The Euro Bull: New Paradigm of FOREX

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As the EUR/USD breaks 1.50, investors should take another look at foreign exchange. 100/barrel oil, $1,000 gold, and $10/bushel wheat are not anomalies, nor is there a bull market in commodities. The US dollar is losing its value and its relevance as a world reserve currency.

What determines the value of a dollar? The common belief is that purchasing power determines the value of money, which is partially correct, but that is not the entire story. In a world of floating currencies, money is also valued in terms of other money. Simply opening a bank account in Europe, and gaining a few % per annum interest, would have returned a US based investor over a 50% return in 5 years. There are a few ways to look at that, but they all point to the same conclusion: the value of the dollar is declining. The other logical observation is that by NOT investing in the Euro, an investor is actually LOSING 50%. This is a difficult mental leap for many to make as they don't see losses in their bank account, but as we see $4/gallon gas, $3/gallon milk and skyrocketing commodity prices, many are noticing. They only have to realize the simple fact: prices are not increasing the value of US Dollars is declining.

Who is not affected by a declining dollar? The poor, debtors, manual laborers, and tradesmen (because you can continue to perform your trade for dollars, pesos, or bananas if need be regardless of the continuing slide of the dollar ••• tomorrow you may charge twice as much but so what?) But if you have any wealth; a house or a stock portfolio, denominated in dollars, the declining US Dollar should be the most important issue to you because that portfolio is losing value as the dollar does. In the worst case scenario, the Fed can default making US Dollars worthless overnight.

Best case, although unlikely it should be mentioned, the Fed could raise rates to 10%, Bush could declare a flat tax, open the borders to foreign investors by deregulation and providing tax incentives, pull out US Military from all foreign engagements, and be the banker of the world. This would catapult the US economy and the US Dollar to currently unimaginable success, but this is a farfetched fantasy. In reality, we are increasing our Military presence around the world, cutting interest rates, and regulating US markets, forcing even homegrown companies to look abroad.

Let's examine why the dollar is declining and what can potentially stop the decline.

The largest player in the US Dollar is clearly the Fed, the sole issuer of the US Dollar. Investment Banks and Hedge Funds, at the end of the day, rely on the Fed for regulation, clearing, liquidity, and currency controls; they are distributors and traders of US Dollars not the manufacturer. It clearly states on the Fed's website that the Fed conducts foreign currency operations in the open market, and maintains US holdings of foreign currency and swaps. This would indicate the Fed has the ability to intervene in currency markets in order to protect the strength of the dollar, and although the Fed may have that ability, it states in the same article that:

US monetary policy actions influence exchange rates. The dollar's exchange value in terms of other currencies is therefore one of the channels through which U.S. monetary policy affects the U.S. economy. If Federal Reserve actions raised U.S. interest rates, for instance, the foreign ex-change value of the dollar generally would rise. An increase in the foreign exchange value of the dollar, in turn, would raise the price in foreign currency of U.S. goods traded on world markets and lower the dollar price of goods imported into the United States. By restraining exports and boosting imports, these developments could lower output and price levels in the economy. In contrast, an increase in interest rates in a foreign country could raise worldwide demand for assets denominated in that country's currency and thereby reduce the dollar's value in terms of that currency. Other things being equal, U.S. output and price levels would tend to increase must the opposite of what happens when U.S. interest rates rise.

The Fed therefore officially controls exchange rates of the US Dollar through Monetary Policy. The Fed, in response to a weakening US economy and a Subprime crisis, has taken an aggressive policy of cutting interest rates, thus dropping the dollar.

So we cannot expect the Fed to solve the weak dollar issue, because they are the creators of it! The Fed could start aggressively raising interest rates and we could see the dollar soar to new highs. But there is a low chance of that happening, as they have indicated the contrary. As the credit crisis unravels, we can expect the Fed to continue cutting rates. With a weak stock market, a weak real estate market, and a weak economy, we can expect more doom and gloom before we see the light at the end of the tunnel, and in the meantime the US Dollar can sink another 80% or more, as the Great British Pound did when it lost its status as reserve currency.

Technically, once a downward spiral starts in currency, it is very difficult to stop. In stocks, an issuer can buy back shares in order to dry up liquidity and stabilize the price; a common practice among penny stocks listed on pink sheets. However if the US Dollar declines, the Fed would need Euros in order to buy back US Dollars, and since the Fed is not an issuer of Euros, it would take a near act of God to convince the ECB to loan the trillions necessary to support the dollar in the event of a default or run on the banks. While the Fed does have some mechanisms in place to stabilize the markets, the act of supporting your own currency is like pulling yourself out of a sinkhole by your own hair. Once the selling starts, it could feed on itself and create a downward spiral ••• as the value goes down more large holders, worried about further losses, may panic and sell, thus adding fuel to the fire.

It would be anything but capitalism if we didn't profit from this once in a lifetime opportunity of a declining dollar. On one hand, wealth will be wiped out en masse ••• on the other, it will be created. A transfer of paper wealth from USD to Euro and other currencies is inevitable; why be on the wrong side of the fence? Germans, Argentineans, Japanese, French, British, Italians, Turks, and many others, can attest to the events surrounding currency collapse and hyper inflation. They say it cannot happen to USA because of the TBTF Too Big to Fail Policy, a fallacious reasoning that came out of a Senate hearing on banking regulation.

All the facts and economic data point to massive dollar sell-off look at a USD/CHF chart and you can plainly see it has already started.

FX as an asset class

There are many ways to invest in FX as an asset, but this should be done only with the help of a qualified professional or someone with experience in FX. Everbank offers foreign currency CD's and foreign currency deposit accounts: https://www.everbank.com/ This will not excite most investors but at least you can have non-dollar denominated deposits insured by the FDIC.

For a more versatile approach, CTA's offer FOREX Managed Accounts, usually with minimums starting at $10,000. These accounts are pure FX trading strategies, some are extremely conservative and others are extremely aggressive. Various strategies can be implemented on these accounts which vary from simple news and economic analysis by traders with 20 years experience, to fully automated quant systems.

Funds such as the MERK hard currency fund offer FX specific returns as a mutual fund. From their website: http://www.merkfund.com/

The Merk Hard Currency Fund (MERKX) is a no-load mutual fund that invests in a basket of hard currencies from countries with strong monetary policies assembled to protect against the depreciation of the U.S. dollar relative to other currencies. Many consumers are aware of the falling dollar but don't know how to protect their capital against its decline. Others are uncomfortable choosing specific foreign currencies to invest in or investing in currency derivatives. The Fund may serve as a valuable diversification component as it seeks to protect against a decline in the dollar while potentially mitigating stock market, credit and interest risks-with the ease of investing in a mutual fund. The Fund may be appropriate for you if you are pursuing a long-term goal with a hard currency component to your portfolio; are willing to tolerate the risks associated with investments in foreign currencies; or are looking for a way to potentially mitigate downside risk in or profit from a secular bear market.

Hedge Funds are another venue for FX investing, but they typically have a $1 Million minimum and employ risky strategies.

FX Overlay

If a business or portfolio has exposure to multiple currencies, a hedging program can be implemented that combines multiple strategies to deal with currency risk. Large corporations such as Intel may have their own treasury desks, but smaller companies or financial firms may not have the resources or knowledge in place to justify such programs, however there are many companies who offer this service, or it could be built using proven models from the ground up.

FX as an industry

Explosive growth opportunities exist in the FX industry as US based investors take notice. The real opportunity in FX is in marketing, because of the widespread lack of knowledge about FX. Sadly, you don't need to know much to make a fortune in this field, and it's the marketers that will ultimately make the most, as they introduce an uneducated and unenlightened public into the most significant market of our age. What will out of work real-estate developers do as the market continues to weaken?

Beware FX Scams!

Because FX is completely deregulated, FX attracts many criminals. The allure of a secretive market only traded by large banks makes a good pitch to unsuspecting suckers. However there are a few easy ways to determine scams from the real thing, such as the NFA, CFTC, SEC, or by dealing with only companies and individuals who associate themselves with large FX firms who are registered with the NFA. The fact that FX attracts criminals doesn't diminish the opportunities in FX any more than the movie oiler Room proves that all stock brokers are cocaine snorting crooks.

This article is by no means exhaustive nor is it intended to be. Regarding bias on the topic, considering we are in this business, the fact that these opportunities exist, and the fact that dollar is declining, is why we ARE in this business and not in stocks or bonds. A day may come where FX is the only significant market left in the world, as domestic exchanges are ravaged by reckless monetary policies and rogue political administrations. In the meantime, protect yourself against calamity and position yourself to capitalize on the opportunity of a lifetime.

If you aren't familiar with Elite E Services, we recommended buying Gold at 279 and investing in New Zealand Dollars in 2002 when the NZD/USD was .39. George Soros made his fortune trading currencies, not selling stocks. In the mid-1990's, Intel made more money in FX than selling processors.

February 26th, 2008 - This day will be remembered by many as the last day of the Dollar's reserve status. May we remember the US Dollar well, in the good times.

About the Author

Elite E Services, a registered CTA and NFA member, develops automated foreign exchange trading systems. With over 100 years combined experience in FX, and over 100 combined years experience in I.T., Elite E Services is leading the cutting edge of systems development for the past 10 years. EES offers managed investment accounts, market analysis, automated trading systems, and custom programming. Elite E Services has companies in 3 countries and clients in over 50. Last year, EES was featured in leading industry publications as a top ranking CTA.