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Currency Cycles — Balancing Risk and Reward

The recent global financial meltdown has turned many investors away from commonly practiced strategies like the “carry-trade” as they seek “safe-haven” in these uncertain times. How do human emotions factor into pricing the currency market? What strategies can you employ to balance your risk and reward trade-offs?

bad news.

Which stage of the currency cycle are we in? Interestingly, that depends on both the currency pair and the time period you are studying. Since 2007, the currency markets have gone through many ups and downs, and possibly, more than one life cycle. As I review the six ISE FX option currency pair values, there has been one common theme (which can quickly

The financial markets are constantly looking ahead for information to price themselves. With the recent dramatic upheavals in the financial markets, hope has been replaced by despair. The markets generally experience four price stages in their own “life cycle”: consolidation, breakout, equilibrium, and the reversal of the previous breakout. The challenge for investors is not only qualifying which stage the market is in, but also the various sub-stages it encounters. Human emotions play a critical role, where market skepticism in a new trend is followed by hope, greed, fear, and capitulation. The foreign exchange market experiences similar life cycles for each of the currency pairs. Understanding how currencies are tightly interwoven into the equity, bond and commodity markets is vitally important for investors. Similar to the stock market, the currency market can rise or fall on good or

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change). Since the reversal of the world’s economic growth trend in 2007, the currencies that have performed the best have been the “safe-haven” currencies. Some common questions are: *Why? When might this change? Which currencies are expected to benefit from a changing world economy?*

For the past decade, the most popular theme in the currency markets has been the so called “carry-trade.” This refers to a strategy where investors borrow low-yielding and lend high-yielding currencies. The carry-trade is mostly executed in times of global financial and exchange rate stability, and pulls back during liquidity shortages. The rationale was to benefit from an improving economic environment by borrowing yen and buying alternative currencies that yielded higher interest rates. The foreign exchange market is dramatically affected by monetary policy. Interest rates affect the “spot’ or cash currency markets; higher rates indicate more inferred growth for that particular currency. What many investors fail to take into account is that the potential rewards must always be balanced by the risks. Higher interest rates imply more growth but they also imply more risk.

In 2008, the carry trade achieved negative returns for investors long on the USD/JPY (ISE symbol: **YUK**). As the U.S. Federal Reserve cut short term rates from a high of 5.25% to nearly 0%, the carry trade experienced massive liquidation. The reversal of the carry trade required investors to buy JPY and sell the higher yielding currency, such as USD, GBP, AUD and CAD. These currencies were previously used in strategies that sought to amplify the positive returns for the carry trader, as long as they did not significantly decline in value. This is exactly what happened in 2008, creating substantial losses for the carry trade strategy.

The weakest currencies in 2008 were the GBP, AUD and CAD. (The corresponding ISE FX symbols are BPX, AUX, and CDD.) These currencies were hit especially hard by the unwinding of leverage. Whether it was operating leverage or financial leverage, or a combination of both, these

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currencies experienced one of the worst years in history. The USD also suffered, but primarily against the yen and the Swiss franc (ISE symbol: **SFC**). The USD/EUR (ISE symbol: **EUI**) remained relatively steady, although not without record currency volatility.

Risk and reward are intrinsically linked. Risk should, therefore, always be incorporated into your investment strategy. High growth currencies, AUD, CAD, USD, GBP and to a lesser extent the EUR have felt the shift in trends. Though investors predicted that, in the event of a global economic decline, the AUD, CAD, USD, GBP, and EUR would suffer, they never expected them to all fall simultaneously at the same levels. Each trading day, the markets prices attempt to reflect global economic conditions for every currency.

As the global economic crisis worsened, the USD actually benefited against many of the major currencies. As of December 26, 2008, the USD has gained value against the CAD, AUD, and GBP. I will use acronyms for these currencies, the CAG currencies (Current Annualized Growth). The USD has only declined against the two safe-haven status currencies, the JPY and Swiss franc (Just Stable). The currencies that anticipated higher growth for this time of year have suffered. At the beginning of 2008, CAB currencies expected significantly more growth than the JS currencies. As a result of the global economic crisis, "JS" currencies have outperformed the "CAB" currencies in 2008 relative to the USD.

ISE FX Options allow investors to make their own foreign exchange forecasts using exchange-listed options. The ISE FX Options are intuitive; all of the pair values are U.S. dollar relative. If you are predicting a USD rally, you could simply buy call options to implement your forecast. Conversely, if you thought the USD is going to decline, you would buy put options. The options can be accessed directly from your equity options broker with expirations up to ten months in length. More sophisticated multi-leg options strategies can be implemented creating your own unique risk and reward tradeoffs.

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CONSTRUCTION OF ISE FX PAIRS			
CONVENTION	ISE FX SYMBOL	RATE MODIFIER	ISE UNDERLYING RATE EXAMPLES
USD/EUR	EUI	100	74.13 (0.7413 X 100)
USD/JPY	YUK	1	94.06 (94.06 X 1)
USD/GBP	BPX	100	66.95 (0.6695 X 100)
USD/CHF	SFC	100	111.93 (1.1193 X 100)
USD/CAD	CDD	100	118.03 (1.1803 X 100)
USD/AUD	AUX	100	137.90 (1.3790 X 100)

As we move through 2009, what can investors expect? How much uncertainty? When will the markets finally “shift” direction? Only time will tell. No market guru can predict with 100% certainty how the markets are going to perform over the next year. ISE FX Options are available each trading day for retail investors, institutions and market makers. As an investor, it’s important to carefully monitor the risk and reward relationships on a daily basis to find the appropriate trades for your portfolios. Trends do reverse. In any potential trade, the key consideration is whether the risk is worth the reward. As markets move through the various “life cycle” stages of consolidation, breakout, equilibrium and the reversal of the previous breakout, human emotion will continue to play its part.

Although it’s not always easy to define, the market stages are a good complement to other key indicators when trading the currency markets. Monetary policy, fiscal policy, balance of trade, inflation, economic growth, and political conditions are just some of the factors that help price the currency market. New market data is reflected daily on the ISE pair values and option premiums, as measured by the option implied volatility. Human emotions can be managed through ISE FX Options. Understanding how currency fluctuations impact

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your portfolio is vitally important. ISE FX Options market allows investors to implement simple FX forecasts with limited risk by purchasing calls or puts, hedging a particular currency risk relative to the U.S dollar, or creating unique option payoffs by implementing multiple leg options strategies. Whether you monitor the technical stages of the currency market, analyze the monetary or fiscal policies or use other methodology, ISE FX Options can help you meet your financial goals.

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