Currency Traders Confused Market For Brains

Anyone who sits down to the poker table knows or should know you cannot depend on getting the winning cards – the "nuts" – hand after hand. The skill comes in turning a handful of dross into something worth playing.

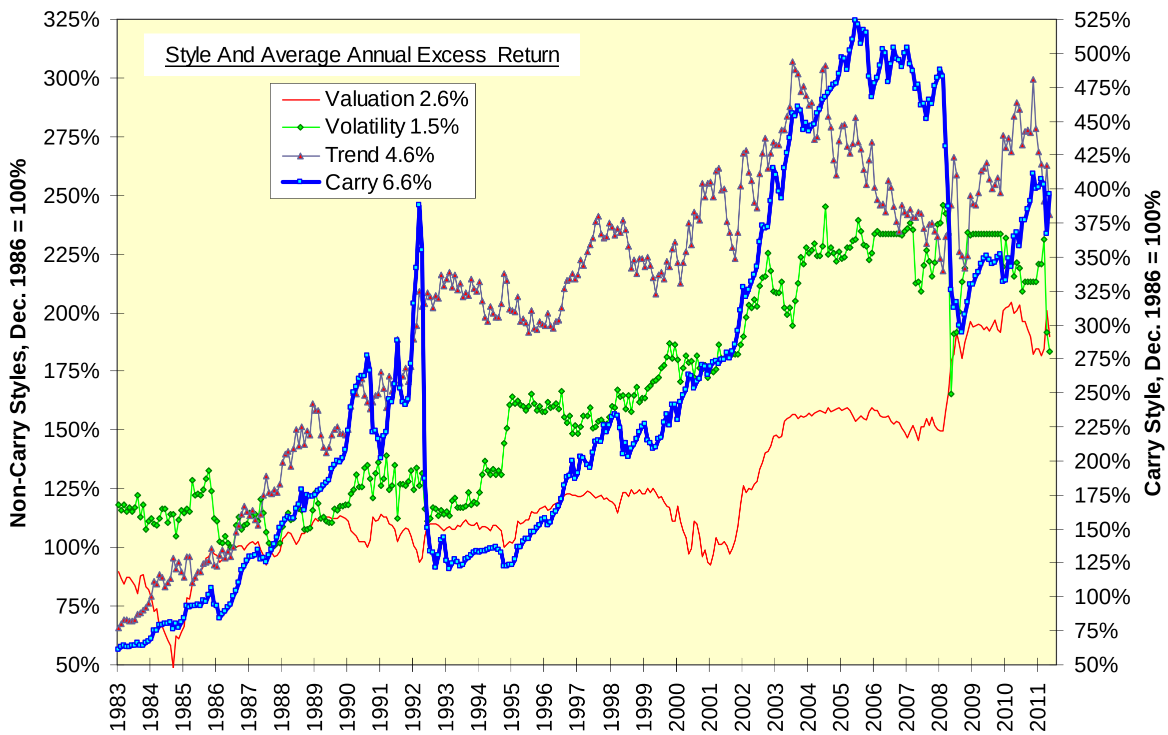
So, too, it is in the case of currency trading. As currencies reflect expected differentials in interest rates and expected differential returns on assets along with a smattering of macroeconomic and political assessments, they can and do put in longer and stronger trends than do most other markets. However, as political decision-makers and central banks are involved in the smattering part, currency markets can produce some swift and ugly rips in the fabric of space-time. As an aside, individual equities are far more volatile and have far larger price gaps and chart formations such as "the big smoking hole" than do any currency markets.

When those central banks and finance ministries (and please, if you do not have one, get one) keep pushing the market one way as they did during both episodes of quantitative easing, they make the world safe for trend-followers, as I noted in June 2011's Why It Works to Follow the Trend in Currencies. However, when central banks switch gears as I discussed in September 2011's Swiss National Bank's Plan to Print Unlimited CHF Will End Disastrously, they clobber both trend-followers and the general class of carry traders, those who borrow low-rate currencies and lend in high-rate currencies. It does not matter how good your track record was before; these actions can blow you out of the water. Worse, if you were right, you were right for the wrong reason and should not put yourself in that position again.

The last four months have been a minefield for currency traders. Not only did the end of QE2 dry up some of the world's supply of excess greenbacks, the Swiss intervened massively against the franc and the Japanese intervened against the yen at least twice. The slowdown in commodity prices hit both the Canadian and Australian dollars, and where can we even begin when discussing the euro? The real hoot in all of this is how everyone manipulates their currency and accuses their major trading parties with – gasp! – manipulating their currencies.

Here is an update of the various currency trading styles tracked by RBS; these used to be tracked by ABN, but how many index providers have been able to keep their maiden names over the past five years. Over the past 28 years, two of the four trading styles, volatility and fundamental valuation, have had average annual excess returns have been less than the average three-month Treasury bill return of 4.798%. Carry and trend-followers have done the best over time, but over the past four months, the trend-followers have lost 12.19% and the carry traders have lost 1.65%.

Performance Of RBS Currency Style Indices



The lesson is quite simple, really. Trend-following is really a wait-for-the-good-cards strategy condemned to doing poorly in markets with heavy event-risk, and carry trading depends on non-intervention from the funding countries such as the U.S., Japan and Switzerland to work. As long as policies around the world remain motivated to finding short-term solutions to long-term problems, we will continue to have the sudden reversals inimical to successful currency trading.