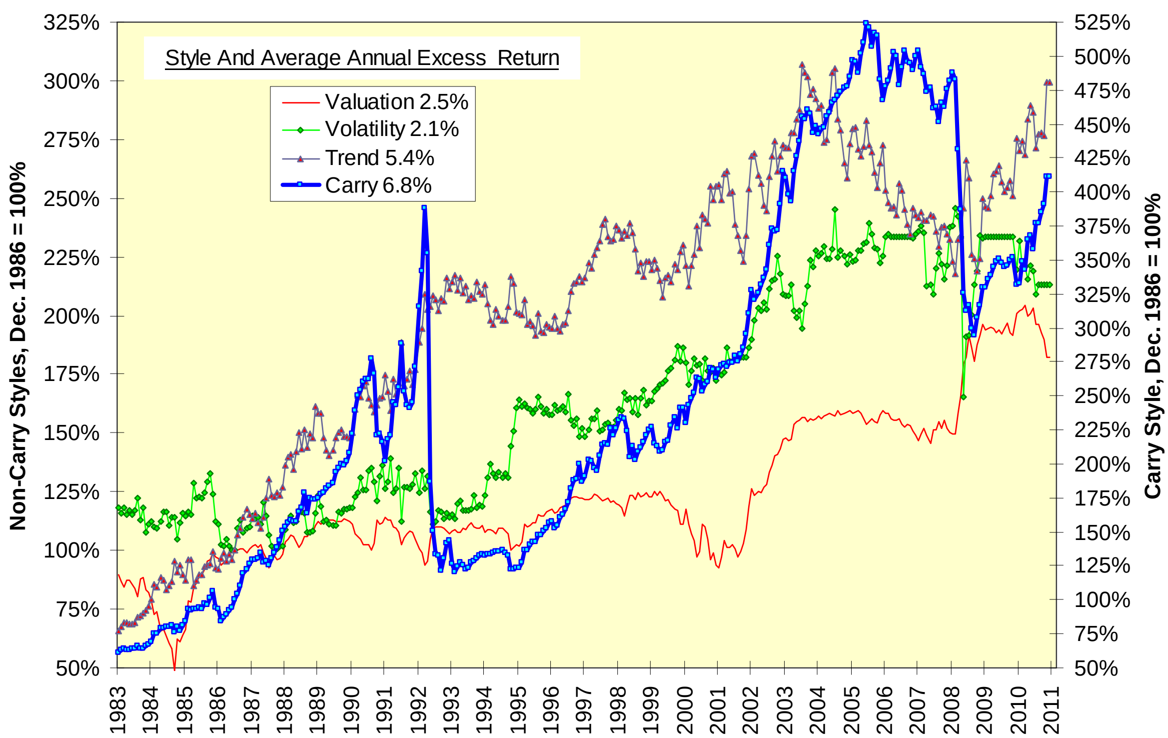
The Trend Is Currency Friend

Aging Baby Boomers directly and their resulting Baby Boomees indirectly recall the Cold War sentiment Communism was like an opportunistic infection upon a wounded body politic. Churchill had described Lenin's train ride across Germany and eventually into Russia in 1917 as "the most grisly of all weapons…in a sealed truck like a plague bacillus."

Can a similar statement be made about technical analysis in currency markets? As noted yesterday, financial repression has distorted interest rate parity and purchasing power parity never works; this leaves a gigantic market where an infinite number of cross-rates are possible thrashing about for some order. When all else fails, haul out the ruler, the Fibonacci retracements, the double-tops, the channels, the moving averages and, for all I care, the oscillators and have at it.

Guess what? It has been working well since the money-printing era began in March 2009. Let's return to a framework introduced in [February 2010] lamenting the poor performance of professional currency traders. If we trace four different currency-trading styles defined by James Binny of RBS back to June 1983, we see one style, the carry trade dominates the others. Very well; this is supposed to happen when you borrow cheap, lend dear and take the occasional gut-wrenching wallop from periods such as September 1992 or the 2008 financial crisis. George Soros broke the Bank of England in the first episode and then spent a good deal of that money same mean and nasty things about non-liberals in the U.S. during the latter episode. Genius is what genius does.

Performance Of RBS Currency Style Indices



But if we shift the starting point of comparison to March 2009, the trend-followers move to the head of the pack with a period return of 36.81% as compared to 33.55% for the carry traders. The strategy is simpler to execute, too; a carry trader has to worry about future interest rate differentials while a trend-follower has to worry about lines on a chart. A bad day watching the screen beats a good day working, anytime.

The Federal Reserve which has by its own admission been targeting stock prices (Look! We can make it rise! Whee!) has helped make the world safe for trend-followers, too. Trend-following works when an underlying development is persistent enough to change underlying economic value in the same direction over time and when there are no real bounds to a price. If, as noted yesterday, any currency rate can clear the market, then there is no actual limit to where a currency can go, higher or lower, if you keep pushing it there. This has been both American policy and the policy of other key central banks. The amazing thing is the relative movements tracked by currency rates may be less than the absolute movements tracked by the value of paper currencies against a fixed standard such as gold or my proverbial handful of dirt, also known as farmland.

In other words, trend-following in currencies is working because central banks are destroying them. Whee!