2012, reducing Euro holdings in each quarter of the year except Q1.

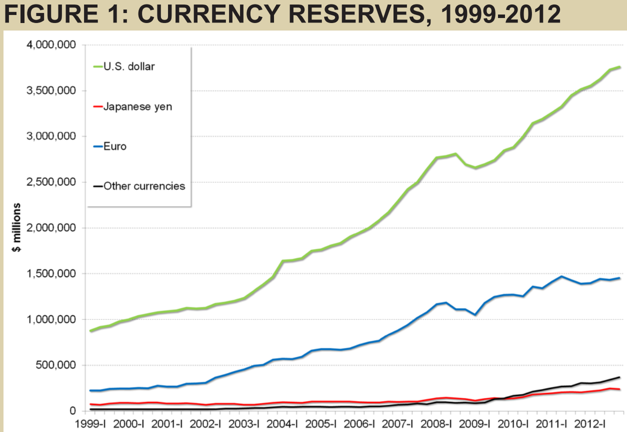
In Q4 2012, British pound and yen holdings were pared by $2.7 billion and $8.5 billion, respectively. Nearly the entire $26.7 billion increase in sterling reserves for 2012 were accounted for by the high-income countries ($21.2 billion). Of the $33 billion increase in yen holdings, the high-income countries accounted for a little more than two-thirds of the total purchases.

High-income countries were also responsible for the majority of the diversification into the "other" category, which is dominated by the Australian and Canadian dollars. The share of allocated reserves accounted for by this category stands at a record 6.1% as of the end of 2012. Roughly $54.8 billion was added to this category last year, $40.5 billion of which was purchased by the high-income countries. (In either Q1 or Q2 this year, the IMF will break out the Australian and Canadian dollars from the "other category," to better reflect what is actually taking place. It is an accounting function, not normative in the sense of prescribing what countries ought to do.)

Finally, despite the relatively low volatility in the foreign exchange market, the IMF's data needs to be adjusted for valuation swings. The figures used for the IMF's calculations show the U.S. dollar rose 2.5% vs. the British pound and 11.5% vs. the yen in Q4, while it appreciated by 2.1% against the Euro. Over the course of 2012, the dollar slipped 2% against the pound and the Euro, while appreciated about 11.4% against the yen.

Marc Chandler is head of global foreign exchange strategies at Brown Brothers Harriman. This article was adapted from his blog, Marc to Market (www.marctomarket.com). *For more information on the author, see p. 4.*

FIGURE 1: CURRENCY RESERVES, 1999-2012



The U.S. dollar status as the world's reserve currency remains intact.
Source: International Monetary Fund (www.IMF.org)

A parameter-less price action FX strategy

Eliminating traditional strategy parameters can result in more robust trading ideas.

BY DANIEL FERNANDEZ

Trading systems generally have trading rules that require specific parameter values to be used. For example, a trading system based on a moving average crossover requires the trader or system developer to make choices about at least two parameters: the type of moving average (e.g., simple or exponential) and the moving average length (the number of price bars in the moving average calculation).

System designers typically conduct historical optimizations to find parameter values that maximize a certain performance metric — for example, the ending net profit. This process leads to the phenomenon commonly known as "over-fitting," where a trading strategy works very well within in-sample conditions (the historical data used to optimize the strategy), but fails under unknown market conditions. Basically, the system is tailored to perform artificially well on a specific period of past price data, but then fails when confronted with new, future data.

Here, we'll explore a way to minimize this problem by creating extremely simple strategies for which entries and exits are based on "parameter-less" comparisons between chart elements — for example, the relative position of current and past prices. For our purposes, a parameter is considered as a variable that controls the amount of information used for calculations (such as an indicator period length) or the use of information (such as a moving average type selection) within a trading rule.

Creating a strategy without parameters in this sense means we have to avoid any calculations that might require a definition across a certain time period. For example, indicators cannot be used within the entry or exit logic because they typically require a specific look-back value (i.e., the number of periods over which the indicator is calculated). This definition of "indicator" includes any calculation that requires the computation of a statistical property across a given number of bars, such as a standard deviation, an average, and so on.

First, let's describe the system we'll use to illustrate this process.

A parameter-less EUR/USD system

To create a parameter-less trading strategy we must rely on the most basic possible comparisons between individual chart elements. Arguably the simplest way to define a trading system is to reference only the open, high, low, and close prices, along with the less than and greater than operators, when defining trading logic.

This simple example uses such basic logic to exploit a simple price action pattern in the Euro/U.S. dollar pair (EUR/USD). The rules are:

1. Go long if the open 24 bars ago is below the open of the most recently closed bar, and the low of the previous closed bar is below the open of the most recently closed bar.
2. Go short if the open 24 bars ago is above the open of the most recently closed bar, and the high of the previous closed bar is above the open of the most recently closed bar.
3. If there is a long trade open and a short signal occurs, close the trade and open a short trade.
4. If there is a short trade open and a long signal occurs, close the trade and open a long trade.

Figure 1 shows a sample long trade in the Euro/U.S.

FIGURE 1: SAMPLE TRADES

The system, which is always in the market, switches from long to short based on comparisons of the open and low prices of specific price bars.

dollar pair (EUR/USD) from 2012. The system is always in the market, as the only way to exit a long trade is by getting a short signal, and vice versa. Note the strategy has no parameters associated with the exit or entry logic; the system acts on a fixed price pattern based on direct comparisons between daily bars.

TABLE 1: SYSTEM PERFORMANCE

Performance metric	Result
Average annual return	8.33%
Absolute return (% initial balance)	634%
Total trades	543
Winning percentage	47%
Profit factor	1.58
Reward-to-risk ratio	1.76
Maximum drawdown	13.01%
Max. drawdown length	1,183 days
Ulcer Index	5.57
Number of years	26

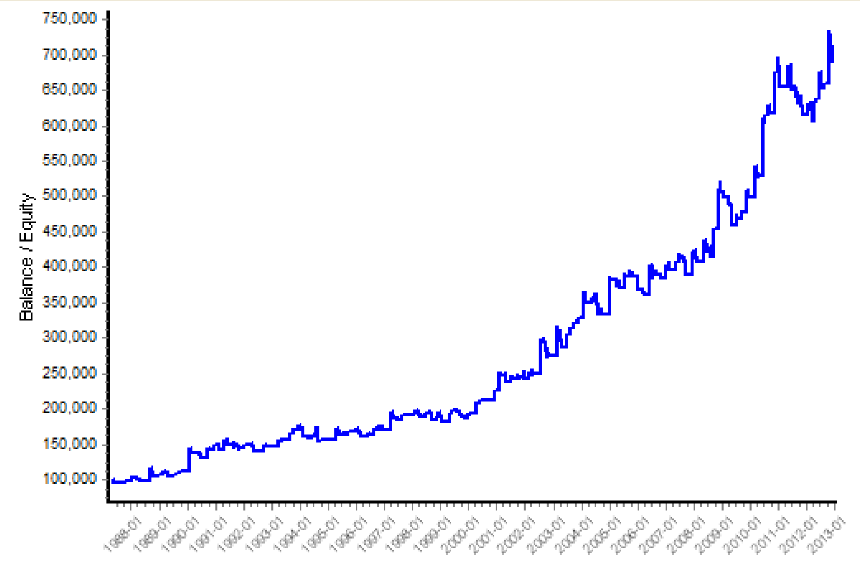
The strategy triggered more than 500 trades over the 26-year test period, producing an 8.33% average annual return.

In order to evaluate the statistics of this trade logic, the system was tested on daily EUR/USD prices from 1987 through 2012; before 2000, deutsche mark/U.S. dollar pair (DEM/USD) data was substituted for EUR/USD prices. The starting account balance was $100,000 and trading costs were set at two pips (0.0002) per trade.

Money management for the system was implemented so the system would lose 1% of account equity for a move two times the 20-day average true range (ATR). For example if the value of the 20-day ATR was 0.0050 (50 pips), the system would lose 1% on an adverse move of 0.0100 (100 pips). It should be pointed out that the system's statistics do not vary significantly with the choice of ATR period length because this variable affects only money management, not the entry/exit logic, which is fixed by the price pattern. Although the risk per trade is not explicitly controlled by the strategy, this money management rule ensures extremely large price moves would be required to cause a significant loss of equity — something confirmed by the largest single-trade loss in the test, which was -6.73%.

Figure 2 shows the system's equity curve. The curve

FIGURE 2: EQUITY CURVE



The system's equity growth was fairly smooth, but it did have a long (if shallow) maximum drawdown.

reflects a noticeably smooth balance accumulation across a very large portion of the 26-year test period, but it's important to note the strategy wouldn't have been easy to trade because of its large maximum drawdown length (1,183 days, between 1994 and 1997) and the significant number of losing years through the whole period (8 out of 26). However the large reward-to-risk ratio (1.76) and profit factor (1.58) imply that only a couple of winning years would have been necessary to get significantly ahead. In fact, as seen in Figure 3, the largest winning year (35.15%) was more than three times the size of the largest losing year (-8.95%).

Simplifying system design and evaluation

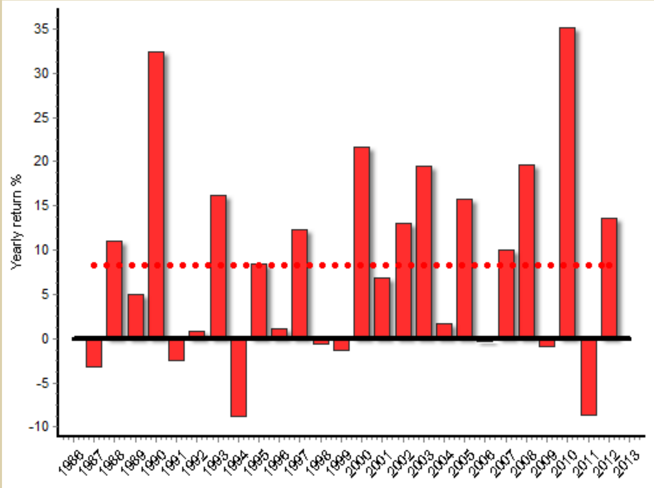
Although a "parameter-less" strategy design does not guarantee success in unknown market conditions (as is the case for any system development methodology), it does eliminate several common system-design problems associated with parameter selection, such as the appropriate degree of optimization, the selection of optimization ranges, and the additional tests that must be conducted to ensure no over-fitting is present.

Also, simple parameter-less strategies based on price patterns facilitate a clearer understanding of the approach's underlying logic and, as a result, a potentially higher degree of confidence in trading it.

Finally, the straightforward nature of these strategies and the elimination of optimization issues opens the door to the use of automatic strategy design software, giving a trader the ability to scan through thousands of simple price patterns to find suitable trading ideas that can later be tested through out-of-sample testing to evaluate candidates for live trading.

Daniel Fernandez is an active trader focusing on forex strategy analysis, particularly algorithmic trading and the mathematical evaluation of long-term system profitability. An initial implementation of the strategy generator idea suggested in the final paragraph can be found at http://mechanicalforex.com/kantu-system-generator. *For more information on the author, see p. 4.*

FIGURE 3: ANNUAL RETURNS

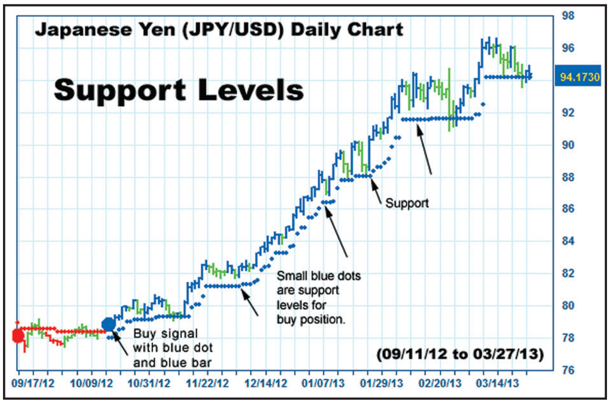


Eight of the 26 years were negative, but the largest up year was more than three times the size of the largest down year.

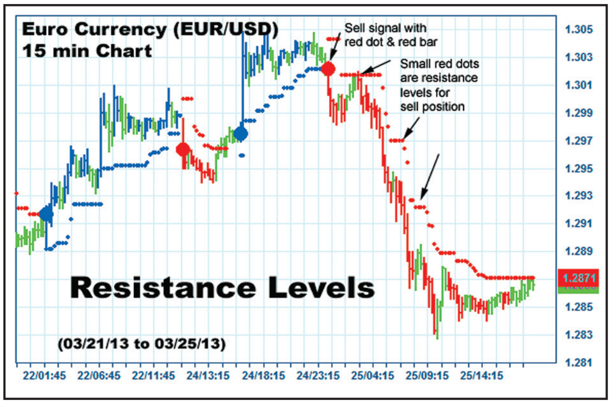
How Do I Know If The Market Has Changed Its Direction Or If It's Just A Temporary Pullback?

AbleTrend T2 Stops Can Help

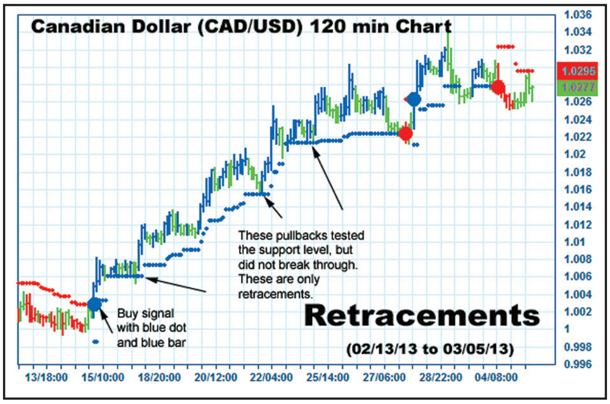
1. Small blue dots are T2 stops for buy positions showing the market support levels



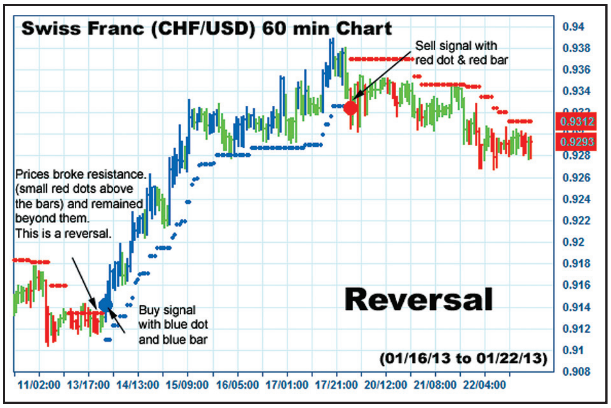
2. Small red dots are T2 stops for sell positions showing market resistance levels



3. T2 stops helps to define the retracements



4. T2 stops helps to define the reversal



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There are no amber waves of currencies

We should fight the impulse to explain commodity price trends via changes in monetary policy.

BY HOWARD L. SIMONS

One of the enduring tales of the Odyssey is our hero, you-know-who, running the straits between Scylla and Charybdis while resisting the Sirens' Song. If this bears any resemblance to the life faced by most traders it surely must derive from resisting the Sirens' Song of Nonsense (album-filler, for those of you old enough to remember albums) about currencies and commodities.

This cacophony is the logic, seemingly impeccable but actually quite peccable, that if a commodity is priced in dollars, then a weaker dollar must lead to the conclusion that more of them will be required to claim a given unit of gold, wheat, sugar, or dirt.

This might be true if we had a one-commodity and a one-currency world where both supply and demand for the commodity in question was both fixed and known and where the prospective changes in the purchasing power of the currency had no effects on behavior. In the real world, however, factors such as supply shocks, substitution, price and income elasticities of demand, changes in interest rates, changes in supply and demand preferences across commodities, taxes, seasonal factors, and a host of other messy variables come into play and distort the simple notion of "dollar-down, commodities-up."

With this is mind, let's go about answering a question that often arises in the global grain market: What effect will a weaker dollar/Euro exchange rate have on grain prices?

No such thing as commodities

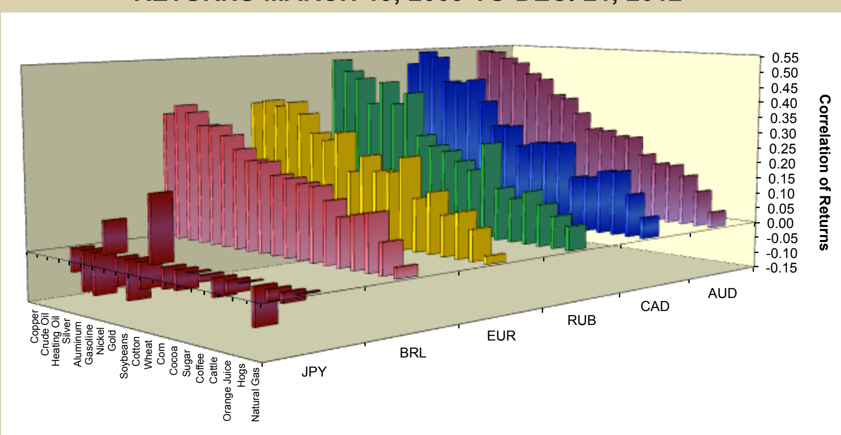
First, let's stipulate there is no such thing as either "commodities" or "the dollar." (Please see "Had enough of the dollar and stuff?" and "Deconstructing the commodity price surge," *Active Trader*, March and November 2008, respectively). To summarize two long arguments, what we refer to collectively as "commodities" is a group of markets related only by the fact that 1) they are exchange-traded and 2) they are tangible.

These markets in turn can be divided into three broad categories: those that are extracted without replacement or recycling, such as crude oil; those that are extracted and recycled indefinitely, such as copper; and those that are regenerated continually, such as grains, oilseeds, and soft commodities.

Second, these markets have very, very unstable correlations of returns both on the individual and on the sub-index levels; they can be demonstrated to oscillate between positive and negative levels with irregular periodicity. This means a long index position may include commodities moving in opposite directions from each other. Yes, this would provide diversification, but it makes no sense for those who seek to maximize return.

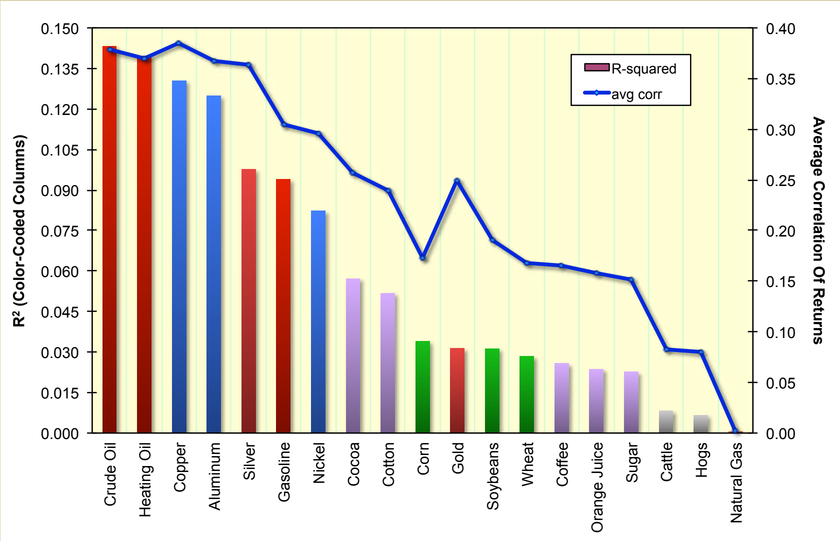
If we turn to the concept of currency indices, the admonition offered in "Weighting for correlation" (*Currency Trader*, July 2011) remains valid: "Don't get into the business of index manage-

FIGURE 1: AVERAGE ROLLING THREE-MONTH CORRELATION OF RETURNS MARCH 19, 2009 TO DEC. 21, 2012



The average three-month rolling correlation of returns is strongest for the AUD, CAD, and RUB.

FIGURE 2: RELATIONSHIP OF EURO TO COMMODITIES SINCE APRIL 26, 2010



The "strongest" links for the Euro (vs. petroleum and industrial metals) are, in fact, weak.

ment." As the objectives behind all currency indices are uncertain — are they supposed to be trading instruments, hedging instruments, economic indicators, or some combination? — they exist in a world without concise purpose. Banding six of them together in a four-decade-long, fixed-weight package as the dollar index, banding 10 of them together in a statistically elegant but hard-to-trade and constantly changing correlation-weighted index, or banding them together in a trade-weighted index or set of indices that cannot be traded leaves no one satisfied.

Here's a simple translator: When people say, "the dollar," they mean the dollar index, which is 57.6% the Euro by weight. When people say, "commodities," they mean the petroleum complex, which will account for 67.7% of the S&P/GSCI commodity index in 2013. Everything else in both cases is there simply to be sociable.

Time dependencies

If the correlations between commodities are variant and unstable and if the correlations between currencies change over time, it stands to reason the correlations between individual commodities and individual currencies change over economic and market regimes. Let's stipulate the work has been done in support of this statement and move on to examine the set of correlations of returns between six currencies and 19 commodities over the entire post-March 2009 era of quantitative easing.

The currencies include the Euro, yen, ruble, real, and both the Australian and Canadian dollars. The European Union is a surprisingly large producer of a host of commodities; the yen is included almost as a straw dog in this regard. The RUB, BRL, AUD, and CAD all represent commodity-export powerhouses.

It should surprise no one the average three-month rolling correlation of returns is strongest for the AUD, CAD, and RUB, in descending order of relationship strength (Figure 1). Within these currencies, their strongest commodity correlations are those against copper, crude oil and heating oil, silver, aluminum, and gasoline.

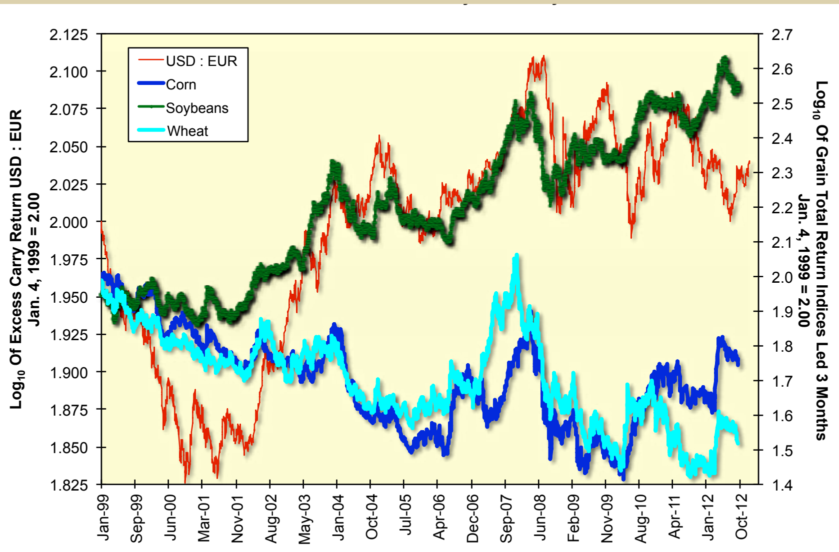
Isolating the Euro

Correlations of returns seem to have a great intuitive appeal to many observers, but they are not as directly useful as the r^2 of a regression relationship in answering the simple question of how much of the variance in a commodity price can be explained by a variable such as the Euro.

Because these relationships can and do shift across market regimes, it's important to confine the analysis to a period with a dominant trend. As the very nature of the Euro and its internal cohesion changed during the sovereign debt crisis beginning in late 2009 (see "The interest rate price of a currency union," *Currency Trader,* March 2013), let's use April 26, 2010 as the start date for analysis. This is when the forward rate ratio between six and nine months ($FRR_{6,9}$) of the Euro began to flatten. It should be noted that flattening ended in September 2011 with Mario Draghi's increasingly aggressive stance at the European Central Bank (ECB).

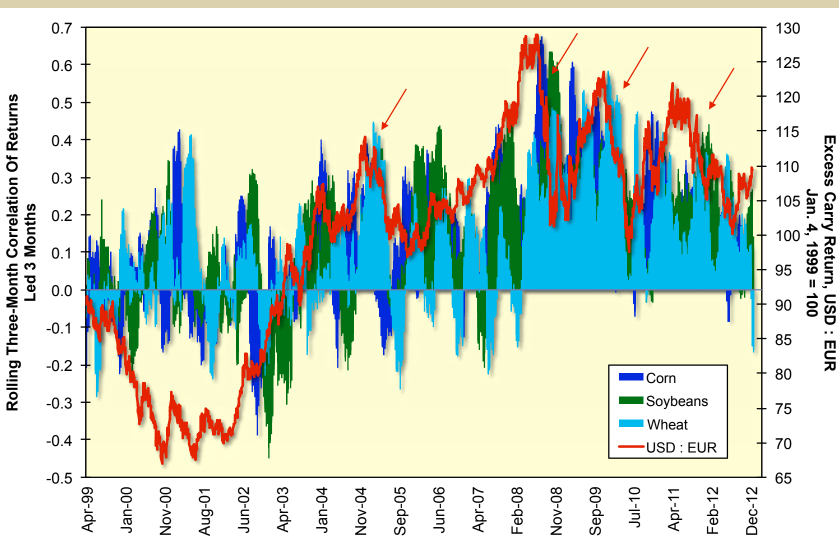
The r^2 levels and average correlations of returns for a wide range of commodities are displayed on a color-coded basis in Figure 2. The strongest links for the Euro, against petroleum and industrial metal commodities, are not very strong at all; none of the r^2 levels exceed 0.15 and none of the average correlation levels exceed 0.40. Normally, we could stop right here if it were not for the overwhelming impulse of traders and analysts to define a linkage mentally between the Euro and "commodity" prices. Please note the very low r^2 levels for the three grain/oilseed markets displayed — corn, soybeans, and soft red winter wheat.

FIGURE 3: EURO AND GRAIN PRICES WEAKLY POSITIVELY CORRELATED



Between 2003 and 2011 there was a visible correlation of the return paths for the Euro and soybean futures, and a much less visible one for corn and wheat futures.

FIGURE 4: POST-2002 EURO WEAKNESS LED TO DECLINING CORRELATION OF RETURNS



The Euro downturns led declines in the three-month rolling correlations of returns by three months.

Isolating grains

Now let's map the Dow Jones-UBS total return indices for these three grain markets against the excess carry return into the Euro (led three months on a common logarithmic scale) going back to the Euro's January 1999 inception (Figure 3). There was a visible correlation between 2003 and 2011 of the return paths for the Euro and for soybean futures and a much less visible one for corn and wheat futures. The corn and wheat return paths are so depressed because of the effects of negative roll yields when contracts are switched.

The data can be rearranged from the time series in Figure 3 to the more stationary correlations of returns in Figure 4. Now when we map the excess carry return of the Euro against the three-month rolling correlations of returns, a defined pattern emerges, which is highlighted with red arrows: The downturns in the Euro lead declines in the three-month rolling correlations of returns by three months. This is the connection between one currency — the Euro — and three commodities; it certainly has to disappoint those expecting something a little stronger. All that can be isolated is a one-sided relationship into an already-weak and statistically insignificant correlation of returns.

The impulse held by many to attribute various commodity price trends to changes in monetary policy as manifested in a single, albeit important, exchange rate needs to be resisted. If you want to analyze grains, look to Kansas and Iowa; don't look to New York City and Washington, D.C.

Howard Simons is president of Rosewood Trading Inc. and a strategist for Bianco Research. *For more information on the author, see p. 4.*

GLOBAL ECONOMIC CALENDAR

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.

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

April	
1	**U.S.:** March ISM manufacturing report
2	
3	
4	**Japan:** Bank of Japan interest-rate announcement **UK:** Bank of England interest-rate announcement **ECB:** Governing council interest-rate announcement
5	**U.S.:** February trade balance **Canada:** March employment report **LTD:** April forex options; April U.S. dollar index (ICE)
6	
7	
8	
9	**Brazil:** March PPI **Mexico:** March 31 PPI and March PPI
10	**Brazil:** March CPI
11	**Australia:** March unemployment **France:** March CPI **Germany:** March CPI **Japan:** March PPI
12	**U.S.:** March PPI and retail sales
13	
14	
15	**India:** March PPI
16	**U.S.:** March CPI and housing starts **UK:** March CPI and PPI
17	**U.S.:** Fed beige book **Canada:** Bank of Canada interest-rate announcement **South Africa:** March CPI **UK:** March employment report
18	**U.S.:** March leading indicators **Hong Kong:** January-March employment report
19	**Canada:** March CPI **Germany:** March PPI **Mexico:** March employment report
20	
21	
22	**Hong Kong:** March CPI
23	
24	**U.S.:** March durable goods **Australia:** Q1 CPI **Mexico:** April 15 CPI
25	**Brazil:** March employment report **South Africa:** March PPI
26	**Japan:** March CPI **U.S.:** Q1 GDP (advance)
27	
28	
29	**U.S.:** March personal income
30	**U.S.:** Q1 ECI **Canada:** March PPI **France:** March PPI **Germany:** March employment report **India:** March CPI **Japan:** March unemployment

May	
1	**U.S.:** April ISM manufacturing report and FOMC interest-rate announcement
2	**U.S.:** March trade balance **ECB:** Governing council interest-rate announcement
3	**U.S.:** March employment report **Australia:** Q1 PPI **LTD:** May forex options; May U.S. dollar index (ICE)

EVENTS

Event: Bollinger Band 2013 Seminar, Los Angeles
Date: April 13-14
Location: Sheraton Gateway Hotel, LAX
For more information: www.bollingerbands.com/seminar

Event: Algorithmic and High Frequency Trading Workshop
Date: May 2-3
Location: Sao Paolo, Brazil
For more information:
Go to http://tinyurl.com/tradingworkshop

Event: The MoneyShow Las Vegas
Date: May 13-16
Location: Las Vegas
For more information: Go to www.moneyshow.com

Event: The Trading Show Chicago
Date: June 24-25
Location: Downtown Marriott, Chicago
For more information: Go to www.terrapinn.com

Market	Sym	Exch	Vol	OI	10-day move / rank	20-day move / rank	60-day move / rank	Volatility ratio / rank
EUR/USD	EC	CME	306.5	197.9	-1.35% / 63%	-1.85% / 25%	-2.91% / 94%	.33 / 50%
JPY/USD	JY	CME	185.4	206.4	2.14% / 86%	-1.46% / 10%	-7.94% / 42%	.09 / 23%
GBP/USD	BP	CME	134.8	204.5	0.56% / 29%	-0.05% / 2%	-6.62% / 84%	.10 / 0%
AUD/USD	AD	CME	98.6	149.3	-0.27% / 17%	1.42% / 83%	0.27% / 19%	.43 / 37%
CAD/USD	CD	CME	75.7	167.1	0.41% / 42%	1.22% / 100%	-2.15% / 75%	.22 / 25%
MXN/USD	MP	CME	43.0	151.8	0.22% / 7%	2.71% / 86%	4.65% / 93%	.17 / 2%
CHF/USD	SF	CME	37.1	48.7	-0.09% / 13%	-1.23% / 24%	-3.67% / 87%	.27 / 3%
U.S. dollar index	DX	ICE	31.5	66.9	0.67% / 26%	1.43% / 52%	3.30% / 73%	.24 / 7%
NZD/USD	NE	CME	14.2	31.0	1.23% / 83%	0.67% / 50%	1.20% / 25%	.63 / 82%
E-Mini EUR/USD	ZE	CME	5.0	5.8	-1.35% / 63%	-1.85% / 25%	-2.91% / 94%	.33 / 50%

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.

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).

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 Feb. 28 ranked by February 2013 return)

	Trading advisor	February return	2013 YTD return	$ Under mgmt. (millions)
1	Iron Fortress FX Mgmt	16.13%	23.50%	15.8
2	CenturionFx Ltd (6X)	14.66%	7.20%	24.8
3	Civic Capital Adv. (Currency Fund LP)	5.56%	8.88%	162.4
4	Gables Capital Mgmt (Global FX)	4.72%	9.07%	15
5	Friedberg Comm. Mgmt. (Curr.)	2.80%	-2.37%	21.9
6	Rhicon Currency Mgmt (Sys. Curr.)	2.67%	4.75%	10
7	TMS (Arktos GCS II)	2.58%	1.10%	10.2
8	Premium Currency (Currencies)	2.42%	0.12%	735.9
9	Harmonic Capital (Gl. Currency)	2.01%	1.35%	916
10	Titanium Capital Partners (FX Macro)	1.95%	5.98%	112
	Top 10 currency traders managing less than $10M & more than $1M			
1	Iron Fortress FX USA	16.13%	23.50%	1.1
2	Fornex (Foyle)	7.58%	10.31%	1.6
3	JarrattDavis (Managed FX)	6.40%	10.41%	5
4	Exclusive Returns (Viktory)	3.35%	4.07%	1.2
5	MDC Trading	3.22%	6.07%	1.5
6	Rhicon Currency Mgmt (Sys. Curr.)	2.67%	4.75%	10
7	MFG (Bulpred USD)	2.17%	4.36%	1.4
8	Capricorn Currency Mgmt (FXG10 EUR)	1.68%	2.85%	3.4
9	JP Global Capital Mgmt (Troika I)	0.74%	7.39%	1.2
10	Lillian Nicola (LDF - Prop)	0.51%	2.25%	5.1

Based on estimates of the composite of all accounts or the fully funded subset method.
Does not reflect the performance of any single account.
PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE PERFORMANCE.

CURRENCIES (vs. U.S. DOLLAR)								
Rank	Currency	March 25 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	Thai baht	0.03414	1.85%	4.55%	5.53%	0.0342	0.0311	3
2	Australian Dollar	1.044375	1.20%	0.49%	0.25%	1.0578	0.9681	13
3	Great Britain pound	1.52298	0.44%	-5.76%	-6.07%	1.6286	1.4892	17
4	Chinese yuan	0.15938	0.21%	0.51%	0.93%	0.1608	0.1566	4
5	Hong Kong dollar	0.1288	-0.10%	-0.17%	-0.14%	0.129025	0.1287	5
6	Canadian dollar	0.97745	-0.13%	-2.95%	-4.29%	1.0334	0.9601	15
7	Indian rupee	0.01839	-0.16%	1.38%	-2.36%	0.0194	0.0174	9
8	New Zealand dollar	0.835675	-0.29%	1.59%	1.52%	0.8491	0.7504	10
9	Taiwan dollar	0.03344	-0.70%	-2.86%	-1.82%	0.0345	0.0327	12
10	Singapore dollar	0.80114	-0.86%	-2.18%	-1.68%	0.8213	0.7732	7
11	Swedish krona	0.15454	-1.02%	1.18%	1.65%	0.159	0.1374	6
12	Japanese yen	0.010585	-1.12%	-10.52%	-17.43%	0.0129	0.0104	11
13	Swiss franc	1.062915	-1.19%	-2.70%	-0.56%	1.1077	1.0074	8
14	Russian ruble	0.032485	-1.29%	-0.23%	-0.23%	0.0345	0.0291	14
15	Euro	1.29878	-1.54%	-1.56%	0.41%	1.3639	1.2099	16
16	Brazilian real	0.49739	-1.91%	3.49%	0.68%	0.5507	0.4674	1
17	South African rand	0.107525	-4.68%	-7.80%	-10.96%	0.1318	0.1073	2

GLOBAL STOCK INDICES									
	Country	Index	March 25	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Japan	Nikkei 225	12,546.46	7.58%	24.47%	38.00%	12,650.30	8,238.96	1
2	U.S.	S&P 500	1,551.69	4.29%	9.29%	7.64%	1,564.91	1,266.74	3
3	Switzerland	Swiss Market	7,758.20	2.16%	12.61%	17.31%	7,874.20	5,712.10	5
4	Germany	Xetra Dax	7,870.90	1.26%	3.07%	6.00%	8,074.47	5,914.43	8
5	South Africa	FTSE/JSE All Share	40,253.25	1.17%	2.10%	11.69%	40,984.22	32,887.45	10
6	UK	FTSE 100	6,378.40	0.36%	7.12%	8.85%	6,534.00	5,229.80	4
7	Canada	S&P/TSX composite	12,680.70	0.24%	2.48%	3.46%	12,904.70	11,209.50	7
8	France	CAC 40	3,727.98	0.18%	1.46%	6.10%	3,871.58	2,922.26	9
9	Singapore	Straits Times	3,267.48	-0.65%	2.72%	6.53%	3,319.19	2,712.31	6
10	Mexico	IPC	42,900.83	-1.37%	-1.37%	6.68%	46,075.00	36,756.10	13
11	Australia	All ordinaries	5,001.50	-1.40%	7.30%	13.79%	5,174.40	4,033.40	2
12	Hong Kong	Hang Seng	22,251.15	-2.49%	-1.29%	7.50%	23,944.70	18,056.40	12
13	Brazil	Bovespa	54,873.00	-3.08%	-9.99%	-9.30%	66,968.00	52,213.00	11
14	India	BSE 30	18,681.42	-3.36%	-3.79%	-0.07%	20,203.70	15,749.00	14
15	Italy	FTSE MIB	15,644.40	-4.33%	-4.66%	-1.81%	17,897.40	12,362.40	15

NON-U.S. DOLLAR FOREX CROSS RATES									
Rank	Currency pair	Symbol	March 25	1-month gain/loss	3-month gain/loss	6-month gain loss	52-week high	52-week low	Previous
1	Aussie $ / Real	AUD/BRL	2.099715	3.17%	-2.89%	-0.43%	2.2253	1.8755	19
2	Aussie $ / Franc	AUD/CHF	0.98256	2.42%	3.28%	0.81%	1.0328	0.9238	10
3	Aussie $ / Yen	AUD/JPY	98.66	2.33%	12.34%	21.40%	99.55	75.6	7
4	Canada $ / Real	CAD/BRL	1.96516	1.81%	-6.22%	-4.94%	2.1463	1.8063	20
5	Pound / Franc	GBP/CHF	1.43283	1.66%	-3.14%	-5.55%	1.5434	1.4062	18
6	Pound / Yen	GBP/JPY	143.87	1.57%	5.35%	13.74%	146.94	119.75	16
7	Aussie $ / New Zeal $	AUD/NZD	1.249755	1.45%	-1.08%	-1.25%	1.3061	1.2175	8
8	Aussie $ / Canada $	AUD/CAD	1.06847	1.34%	3.54%	4.74%	1.0685	0.9951	6
9	Canada $ / Yen	CAD/JPY	92.34	1.00%	8.49%	15.90%	93.95	74.85	1
10	New Zeal $ / Yen	NZD/JPY	78.965	0.86%	13.59%	22.97%	79.4	58.78	5
11	Yen / Real	JPY/BRL	0.021285	0.83%	-13.55%	-17.96%	0.0262	0.0202	17
12	Pound / Canada $	GBP/CAD	1.558115	0.58%	-2.89%	-1.86%	1.6162	1.5286	13
13	Euro / Real	EUR/BRL	2.6112	0.38%	-4.87%	-0.26%	2.7714	2.383	21
14	Franc / Yen	CHF/JPY	100.41	-0.08%	8.77%	20.41%	102.90	78.81	4
15	Euro / Franc	EUR/CHF	1.221925	-0.36%	1.17%	0.97%	1.2479	1.2003	14
16	Euro / Yen	EUR/JPY	122.705	-0.42%	10.05%	21.60%	126.88	94.65	12
17	Pound / Aussie $	GBP/AUD	1.45827	-0.75%	-6.22%	-6.30%	1.6123	1.4455	15
18	Franc / Canada $	CHF/CAD	1.087435	-1.06%	0.26%	3.90%	1.1055	1.0128	2
19	Euro / Canada $	EUR/CAD	1.32874	-1.41%	1.43%	4.91%	1.3607	1.2164	9
20	Euro / Pound	EUR/GBP	0.852775	-1.98%	4.45%	6.90%	0.8747	0.7779	3
21	Euro / Aussie $	EUR/AUD	1.243625	-2.70%	-2.04%	0.16%	1.3107	1.1614	11

GLOBAL CENTRAL BANK LENDING RATES					
Country	Interest rate	Rate	Last change	Sept. 2012	March 2012
United States	Fed funds rate	0-0.25	0.5 (Dec 08)	0-0.25	0-0.25
Japan	Overnight call rate	0-0.1	0-0.1 (Oct 10)	0-0.1	0-0.1
Eurozone	Refi rate	0.75	0.25 (Jul 12)	0.75	1
UK	Repo rate	0.5	0.5 (Mar 09)	0.5	0.5
Canada	Overnight rate	1	0.25 (Sep 10)	1	1
Switzerland	3-month Swiss Libor	0-0.25	0.25 (Aug 11)	0-0.25	0-0.25
Australia	Cash rate	3	0.25 (Dec 12)	3.5	4.25
New Zealand	Cash rate	2.5	0.5 (Mar 11)	2.5	2.5
Brazil	Selic rate	7.25	0.25 (Oct 12)	7.5	9.75
Korea	Korea base rate	2.75	0.25 (Oct 12)	3	3.25
Taiwan	Discount rate	1.875	0.125 (Jun 11)	1.875	1.875
India	Repo rate	7.5	0.25 (Mar 13)	8	8.5
South Africa	Repurchase rate	5	0.5 (Jul 12)	5	5.5

GDP		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	Q4	3/22	3.4%	2.7%	6/24
	Brazil	Q4	3/1	6.5%	7.2%	5/29
	Canada	Q4	3/1	0.8%	2.5%	5/31
EUROPE	France	Q4	3/27	-0.3%	0.0%	6/26
	Germany	Q4	2/14	-0.3%	1.6%	5/15
	UK	Q4	3/27	-0.3%	0.2%	6/27
AFRICA	S. Africa	Q4	3/12	2.9%	7.9%	5/28
ASIA and S. PACIFIC	Australia	Q4	3/6	0.6%	2.9%	5/5
	Hong Kong	Q4	2/27	6.2%	7.2%	5/10
	India	Q4	2/28	12.4%	12.0%	5/31
	Japan	Q4	2/14	-0.1%	-0.4%	5/16
	Singapore	Q4	2/22	0.7%	1.5%	5/24

Unemployment		Period	Release date	Rate	Change	1-year change	Next release
AMERICAS	Argentina	Q4	2/19	6.9%	-0.2%	0.2%	5/20
	Brazil	Feb.	3/28	5.6%	0.2%	-0.1%	4/25
	Canada	Feb.	3/8	7.0%	0.0%	-0.4%	4/5
EUROPE	France	Q4	3/7	10.2%	0.3%	0.8%	6/6
	Germany	Feb.	3/28	6.0%	0.1%	0.1%	4/30
	UK	Oct.-Dec.	2/20	7.8%	0.0%	0.2%	5/20
ASIA and S. PACIFIC	Australia	Feb.	3/14	5.4%	0.0%	0.2%	4/11
	Hong Kong	Oct.-Dec.	1/17	3.1%	-0.3%	-0.2%	4/30
	Japan	Feb.	3/29	4.3%	0.1%	-0.2%	4/30
	Singapore	Q4	1/31	1.8%	-0.1%	-0.2%	4/30

CPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	Feb.	3/13	0.5%	10.8%	4/12
	Brazil	Feb.	3/8	0.6%	1.5%	4/10
	Canada	Feb.	3/27	1.2%	1.2%	4/19
EUROPE	France	Feb.	3/13	0.3%	1.0%	4/11
	Germany	Feb.	3/12	0.6%	1.5%	4/11
	UK	Feb.	3/19	0.7%	2.8%	4/16
AFRICA	S. Africa	Feb.	3/20	1.0%	5.9%	4/17
ASIA and S. PACIFIC	Australia	Q4	1/23	0.2%	2.2%	4/24
	Hong Kong	Feb.	3/21	1.1%	4.4%	4/22
	India	Feb.	3/31	0.1%	12.1%	4/30
	Japan	Feb.	3/29	-0.2%	-0.7%	4/26
	Singapore	Feb.	3/25	1.0%	4.9%	4/30

PPI		Period	Release date	Change	1-year change	Next release
AMERICAS	Argentina	Feb.	3/13	1.0%	13.3%	4/12
	Canada	Feb.	3/28	1.4%	1.0%	4/30
EUROPE	France	Feb.	3/29	0.4%	1.9%	4/30
	Germany	Feb.	3/20	-0.1%	1.2%	4/19
	UK	Feb.	3/19	0.8%	2.3%	4/16
AFRICA	S. Africa	Feb.	3/5	0.6%	5.4%	4/25
ASIA and S. PACIFIC	Australia	Q4	2/1	0.2%	1.0%	5/3
	Hong Kong	Q4	3/14	0.2%	-1.1%	6/14
	India	Feb.	3/14	0.6%	6.8%	4/15
	Japan	Feb.	3/12	0.4%	-0.1%	4/11
	Singapore	Feb.	3/28	1.5%	-5.0%	5/20

As of April 1 LEGEND: Change: Change from previous report release. NLT: No later than. Rate: Unemployment rate.

If at first you don't succeed...

TRADE

Date: April 1.

Entry: Long the Euro/U.S. dollar pair (EUR/USD) at 1.2846.

Reason for trade/setup: Although the price action implied by last month's Spot Check failed to materialize (resulting in a losing long Euro trade in the March Forex Trade Journal), April ushered in another opportunity to attempt a buy in the EUR/USD pair. A brisk rally early in the U.S. forex trading session reversed some of the negative momentum of the previous week, which was a down-closing outside week (higher high, lower low, lower close, and close below the open). Over the past decade such "bearish" weeks (31 previous examples) have tended to be followed by bullish price action, most notably in the first week when the EUR/USD pair closed higher 65% of the time.

A paper trade was entered on a limit order at 1.2850 on a pullback from the day's high around 1.2867.

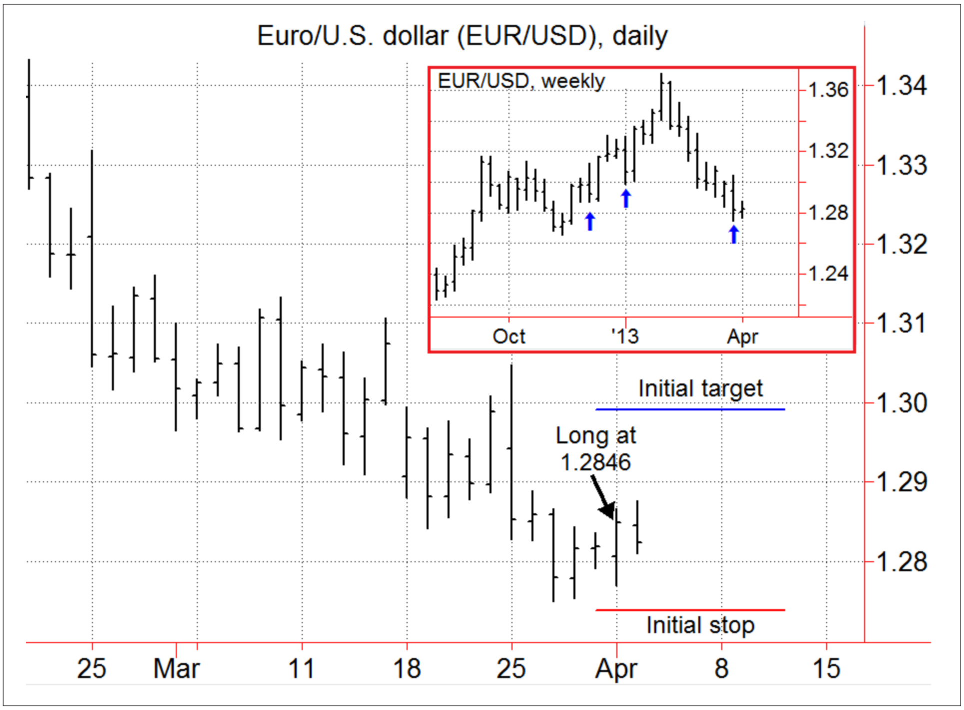
Initial stop: 1.2738.

Initial target: 1.2989.

RESULT

Exit: Trade still open on April 2.

Profit/loss: -0.0024, marked to market at 1.3046 around 10:40 a.m. ET on April 2.



Source: TradeStation

Outcome: The pair consolidated a bit the day after entry, pushing to a marginal higher high and then sagging as the U.S. session unfolded. The stop is being kept relatively close — a necessity in this type of countertrend situation. Although it's true that previous down-closing weeks were followed more often than not by up moves, many of them occurred in distinctly bullish environments, which is not the case here. Any move more than a few pips below the previous week's low will negate the pattern's relevance.

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	MTM	Date	P/L point	P/L %	LOP	LOL	Trade length
4/1/13	EUR/USD	1.2846	1.2738	1.2989	1.32	1.2849	4/2/13	.0003	0.02%	.0031	-.0024	1 day

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). MTM: marked-to-market — the open trade profit or loss at a given point in time.