Chapter One

When Lightning Strikes

Financial Crises and the Rise of Currency Trading

DO YOU KNOW SOMEONE WHO'S BEEN STRUCK BY LIGHTNING? What about someone who's been struck by lightning *twice*? According to the National Weather Service, the odds of someone being struck by lightning in a given year are 1 in 750,000. That makes it extremely unlikely that a person will be struck by lightning once, much less twice.

However, because lightning aims for the tallest object in a given area, it's not at all uncommon for it to hit the same place more than once. For that reason, lightning rods are placed atop city skyscrapers to attract the bolts and absorb the hit.

Lightning rods attract lightning just like financial markets attract greed, which inevitably brews disaster. Given the right conditions, disasters in the financial markets—like lightning—can hit more than once and investors must be prepared.

Back in 2007, Nassim Nicholas Taleb wrote what became a very famous book called *The Black Swan: The Impact of the Highly Improbable*. Taleb describes a Black Swan as an extremely rare event that catches people by surprise, has a major impact, and is then rationalized as if it had been expected to happen all along. Unfortunately, as we've all seen, Black Swan events have become much more common in recent years. As bubbles in the economy begin to reach their breaking points, it is important for investors to identify ways to deflect risk and possibly capitalize on those events because fortunes are at stake. In fact, two of the world's most famous global investors made their fortunes when other people were panicking and running for the exit.

In 1992, at the ripe young age of 62, George Soros gambled that the U.K. would not be able to maintain high interest rates necessary to keep the British pound within the tight currency band mandated by Exchange Rate Mechanism (ERM). Soros believed the weak economy and high unemployment would force the U.K. to abandon the ERM and cut rates. He turned his speculation into action by establishing a massive $10 billion short position in the British pound through the use of as many different instruments as he could find. Of course, Soros was not the only one selling the pound. As speculation grew about the U.K. abandoning the ERM, no one wanted to hold pounds. What separated Soros from other investors was that when most people were on the defensive, selling pounds and squaring their exposures into the madness, Soros was on the offensive, attacking the pound until the Bank of England cried uncle. A month later, Soros's Quantum Fund cashed in and banked approximately $2 billion in profit.

The second financial legend is Sir John Templeton, who took a very different approach from that of George Soros. Founder of the world's largest equity fund, the Templeton Growth Fund, Templeton was a deeply religious man and a contrarian at heart. He loved to buy the crashes and come in during what he called times of "maximum pessimism." For example, Templeton swooped into Ford when the automaker appeared to be headed for bankruptcy in 1978 and poured money into Peru when it was awash with communists in the 1980s. However, he was not always a buyer. In 2000, when everyone else was buying technology stocks, he shorted dozens of technology companies. Templeton liked to get in when the underlying fundamentals were extremely out of line with the perceptions of the reality. Those opportunities don't come along every day, but when they do, they can present enormous opportunities.

The Worst Decade Ever

Time magazine labeled the first 10 years of the twenty-first century as the worst decade ever. Apart from wars and environmental catastrophes, there were two market crashes: the dot-com bubble at the beginning of the decade and the global financial crisis at the end. The global financial crisis wiped out the savings of families around the world, plunged millions of people into unemployment, and claimed a number of Wall Street's oldest institutions including Lehman Brothers, Merrill Lynch, and Bear Stearns. Most people did not imagine that a company like Lehman, that was established in 1850 and survived two World Wars and the Great Depression, could be pushed into bankruptcy during our lifetime. There are countless stories of individual investors who lost 50 to 90 percent of their retirement funds. The debacle in one way or another affected the lives of every American. Yet, believe it or not, a handful of savvy investors profited handsomely during this period when most were losing their shirts.

The subprime crisis that began in 2007 eventually morphed into the global financial crisis. The origin of the crisis was the popping of the technology bubble, which led Alan Greenspan, the Federal Reserve chairman at the time, to stimulate the economy by cutting interest rates aggressively. Unfortunately, he left interest rates too low for too long, creating housing and credit bubbles. Money was flowing into the U.S. economy from spigots as the Dow Jones Industrial Average raced from 8,000 in 2003 to a high 14,000 by 2007. The low cost of borrowing encouraged Americans to refinance their current homes, trade up, or buy investment property—and in some cases, all of the above.

Many of you may have participated or at least had ringside seats to the hysteria—even if it was only watching TV shows like *Flip This House* on A&E or *Flip That House* on the Discovery Channel. At the time, everyone from your local barber to taxi drivers was dabbling in real estate and believed to the core that in the long term, you could never lose money on housing. Boy, were they wrong. By 2005, real estate had accounted for 70 percent of the rise in net household wealth and an astounding 50 percent of overall growth in the U.S. economy in the first half of that year. Between 2001 and 2005, more than half of the private sector payroll jobs created were in housing related sectors. Who could blame the average American when house prices in places like Phoenix, Arizona, were rising as much as 45 percent a quarter. But when things got bad, they became very bad very quickly. When the housing bubble burst, prices in some states fell nearly 50 percent from their peak levels in 2006. Between the middle of 2007 and the beginning of 2009, U.S. stocks also dropped more than 50 percent. By March 2009, Americans lost more than $15 trillion in total net worth. The housing market bubble is exactly what Sir John Templeton would have called "maximum optimism."

In retrospect, many of us would wonder, how could we have not seen the warnings signs. With banks willing to lend to almost anyone, and average Americans overloading on debt, how could it have gone on forever? At the time, the bursting of the technology bubble was still in recent memory, which should have reminded us about the consequences of excesses. Although the subprime crisis created the largest housing bubble ever, it was certainly not the only one in recent history.

In the past 40 years alone, there were two housing bubbles in the United States, one that peaked in 1979 and another in 1989. Between 1987 and 1991, the housing bubble in Japan also collapsed, pushing the country into a long period of zero growth and what the Japanese referred to as the "Lost Decade." In 1998, the housing market in Hong Kong collapsed after the central bank raised interest rates from 8 to 23 percent to defend the currency during the Asian financial crisis. These bubbles may have occurred outside U.S. borders but they had global ramifications and made headlines across the world. Unfortunately, most U.S. homeowners and investors missed these all-too-obvious warning signs.

In fairness, a small number of experts, including Templeton just before he passed away, warned that the bubble would eventually burst, but their contrarian views were written off and fell on deaf ears. The crisis wiped out individual investors, mutual funds, hedge funds, and investments banks, but for those who anticipated the collapse, knew that bubbles eventually become deflated, and took speculative positions, fortunes were made. The biggest winner that we know of was John Paulson of Paulson & Company. The soft-spoken Harvard MBA and hedge fund manager was convinced that subprime mortgages would falter and began to warn his investors in 2006 that the housing bubble was bound to pop. His hedge fund made significant bets in anticipation of a collapse and by September 2007, his funds were up an average of 340 percent.

At a time when almost everyone else was losing money, Paulson and his investors raked in billions. In performance fees alone, Paulson's nine funds earned more than $2.5 billion between September 2006 and September 2007. Other winners in this period included Philip Falcone of Harbinger Capital Partners and Jim Simons of Renaissance Technologies LLC, both of whom collected more than $1 billion in performance fees, with Simons's $6 billion Medallion fund returning more than 50 percent. While all three of these funds bet successfully on the collapse in the housing market, other market players found alternative paths to making money from the subprime crisis.

Citadel Investment Group, one of the world's largest hedge funds, returned more than $800 million by purchasing distressed debt that no one else was willing to buy. For example, they took over the energy trades of Amaranth Advisors and acquired stakes in companies such as E*Trade.

Finally, the third set of funds that made money during the subprime crisis were high frequency trading outfits that focused on ultra short-term trading opportunities. Focusing on the very short term made them less exposed to the big moves in the market. Contrary to popular belief, the subprime crisis did not produce just losers, particularly among those who anticipated the crisis, picked up bargains, or focused on very short-term opportunities.

The Eurozone Feels the Squeeze

One crisis has led to another and now we are faced with new troubles in Europe. In response to the global financial crisis, central banks around the world increased spending to stimulate their economies and as a result drove their fiscal deficits to double-digit levels. Although many countries, including the United States and the United Kingdom, also have heavy debt burdens as a percentage of GDP, the Eurozone was punished when news broke that Greece's budget deficit, at 13 percent of GDP, was twice as large as previously estimated. They had fudged the numbers and were forced to admit the real state of their finances.

This triggered a series of warnings and then downgrades by rating agencies as investors grew concerned about the country's high borrowing costs and ability to meet upcoming debt payments. European policy makers let the problems exacerbate, to the criticism of many investors, before finally stepping in with a massive rescue plan that was worth nearly USD$1 trillion. Unfortunately, the ambitious plan failed to stabilize the markets even after the European Central Bank broke all the rules and started to buy government bonds and provide unlimited liquidity. Yet the euro remains at very weak levels (having fallen as much as 20 percent between January 2010 and

June 2010) while credit spreads for countries such as Portugal, Ireland, Spain, and Greece hit record levels. At the time of publication, it is still unclear how the sovereign debt crisis will play out and the magnitude of its impact.

Even if the markets stabilize, individual countries have pledged to aggressively reduce their budget deficits, which means spending cuts and tax increases that should curtail Eurozone growth as the belt buckles in Europe get tighter and tighter. It is too early to count the losers against the winners on this, but those who anticipated the move would have come out on top once again. Some funds have bought credit default swaps on Spanish, Italian, and Irish debt as a sort of insurance in the case of default. Just think—investors who shorted euros when Greece's troubles began in late 2009 could have made as much as 20 percent by the end of June 2010.

The subprime and the sovereign debt crisis showed us how we cannot focus solely on what is happening in our own little part of the world because, as we have seen, the problems in one country like the United States could destroy the economies of other countries. As the world's largest trading partner, it is easy to understand why everyone else would be affected by the troubles in the United States, but in recent years, problems in other countries also had a ripple effect on other parts of the world.

Countries as far away as Australia have complained about the impact of the European debt crisis on their local economy. Even big and mighty China has found Europe and Greece's problem nerve-racking, illustrating just how interconnected the world really is.

The Rise of Currencies

The two most recent crises have focused attention on the foreign exchange market. In many ways, currencies are one of the best confidence indicators for a country. When foreign investors are optimistic about the outlook for a country, they tend to buy the currency and use those funds to invest in domestic stocks or bonds. However, when they grow concerned for economic, political, or social reasons, they will sell their foreign holdings, dump the currency, and move the money home. When this happens on a large scale, it can cause a major move in the currency and force the government to address the situation.

If a currency becomes too weak, as the euro did during the sovereign debt crisis, there are concerns about inflationary pressures. If it becomes too strong, exporters cry for help because it reduces the competiveness of their goods. Extreme moves in currencies can also affect the earnings of multinational companies. For example, if a company has a lot of accounts payable in other currencies, a strong local currency will reduce the value of the accounts payable while a weak local currency will increase it. At the same time, exporters typically love a weak currency and despise a strong one.

Currencies matter in different ways to different people; we will discuss this in further detail in Chapter 2. The subprime crisis that began in the United States and the European sovereign debt crisis may have lifted currencies from the business news to the headline news, but the popularity of currencies is not particularly new. Over the past 10 years, the forex market has grown significantly. Back in 2004, the Bank for International Settlements reported that the daily turnover in the forex market was approximately $1.9 trillion. When they released their triennial survey again in 2010, volume had increased to $4 trillion. For the first time ever, banks also did more transactions with "other financial institutions" (think retail forex brokers) than with other banks. Therefore, a large part of the growth in foreign exchange can be attributed to individual investors discovering the opportunities in forex trading.

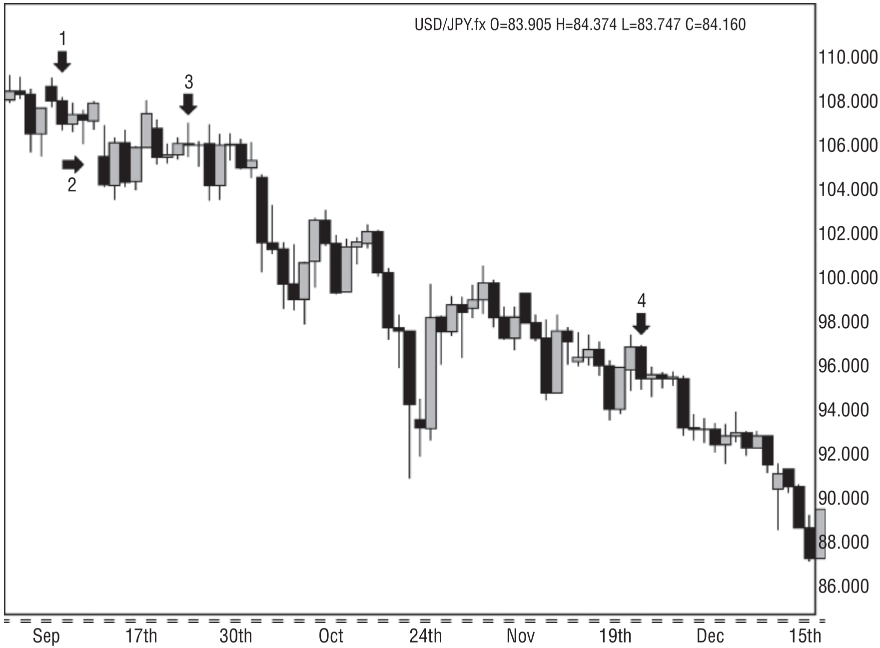
Turning Headlines into Opportunities

If history tells us anything (and we know it does), there will be more crises, large and small, in various parts of the world over the next 10 years. When they occur, you will have the choice of being on the offense or the defense. So as my Aunt Judy always asked, how will you turn lemons into lemonade? Hindsight is always 20/20; in retrospect, it is easy say that dot-com companies with zero to negative earnings did not deserve their sky-high valuations or that people would eventually stop paying astronomical prices for homes, especially as inventory flooded the market and consumers became overburdened with debt. The key is to not get caught up in the madness and be able to think rationally about whether the price of the asset is appropriate given the risks and valuations.

Of course, this is easier said than done, but not impossible if we consider the different ways that a small investor could have capitalized on the recent crises.

Let's start off with the subprime crisis. As we all know, the crisis caused a number of financial institutions to fail. Some were seized by the government; others were rescued, sold to competitors, or forced into bankruptcy. Although some people may argue that it is immoral to profit from someone else's misfortune, that was how Soros, Paulson, and Templeton made a large part of their wealth. Exhibit 1.1 is a daily chart illustrating how the U.S. dollar and the Japanese yen—known as the USD/JPY currency pair—behaved after the failure of major financial institutions. The first arrow points to the time

Exhibit 1.1 The Reaction of the U.S. Dollar and Japanese Yen to the Failure of Major Financial Institutions



Source: GFT Dealbook 360.

when Fannie Mae and Freddie Mac were seized. The second arrow indicates when Lehman Brothers filed for bankruptcy. The third arrow points to when Washington Mutual collapsed, and the fourth indicates when the U.S. government was forced to rescue Citigroup. As you can see, in each case the currency pair extended its losses. Even rescues or acquisitions failed to lift the dollar on the fear that more trouble would come. Those investors who sold dollars against the Japanese yen during the subprime crisis were handsomely rewarded.

Moving on to the European sovereign debt crisis, as the events in Greece unfolded and it became more apparent that the country was headed for financial trouble, credit rating agencies began to slash its debt rating. A credit rating agency is a company that assigns credit ratings that are meant to show the likelihood of an issuer defaulting on its debt. Ratings are given in the form of letter grades, almost like a report card. When a country's rating is downgraded, it means that, for one reason or another, they've become more likely to default on their debt. In October 2009, one of the leading credit rating agencies, Fitch Ratings, downgraded Greece's sovereign debt rating to A−, triggering what later turned into a 20 percent sell-off in the euro (EUR) against the U.S. dollar. As in the case of the USD/JPY, each time Greece or another sick country within the Eurozone was downgraded, the EUR/USD sold off. These downgrades set off waves of concern among investors because it meant that the country was moving closer and closer to defaulting on its loans. By April 2010, Greece's debt ratings had been slashed to junk levels. One way to capitalize on the crisis would have been to turn the headlines into trading opportunities—or, in other words, sell when the panic begins because one downgrade will often be followed by another.

Even if you don't feel comfortable turning the stories into opportunities and prefer to trade on chart levels, you could have capitalized on the moves in both currency pairs by selling the breaks of key levels. For example, 105, 100, and 95 were all important psychological levels in the USD/JPY. The same is true for 1.45, 1.40, 1.35, and 1.30 in the EUR/USD.

Currencies are trending in nature, especially during times of panic, and therefore, joining a move may yield better results than fading it. If you are not patient enough to sit with a trade for long, you can consider something shorter term in the direction of the prevailing market sentiment. For example, after a downgrade, you may want to look for opportunities to sell the EUR/USD for a short-term potential profit, assuming that trouble begets more trouble with a stop to limit the losses.

Get It? Got It? Good!

- Financial crises are becoming increasingly common.
- But not everyone is a loser! Legendary investors like Sir John Templeton have shown that there are bargains to be found during times of crisis.
- Some professional money managers such as George Soros and John Paulson were smart to anticipate recent market meltdowns and profited big-time.
- In times of crisis, currency trading is a way to turn headlines into opportunities.