

FX OPTIONS: The Credit Crisis & the Foreign Exchange Market

OPTIONS EDUCATION



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## The Credit Crisis and the Foreign Exchange Market: What's Next for the U.S. dollar?

Despite the current global economic crisis, demand for the U.S. dollar has increased. What alternative investment opportunities are there in the foreign currency market?

The global financial markets have recently experienced extreme selling pressure. Investors are left to ponder why are the financial markets so weak? Where and when did this contagious "financial disease" start? Do the financial markets really affect me? How will it run its course and when will it end? What's amazing is that the foreign exchange markets are handling this "financial earthquake" very different from what investors would have expected just a year ago.

Stock, bond, commodity and real estate markets are under a selling siege. Financial experts are saying that "financial deleveraging" are one of the primary reasons for the global asset sell-off. I will attempt to explain how the markets became so over-leveraged and its implications. In finance, leverage is using given resources in such a way that the potential positive or negative outcome is magnified and/or enhanced. It generally refers to using borrowed funds, or debt, in an attempt to increase equity returns.

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So the use of leverage is bad, right? No, not necessarily, it is the amount of leverage that amplifies the returns for assets. With the over-use of leverage, even the smallest setback can wreak havoc on the financial systems. Without any leverage, the world's economy would grow at a much slower pace than its potential growth rate. The real issue is how much leverage is appropri-

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ate. There may be economic “bumps in the road”; the question is can the economic shock absorbers handle the bumps. The markets are currently trying to transition from a highly leveraged environment to a substantially reduced environment in a relatively short period of time. This transition has not occurred in an orderly fashion.

How did this economic mess start? That is a tough question to answer, but many experts believe that the markets allowed too much capital to be allocated to questionable projects. There are a multitude of reasons why there was an abundance of capital available, including very low interest rates for a relatively long period of time in many major banking centers (Tokyo and New York are two examples), securitization of the mortgage market without proper documentation of qualified residential mortgages and insufficient regulation of the non-transparent OTC derivative markets. But probably the most important factor in the current economic situation was the asset-liability mismatch. Borrowing short-term to invest long-term makes sense as long as there is capital to be borrowed. Many models assume you can “earn the spread” by utilizing this strategy. Again this “appears” successful from a modeling standpoint, but if you can’t fund the short-term, there isn’t any long-term. Be careful of models, the weakest part of mathematical models are the assumptions used. The modeled world cannot possibly replicate the “real world” 100% of the time. .

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The current economic crisis may have started as far back as the late 1990’s, when the U.S. housing industry gained strength relative to the general economy. In 1999, the U.S. banking and insurance industries were further deregulated with the repeal of the Glass-Steagall Act. The following year, the Commodity Futures Modernization Act of 2000 was passed, barring regulation of the OTC swap market. This may have been the watershed event that that dramatically and negatively impacted the current economic environment. As the dot-com recession receded, the U.S housing bubble started to gain momentum. In 2004, five U.S. investment banking firms were permitted to increase their

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financial leverage with the so called net capital rule. This allowed them to increase their maximum capital leverage from 12:1 to 40:1. By 2005, large parts of the U.S. market were experiencing a “real estate pricing bubble” and 2006 is the top of that bubble. Home prices only began to fall in early 2007. As prices fell, lenders began to pull back from their lenient lending practices, which only exacerbated the decline. This was the beginning of the credit crunch or what is now known as the “re-pricing of risk”. By September 2007, the first large financial casualty appeared; a large bank in the U.K. was experiencing a “run-on-the-bank.” Northern Rock was the first large financial institution to experience this panic. Depositors became nervous about their money and withdrew their savings, this behavior feeds upon itself. This was the origin of the vicious financial deleveraging cycle, banks, brokerage firms, insurance companies have all been affected in various ways. The financial world is now learning to live with much less leverage, possibly more regulation and most importantly, learning how to effectively balance their asset-liability mix.

What happens in the financial markets really does matter to people on “Main Street.” Capital markets were created to efficiently allocate financial resources to those entities that use capital from those that are looking to invest their excess capital at varying rates of return. This allocation process does not always work without flaws, as we have seen recently, but it is the preferred mechanism for capitalism. The financial markets create jobs, they allow for excess capital to be saved. The capital markets also allow individuals to borrow money for higher priced items such as cars or even homes over longer periods of time. Without financial intermediation, both borrowers and lenders would be worse off. The borrowing costs would increase dramatically and the general economy would suffer due to those higher borrowing costs. The financial markets affect all individuals, regardless if you are a borrower or a lender. In fact, most individuals start off as borrowers earlier in their life, and, as they mature, they usually gravitate to become lenders to facilitate borrowing.

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Looking at the current market malaise, how will it run its course? No market guru can accurately predict when the market will rebound or how this deleveraging process can be remedied. Some experts believe that the essence of the problem is asset deflation. Governments throughout the world are busy pumping money into the financial system to stem the decline in asset prices. The U.S. Fed has been lending USD to central banks in trade for their currency as investors sell out of foreign markets and go to cash and repatriate money to the U.S. This seems counter-intuitive to most investors; the US dollar has been rallying, despite such terrible fundamentals in the U.S. economy.

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The foreign exchange market prices the relative value of various currencies each day. The respective country's money markets (short-term money) and the foreign exchange market are interwoven. Investors must balance the growth prospects (including inflation) for the various currencies in relation to each other. Governments use fiscal policy (spending and taxation) and monetary policy to affect their economies. Monetary policy is implemented by the government central bank such as the US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, Bank of Canada, Reserve Bank of Australia and the Swiss National Bank. These institutions are some of largest central banks in the world responsible for monetary policy, which consists of the supply and velocity of money, as well as the cost of money (interest rate). The primary tool for the central banks is open market operations. The Open Market Operations are done by controlling the quantity of money in circulation by buying and selling credit instruments (bonds and bills in US), foreign currencies and commodities. Central banks have been known to target various objectives such as a certain interest rate (US Fed funds), a foreign exchange relationship with another currency, or a relative value with a commodity such as gold. All of these operations affect either increasing or decreasing the amount of money in circulation to reach their stated objectives.

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#### 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)

The excessive weakness in the banking system in 2008 has created a paradoxical situation by increasing the demand for the US dollar. The inter-bank market has not been working effectively in 2008. After the failures, or near failures, of Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, Washington Mutual, Wachovia and Fortis the LIBOR (London Interbank Offered Rate) is extremely high. LIBOR is the rate banks are willing to lend to each other. The higher the rate the greater the uncertainty about other banks ability to repay these loans. Short-term money transferal is paramount for a free market society. High LIBOR rates have decreased the steady flow of money to a small drip. If you cannot borrow short-term to finance payrolls, buy inventory or any other business essentials, this effectively freezes the economy. The entire free market becomes threatened.

Will the financial rescue by governments worldwide be sufficient? Only time will tell. Many experts believe that governments must work in an extremely coordinated matter to handle the current crisis. A big part of the problem is the lack of confidence between banks, insurance companies, pension funds, endowment funds and individual investors. Most market participants are unwilling to invest or even lend their spare capital. The foreign exchange market may be one market investors should closely watch for further clues on the credit crisis. The International Securities Exchange offers options trading on six currency pairs, ISE FX Options,

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which are completely transparent and allow investors to implement their view of the US dollar relative to the major currencies. Another terrific benefit to trading exchange-listed options is the near elimination of counter-party risk. Please refer to the table on the previous page for a further explanation of ISE FX Options.

The credit crisis seemed to worsen simultaneously with the US dollar strengthening in late summer of 2008. One explanation is that U.S. investors are selling large quantities of international stocks and bonds and bringing the USD back home to meet their current liquidity needs. If entities cannot roll their credit demands through short-term money markets, they may be purchasing those dollars in the foreign exchange market creating more demand for the US dollar. This encourages US investors to "sell any and all international bids in stocks and bonds." Once US investors receive the currency, they sell it and purchase USD to meet their obligations.

The credit crisis of 2008 is equivalent to a "financial earthquake." It has affected investors all over the world. Money centers in Tokyo, Sydney, Frankfurt, London, Toronto and New York have been affected as well as global investors all throughout the world. Investors can use ISE FX Options to implement their own specific U.S. dollar forecasts whether you are bullish, bearish or even neutral. Options allow investors tremendous versatility in implementing those forecasts. Since the ISE FX Options are a US dollar-based trading instrument, if you are bullish on the USD, you could simply buy call options. If you are bearish, you could buy puts. Spreads and other more complex strategies are also available.

The recent, unprecedented liquidity crisis in the global financial markets has created many unintended consequences, but the question of who is ultimately responsible is really irrelevant. Most experts can direct the blame to countless entities, so playing the "blame game" is moot. The current credit crisis affects everyone, some more than others. What is surprising for many market participants is that the USD has held up so well during this financial crisis. ISE FX Options gives investors the ability to hedge US dollar exposure or implement a certain view of the currency market. What is important is your view of the USD. Will demand continue to increase or will the US dollar experience a sell-off, either way, ISE FX Options are available for your investment portfolio.

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