

FX OPTIONS: Credit Crisis: Other Options for Investors

OPTIONS EDUCATION



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The Credit Crisis: Other Options for Investors

The current credit crisis has panicked investors, but this has also created new opportunities.

The financial markets have entered a new phase in the global credit crisis, having recently been roiled by vicious headwinds from government responses to the situation. I will attempt to explain these developments and, more specifically, their implications for the currency markets.

It's too early to quantify the full extent of the current global crisis. Last fall of 2007, many financial analysts had estimated that the asset write-downs would be in the \$200-400B range. By the fall of 2008, predictions for asset write-down have multiplied from those original estimates. Only time will tell what the actual impact will be. For investors analyzing the global currency market, it's important to try to understand how governments are dealing with the global crisis.

History does repeat itself. Though events are never identical; capital markets tend to experience periods of instability and significant volatility during asset boom/bust cycles: the Dutch Tulip mania of the 1630's, South Sea bubble in England of 1720, railway mania of the 1800's, Banker's Panic of 1907, over-extension of margins for stocks in the 1920's, real estate over-lending in 1980's, the Asian currency crisis of 1997, and more recently the "Dotcom" bubble of 2000. There are additional volatile periods in history, some of which were handled more efficiently than others. The common denominator for these events has been a tremendous surge in

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short-term investment flows prior to the crisis. The currency markets have been at the epicenter of most of these financial tsunamis.

Let's get back to the current credit crisis, which not only resulted from a real estate market bubble but also from a highly over-leveraged financial system. Initially, the world turned to the U.S. to solve the crisis, which appears now to have been oversimplified. Financial institutions throughout the world, including the U.S., UK, Germany, France, Belgium, Netherlands, Luxembourg, Spain, Italy, Greece, Australia, Iceland and Ireland have all reacted differently. The initial "Paulson Plan," was created by the U.S. government to buy assets from sellers at fair prices allowing the sellers to reduce their overall financial leverage. Theoretically, this plan would unclog the financial intermediation process. The goal was to "jump-start" the economy by increasing the overall confidence in the financial system. The challenge was being able to fairly price these assets. If the price was too low, the government (taxpayers) would benefit, but financial institutions would be adversely impacted. Conversely, if the U.S. government overpaid, the sellers (ailing banks) would benefit, but the government (taxpayers) would pay a stiff price. Many legislators were concerned that U.S. taxpayers would end up financing a small group of financial institutions. After many modifications, deliberations and being voted down the first time, the bill was finally passed by the U.S. Congress.

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Markets ebb and flow each day based on human emotions: fear, greed, hope, and despair. Market integrity helps to foster faith in the economic system. Confidence is vital. Without confidence, the markets may not be able to find sufficient buyers of securities. Overconfidence creates a different problem, market over-enthusiasm or too few sellers. Balancing the appropriate amount of capital for the economy is also critical. Too little capital provides few growth opportunities. Too much capital provides too much growth, by allocating financial resources to projects that are unnecessary. After the passage of the Troubled Asset Relief Programme (TARP), investors fled the markets. Stocks, corporate bonds, and the currency market traded in a panic mode. The equity and corporate bond markets moved in

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one direction, **down**. Surprisingly, the US dollar (with one exception) also moved in one direction against the major currencies, **up**. The USD has moved up against the euro, pound, and franc. It moved up most against commodity currencies such as the Canadian dollar (CAD) and, even more sharply, against the Australian dollar (AUD). The USD did recede against the Japanese yen (JPY) due to the safe haven status in the currency marketplace. How can you take advantage of the recent rally? Hedge your currency exposure? ISE FX Options® allow you to implement your views of the foreign exchange market with all the benefits of the listed options market.

ISE FX Options are simple to understand. These exchange-listed securities are dollar relative, meaning they are based on what the US dollar is worth in relation to another currency. Investors will easily recognize USD strength when a rate increases and USD weakness when a rate decreases. The option premiums are quoted in US dollars using cash settlement through the Options Clearing Corporation (OCC). This feature eliminates investors having to deliver foreign currencies, or having those currencies delivered. If options have value at expiration, they are simply settled in cash, a very intuitive process. Since the ISE FX Options are dollar relative, calls will benefit from a strengthening USD, while puts will benefit from a weakening USD. Many of the familiar options strategies can be implemented using a traditional equity options broker. Below is an explanation of each of the FX Options currency pairs.

CONSTRUCTION OF ISE FX PAIRS

CONVENTION	ISE FX SYMBOL	RATE MODIFIER	ISE UNDERLYING RATE EXAMPLES
USD/AUD	AUX	100	107.10 (1.0710 X 100)
USD/GBP	BPX	100	50.65 (0.5065 X 100)
USD/CAD	CDD	100	102.88 (1.0288 X 100)
USD/EUR	EUI	100	64.36 (0.6436 X 100)
USD/CHF	SFC	100	104.96 (1.0496 X 100)
USD/JPY	YUK	1	107.57 (107.57 X 1)

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After the extreme reaction to the U.S. TARP plan, the world braced for another government policy decision. It was during this turmoil that bank depositors globally began to lose faith in the banking system and its ability to meet *bank demand deposits*.

U.S.-based Wachovia escaped a run after announcing an agreement with Citigroup and FDIC for certain assets. Subsequently, Wells Fargo submitted a bid for all of Wachovia assets and liabilities. Ultimately, it was the arrangement with Wells Fargo that was approved, since it removed the taxpayer from financial responsibility. At the same time, many banks throughout the world were experiencing similar runs on their deposits. Even large investment banks were not immune to these withdrawals of assets.

Iceland was another victim of capital flows where foreign investors began withdrawing large amounts of capital. This outflow of capital affected every citizen in Iceland since its currency, the Krona, collapsed. While this was taking place, many nations were in a tight spot since they had to consider their own interests. For example, Ireland, acting unilaterally, was the first to react to Iceland's situation by guaranteeing all bank deposits. This was an extreme message in extreme times. The rest of Europe was not thrilled with Ireland's decision since it placed pressure on them to raise their bank deposit insurance limits, which is exactly what happened in the U.K., France, the Netherlands, Germany, Belgium, as well as the U.S. and Australia, in an effort to rescue their floundering financial institutions.

In Europe, the decision was to move in a coordinated and systematic fashion, rather than previous ad-hoc efforts. The UK and Germany decided to move decisively as asset prices began to drop much faster than previously anticipated. The U.S. TARP plan would take too long to implement and there was just too much potential financial damage. Many felt that something else would have to be done while the TARP details were being constructed. The UK government announced plans to inject massive amounts of capital into its largest banks. In effect, it was nationalizing its banks or, at least, partially nationalizing. Germany also announced

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a similar plan to support its banking system through an equity-injection program to avoid a global financial meltdown.

Global recapitalization was the next stage in the crisis. Since the US Treasury's asset auction process would take too long to implement, something had to be done, and quickly. The world's economy was suffering from a lack of oxygen, capital. Without the capital infusion, there would be devastating consequences. Capital is critical for banks, since, for every dollar they hold, they can lend out multiples of these original holding. Banks can raise capital by selling stock or retained earnings, but losses reduce that capital. Unfortunately, banks have seen their capital drop due to the massive write-downs from poor investments in the securitization of the mortgage industry. If the banks can't lend, and nobody knows what the "alphabet soup" assets are really worth, then capital can't be intermediated. A complete lack of transparency and confidence will then result.

The US government recently also agreed to invest up to \$250B in nine US banks: Citigroup, JPM Chase, Bank of America, Goldman Sachs, Morgan Stanley, State Street Bank, Bank of New York Mellon and Wells Fargo. In this plan, the government would buy preferred stock to increase available capital in each of the banks. There were detractors of the plan on both the left and right, but for very different reasons. Critics on the right believed that this would pave the way for socialism and endanger American capitalism, while critics on the left believed that this was just another Wall Street "bail-out".

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Will this work? No one really knows for sure. Recapitalization is the current short-term solution to help inject the needed oxygen into the free market system. What does this mean for the financial markets? At a minimum, it appears that the financial system now has more capital than it did prior to capital injections. The real answer is integrity and transparency. If the markets (investors) believe that this is a credible first step this may process may work. It all depends on many factors. What are the mortgage assets really worth? Will the TARP auction process work? Who will buy these assets? At what price? Even longer term, will these actions change

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the form of capitalism. If so, which countries/regions will be affected the most? Which assets will be most affected? Currencies measure the relative attractiveness of one country to another. Which currencies have the most to gain? Which currencies have the most to lose?

Continued coordination within the financial world is mandatory. Europe is loosening its “mark to market” accounting rules that force banks to write-off assets in an expeditious manner. The crucial question is what are these assets worth? The markets need to quantify a current value based on realistic future expectations. The essence of the problem is the lack of transparency created by the non-regulated OTC derivative market.

**Investors should
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strategy.**

The implications of how each country reacts to the crisis will ultimately impact their currency’s value. Investors should always consider risk relative to reward for any investment strategy. The markets tend to be quasi-efficient, meaning that that they do a reasonably good job of pricing assets each day. Though, periods of irrational behavior can exist from time to time. The problem, as an investor, is that you never really know for certain the “who, what, when, where, and how” of the markets. For instance, it’s impossible to predict exactly what is going to significantly impact pricing? What assets will investors prefer next, or prefer to avoid? When will rationality or irrationality return to the markets? Currently many experts believe the market is acting irrationally as measured by the implied volatilities of the markets. Markets can be volatile for long periods of time though. The famous British economist John Maynard Keynes noted once that “markets can sometimes remain irrational longer than you can remain solvent.” Which countries will normality return the quickest? What are the longer term effects on the major currencies? How will the various central banks deal with the many financial challenges in the future? Many experts would give central banks mixed marks so far, but recently various initiatives may change those low grades. The listed option currency market allows investors to select from many alternatives to implement their own views of the market. These exchange-listed op-

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tions offer the near-elimination of counter-party credit risk, as well as liquidity and complete transparency.

Recently, the currency pairs have been much more volatility than market participants would have expected only one year ago. It's important to consider that in the listed option market, investors are able to implement their own strategy with their own unique risk and reward payoffs. Options give investors choices. There is never just one best strategy for the market, each investor must decide based on their own goals and risk tolerances. Investors occasionally may be lulled into "me-too" investments. What that means is that investors tend to feel much safer when others are implementing similar option strategies. If foreign currency volatility is low, does that mean it will remain low? Conversely, if foreign currency volatility is high, does that mean it will remain high? Investments are made without 100% certainty of any particular outcome. Some of the problems of today's markets are due to complacent views by investors when interest rates were low in certain currencies in relation to other currencies. As the global economic landscape has changed, it left many investors with unprofitable positions that they were forced to exit from with large losses. As an investor, you need to consider the ramifications of dynamic market conditions and how it will impact your investments. Quite simply, what if my forecast turns out to be wrong, how much could I potentially lose on ill-timed forecast? Options can help investors by offering numerous alternatives. The option market can provide a limited risk method of participating in the foreign currency markets.

One example of an extremely elevated FX options volatility is the USD/AUD (ISE symbol AUX). The ISE value of AUX has increased significantly, the USD has increased by approximately 42% in less than one year. The current implied volatility of AUX is 41% in mid-October 2008. Option pricing models (depending on the inputs chosen) early in 2008 might have predicted a 99% probability that the US dollar would not have risen by 42% against the AUD this year. The approximate volatility of the USD/AUD (AUX) in early 2007 was 12%). Just as a reference point the USD/JPY volatility approached 40% during the Russian Ruble crisis of 1998. Currently, (October 2008) the USD/JPY (YUK) implied volatility is approximately 23%. The implication is that all option pricing models are useful

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but no model is infallible. Many investors were led to believe that a 99% certainty is a guarantee of a certain outcome. No model can accurately deliver 100% certainty to any future outcome. Markets are emotional and can move in unexpected ways. ISE FX Options were created to provide foreign exchange investors the ability to tailor their own risk and reward profiles to meet their own financial objectives.

Even the most knowledgeable investor cannot accurately predict when the market will return to a less volatile trading state.

The tremendous turbulence in the markets has left many investors in a state of shock. Even the most knowledgeable investor cannot accurately predict when the market will return to a less volatile trading state. History tells us unexpected events will occur. By definition we won't know when, why or how these unexpected events will unfold. Governments throughout the world are dealing with the crisis in various ways. Active coordination between the countries may be the first step in helping mend the markets. How the various countries intervene in this crisis may ultimately determine how this world credit crisis of 2008 unfolds. Investors should always consider risk and reward of any investment and how that investment "fits" into their particular portfolio. ISE FX Options allow investors to select from the "most likely" events to the "most unlikely" events as measured by the market participant's probability assessments. As an investor, developing a process for your investment decisions is helpful to implementing your views on the US dollar. ISE FX Options allow you to decide for yourself what the potential ramifications will be for the various currencies and make the ultimate choice.

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