



Quotable

“Even our subdued optimism may seem surprising, because the standard gauges of household leverage - ratios of debt to income, debt to assets, or mortgage debt to owners' equity in real estate - paint a bleak picture of the average household balance sheet. While household debt in relation to disposable income has declined significantly from its peak of 123.6% in 3Q07, we estimate that it stood at 110.7% at the end of 2Q, or only back to 2004 levels. Moreover, mortgage debt in relation to tangible assets remained at 44% by 1Q10, while such debt in relation to owners' equity stood at 163%, both more than double historical norms.”

Richard Berner

FX Trading – Should the Fed raise rates? Absolutely! Interbank market is key...still.

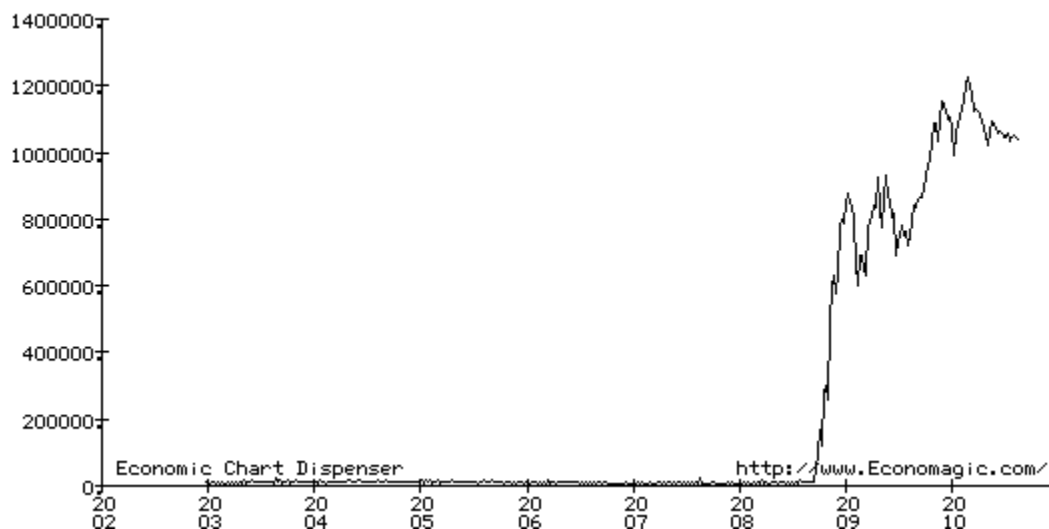
A friend wrote to me the other day and sent a [link to an article on Bloomberg.com](#) wherein the IMF former chief economist argues the Fed should hike interest rates. My friend wrote:

My question to you is, what can Central banks do to prevent another bubble; can they really increase rates when there is so little demand for credit?

As to the first part of my friend's question, I didn't really respond. But I think history shows bubbles are formed by the central bank's suppressing interest rates well below where a normally functioning market would price credit, thereby creating fuel to bid up asset prices in the financial economy and stimulate additional malinvestment in the real economy. And of course we know the game: as real asset prices are bid up, it creates more collateral value to bid up financial asset prices in a self-reinforcing manner even though it should be clear to all that interest rates are artificially low.

As to the second part, I absolutely believe the Fed should raise interest rates. Why? Because it will help to unlock the interbank lending market. Who cares about the interbank lending market you may ask, knowing it is a market where banks lend excess reserves to each other? Anyone who lives and works in the real world and is seeking credit to fund a viable business should care because the interbank lending market is the conduit through which all those excess reserves now sitting on banks' balance sheets make their way to the real economy.

Reserve balances with Federal Reserve Banks: Overview items: Millions



This is a topic we covered back in late 2009. It is still pertinent today. Sadly, given the Keynesian zeitgeist mentality, the idea of raising rates in the midst of a so-called “demand problem” leads to shrieks of horror even if it is the right thing to do. Our esteemed leaders have a penchant for rarely doing the right thing when it gets in the way of their political fabrications.

Because credit is an input into working capital, a credit constraint acts very much like a supply constraint on physical capital. In either case, dumping more liquidity into the system does not increase output. But why should congestion in the wholesale interbank market constrain banks who see good retail lending opportunities? Why don't such banks just raise their interest rates to final (retail) borrowers enough to maintain their profit margins and willingness to lend? This is an important and not generally understood point. Retail lending involves making risky forward commitments, much like transacting in forward markets in foreign exchange. For example, a bank might open a line of credit to a well-known corporate customer that could be drawn upon over the next year. But below some well-defined maximum, the customer chooses when to draw it down, and by how much. **The willingness of banks to make such forward commitments to lend to nonbank firms and households depends very much on the wholesale interbank market. If the wholesale interbank market works smoothly without counterparty risk at positive interest rates, then even currently illiquid banks can make forward loan commitments to their retail customers.** If such a bank happens to be still illiquid when a corporate customer suddenly draws down its credit line, the bank can cover its retail commitment by bidding for funds in the wholesale market at close to the “risk-free” interest rate. Because the riskiness of making forward retail loan commitments is thereby reduced, the bank's willingness to do more retail lending increases. (Otherwise, without participating in the interbank market, each commercial bank would have to hold much higher liquid reserves against its potential retail lending opportunities.)

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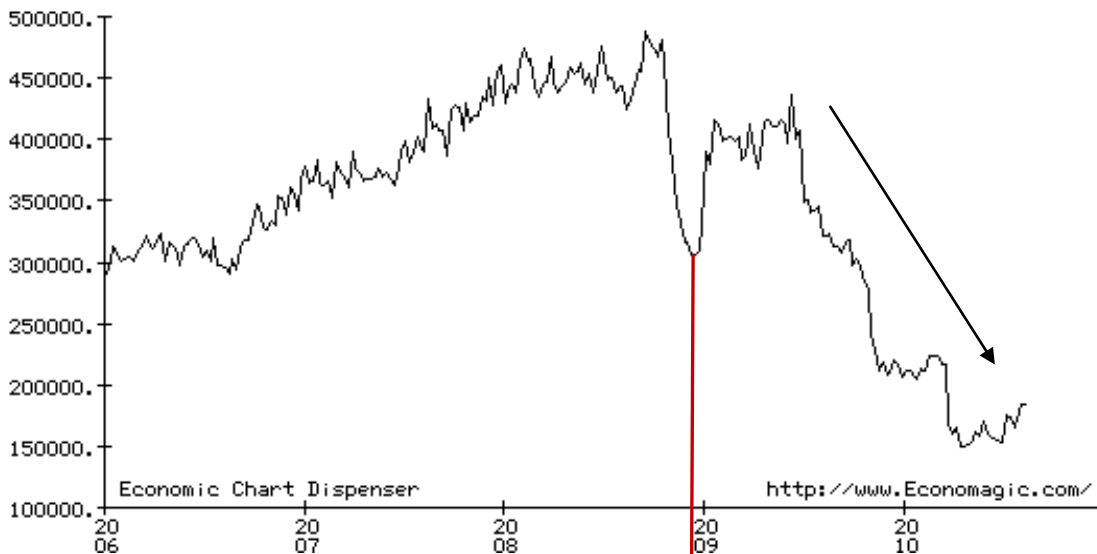
Stanford Professor Ronald McKinnon,
writing in the Fall 2009 edition of
International Economy magazine

So, for all those that believe low interest rates are a panacea, think again. Add to this the fact that consumer income from savings is suppressed by artificially low interest rates, which in turns adds some incentive for consumers to stretch for yield into risky assets, as they say. But being burnt in risky assets, it then leads to consumers going into their collective shells and creates yet another drag on the economy. These dislocations are all created by the manipulation of credit and so called “stimulus” only leads to prolonging recession/depression. But I digress.

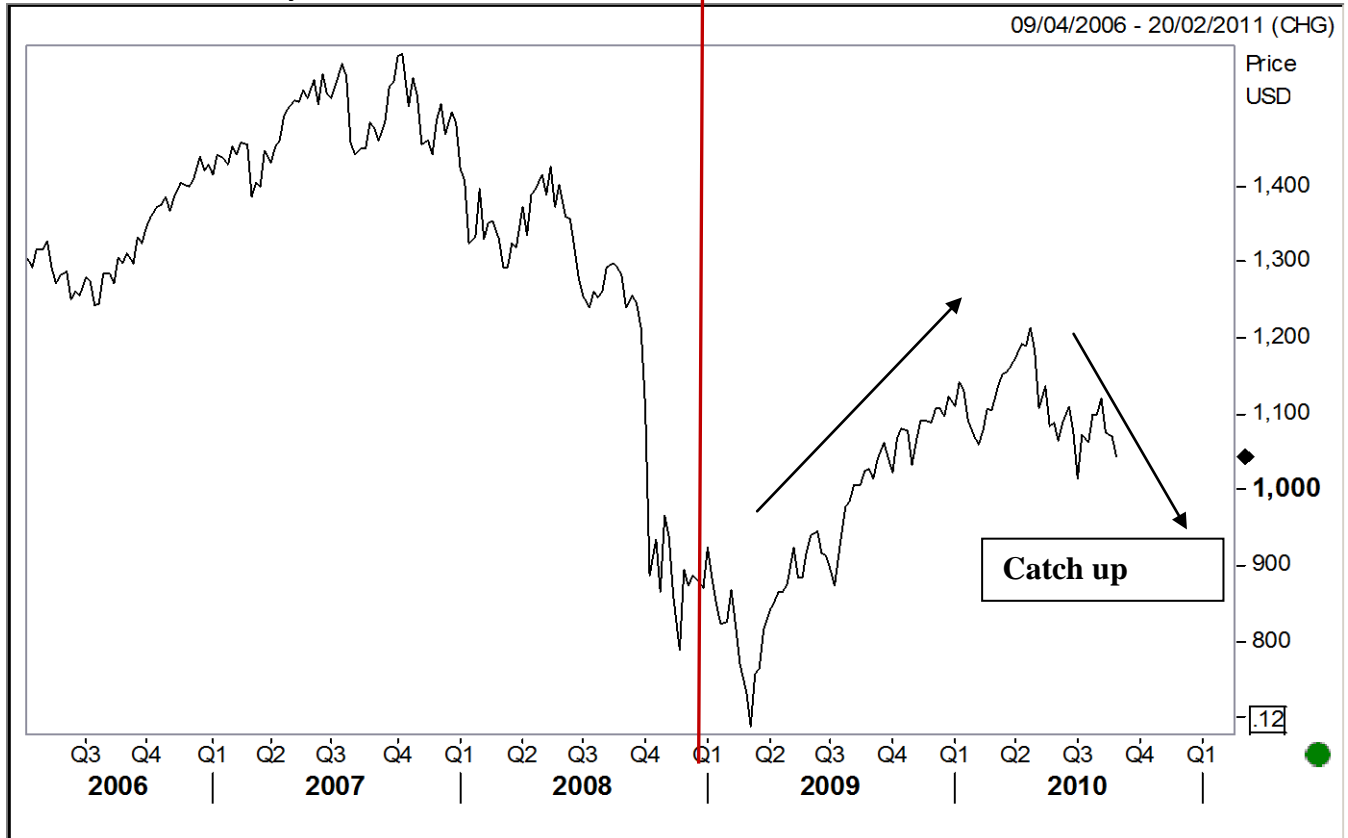
Take a look at the charts below. We have lined up an **Interbank Lending chart** with the **S&P 500 Index**. We wonder if this dearth of lending to the real economy is about to catch up with the bidding up of financial assets thanks to the juice provided by the Fed...

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Interbank loans, all commercial banks, seasonally adjusted; Millions of



S&P 500 Index Weekly:



In addition to sipping wine and eating croissants, the supposed best and brightest economic minds—in the world central banks (I realize that may be a bit oxymoronic)--will be sharing thoughts and ideas on how best to get the world's economies moving again. Going out on a limb, I suspect the assembled brain trust will once again tell us they are on the right course, as stimulus is the only path to nirvana.

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We don't need a position paper or a PhD. to counter that nonsense; all we need to do is ask the brain trust this question: Have you guys ever heard of a place called Japan?

Jack Crooks
Black Swan Capital LLC
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Leading the Way to Lower Highs, Lower Lows: An Opportunity!

You're probably well aware of the correlation between major asset classes by now. And that goes to the same risk-on, risk-off trading theme that's been driving capital flow.

The rally in stock markets through the month of July meant a similar rally in currencies, at the dollar's expense. We called the beginning of the correction back in June when we alerted our Currency Investor members to exit a position that profited from a weaker euro. That trade netted a very nice gain. Since then we've been waiting for signals that the correction has come to an end, that the euro would resume its decline. We seem to have reached that point.

Sentiment has shifted back into bearish territory ... and the major global risks have not been addressed to any meaningful extent. A new, deep move lower in the euro could be triggered by a coming collapse in stocks. A failed test on the S&P 500 of critical resistance has been followed by a lower low and a lower high – the markings of a downtrend in the making. Will you be ready to play it? Will you know how?

[Currency Investor.](#)

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