



## Overview Friday 18 February 2011

- A ramble about beliefs, the black swan, lessons, risk, and trading...as we reflect on our view that has been getting hammered the last couple of days. We will be doing some homework this weekend.
- Stopped out of **AUDCAD** yesterday, on the big rebound in Aussie. Stopped out of **USDCHF** this morning. Ugh...getting toasted...we will get it back!
- **Euro** acting well on not so good news; traders jumped the euro long side on the comments from Bini Smaghi (real name) at the ECB when he said the bank was poised and ready to hike in order to control inflation. This on the heels of news last night of increased borrowing of ECB capital suggesting things are tightening up for the periphery or a big bank out there (which pushed the euro sharply lower in Asia)...1.3743 is next key resistance for EURUSD; it represents the correction high back on February 9<sup>th</sup>.

## Current Portfolio

### Open Positions

Entry Date	Symbol	Long (Short)	Entry Price	Stop Loss	Last Price	Profit PIPs	Profit Target	Percent Returns
MAJORS								
1/3/2011	USDJPY	Long	81.42	<b>80.9</b>	83.1300	171	89.17	2.1%
2/7/2011	EURUSD	Short	1.354	1.379	1.3675	-135	1.2584	-1.0%

## Economic Data (Reuters and IFR Markets)

### Market Briefs

- Japan government likely to upgrade economic assessment in February - Nikkei.
- PBOC fixes CNY at record high 6.5781 against USD
- PBOC Gov decide pace of CNY appreciation, intl. pressure not a consideration Rts
- World Bk Pres. Urges major economies to modernize global monetary system - FT
- German Jan PPI 5.7% y/y vs 5.3% prev, 5.1% exp
- U.K Jan retail sales 5.3% y/y vs -0.7% prev, 4.1% exp

## Quotable

“Have more than thou showest, Speak less than thou knowest.”

William Shakespeare

## Commentary & Analysis

### Beliefs, lessons, full moons, and Mr. Market...

Funny story, but true, and maybe it parallels your path in this currency game ...

When I first started trading currencies seriously (currency futures actually) I was very fired up—ready to make my millions and then move on to conquer the rest of the world (youth is great that way). Little did I know at the time I just finished reading what could still be the best single book ever written about the currency markets: *The Way of the Dollar*, by John Percival. Mr. Percival doesn't know this, because unfortunately I have never had the opportunity to meet or speak with him, but he was the only mentor I had in this market. I read that book from cover to cover ... pages are falling out ... highlighted and notes everywhere. It is the type of thing you rarely get in a book, further insight every time you go back to it. I still do.

Mr. Percival made a key point in the book that struck me, as I was coming into the investment world armed, I thought, with my MBA in finance and economics, with equivalent in accounting. I worked as a financial analyst and even did a stint in the never-never land of corporate strategic planning—talk about being paid to do absolutely nothing of value. Anyway, Mr. Percival's book opened my eyes at least a little, many years of being crushed by markets and making the same excruciating mistakes over and over again until the idea of risk finally established itself deep in the gut and opened them even wider.

But back to Mr. Percival, he said this in the introduction to his book:

Finally one had to see if there were other relationships which had any predictive value for currencies—like inflation, trade, money supply, oil prices, economic growth, et al. So far, the conclusion is that few such relationships—and none of the relationships that most observers seem to rely on—are useful for predicting the dollar.

Say what? I thought to myself. Heck, I have all these so-called analytical skills and spent a bunch of money putting myself through night school (living with and mooching off future in-laws as much as possible at the time waiting for my sweetheart to finish her undergraduate matriculation—seriously JR, that is not a dirty word about your mother). So with “vaunted MBA” (LOL) in hand and now I am told to pack it up and put it in the drawer, effectively, if I want to trade currencies with any degree of success. Yikes!

Again, it took a while for Mr. Percival's early lesson to sink in. In fact I still make the mistake of assigning causality to factors where none really exist. I think this is an area where many other people make the same mistake. I often receive emails telling me the dollar can never rally or things can't happen because of A-B-C...the relationship is "perfectly clear."

The favorite rationale I hear most is about debt (granted a serious problem and not one to be taken lightly by any means). But when it comes to currencies, over time there is very little correlation between debt and the movement in the dollar, or many other currencies for that matter. But it seems this is not enough for many when they hear this. The reality I have learned is people latch on to ideas they cannot let go of; nothing new there. But the degree to which they cling to these beliefs in financial markets is unusually strong. I sometimes write back to said emailers and suggest they look at the debt profile of Japan—that currency has gone up and down a lot during a period where debt levels as a percentage of GDP have soared consistently. But of course "Japan is self-funded therefore that example doesn't matter" is often the retort—still clinging tightly to their belief. [This is what makes markets I guess.]

Karl Popper, a German philosopher, scribbled away about big issues long before Nassim Taleb ever had a real thought in his life. Now of course, Taleb is the thought master and a darling of the financial conference crowd after having effectively ripped-off Popper and Russell and Hume to make their real thought appear as Taleb's own; but again no surprise, that is what promoters, especially those with egos the size of Oklahoma, do in order to get people to read their books; fortunately Mr. Taleb's book—*The Black Swan*—is decent, even if it is mostly a verbose rehash of his earlier excellent book—*Fooled by Randomness*.

I guess you can sense a little angst on my part here toward Mr. Taleb. If so, you are correct. My company was named Black Swan Capital long before Taleb was considering a book of the same name, yet I am asked constantly if I took the name because of "Taleb's book" ... ugh ... and so it goes. I digress...

Back to Popper, whom I started reading in 1988, thanks to finding reference to him from Mr. George Soros' great book: *Alchemy of Finance*. Back then Mr. Soros stuck to his knitting as arguably the best global macro trader ever. Sadly, we know the rest of the story. Sorry, back to Popper...

Popper referred to the black swan in his 1953 essay on the *Problem with Induction*. Induction's application in the financial world is best known as "back testing;" we all know how dangerous that can be to a trading account. Reading Popper gives one a deeper understanding of why we

cling to beliefs so tightly and assume we can confidently project our expectations into the future and be confident we will be *right*.

Sometimes I am asked: “Why are you so confident that x, y, or z will happen?” It is a hard question to answer; by saying I am never fully confident and have only degrees of that trait, in enough of a degree to pull the trigger, leads to more confusing for the questioner. So, instead I provide some rationales, yet knowing said rationales can be proven wrong at any instant by Mr. Market. Reading Popper should come with a warning label as he will do that to you.

Popper was fond of Hume and used his reasoning for much of the basis of his argument about induction, carrying it further. Popper wrote:

...But Hume held, at the same time, that although induction was rationally invalid, it was a psychological fact, and that we all rely on it.

Thus Hume’s two problems of induction were:

- 1) The logical problem: Are we rationally justified in reasoning from repeated instances of which we have had experience to instances of which we have had no experience?

Hume’s unrelenting answer was: No, we are not justified, however great the number of repetitions may be. And he added that it did not make the slightest difference if, in this problem, we ask for the justification not of certain belief, but of *probable* belief. Instances of which we have had experience do not allow us to reason or argue the *probability* of instances of which we have had no experience, any more than to the *certainty* of such instances.

- 2) The following psychological question: *How is it that nevertheless all reasonable people expect and believe that instances of which they have had no experience will conform to those of which they have had experience? Or in other words, why do we all have expectations, and why do we hold on to them with such great confidence, or such strong belief?*

Hume’s answer to this psychological problem of induction was: Because of ‘custom or habit’; or in other words, because of the irrational but irresistible power or the law of association. We are conditioned by repetition; a conditioning mechanism without which, Hume says, we could hardly survive.

Okay...I realize this is getting thick, hang in there, almost there.

Popper agreed with the first part of what Hume talked about—the *logical problem*. But neither Popper, nor Bertram Russel, a disciple of Hume, could accept the irrationality of the second part—the *psychological problem*.

**It is here were we get to the black swan.** Popper posed that yes we must use experience of past instances to advance our knowledge but we must accept the fact that just because so many past instances were effectively consistent, or the same, it does not therefore mean a theory based upon those past instances has been proven. The reason he says this is because there may be some future instance out there that invalidates all that has come before it, and it only takes one such instance to do that. Therefore, all theories can be falsified, but they cannot be proven simply by past experience.

...Or in other words, from a purely logical point of view, **the acceptance of one counterinstance to 'All swans are white' implies the falsity of the law 'All swans are white'**—that law, that is, whose counterinstance we accepted. Induction is logically invalid; but refutation or falsification is a logically valid way of arguing from a single counterinstance to—or, rather, against—the corresponding law.

This logical situation is completely independent of any question of whether we would, in practice, accept a single counterinstance—for example, a solitary black swan—in refutation of a so far highly successful law. I do not suggest that we would necessarily be so easily satisfied' we might well suspect that the black specimen before us was not a swan. And in practice, anyway, we would be most reluctant to accept an isolated counterinstance. But this is a different question. Logic forces us to reject even the most successful law the moment we accept one single counterinstance."

Thus, the theory, or law, that all swans were white was falsified once a black swan living in Australia was discovered. Till then, everyone knew all swans were white. Done deal!

Of course everyone knew Triple AAA-rated tranches of securities were safe. Everyone knows municipal bonds will be fine because the default rate has always been low in the past. Everyone knows that gold is the only real money. Everyone knows inflation is a monetary phenomenon. Everyone knows the dollar must go down. Everyone knows that China will rule the world soon.

We could go on and on into infinitum with what everyone thinks they know. But interestingly, the things we seem to think we know often don't even have the consistent instances of induction in their favor. We cling to ideas in the financial world that have been falsified before but seem to gather a second life. This isn't even close to the word *logical*.

I think this is why the kernels in financial markets seem to be centered on the understanding that markets are driven by irrational expectations; therefore sentiment is where one should maintain focus. [This gives some theoretical backing to also using technical analysis, as price is the price—action personified regardless of the irrationality or false rationales. It is also why the field of behavioral economics will likely obsolete much of what we have been taught about the dismal science.]

Now back to Percival, again from his introduction to *The Way of the Dollar*:

Because the system's constituent parts are mostly based on human behavior which doesn't change, not on fashion, we can be confident it will continue to work.

The financial markets, as anyone familiar with them knows, are deeply paradoxical. They have a logic of their own which is why in a way the opposite of normal logic. Hence the market adage 'sell on the news' applies to good news not bad news. Hence other bits of market lore like 'a bull market climbs a wall of worry: a bear market flows down a river of hope.' Markets do whatever they need to do to confound the greatest number of people.

This happens because prices reflect expectations. If everyone expects unemployment to rise, or a trade balance to fall, or inflation to remain steady, there is no intrinsic reason why they should be wrong: the expectation doesn't affect the outcome. But if everyone expects shares to fall, or the dollar to rise, there is every reason why they should be wrong: because current share price levels already reflect the expectations of lower prices, and the current level of the dollar already discounts a rise. **In other words, the expectation vitiates the outcome.**

You can see why Mr. John Percival is an excellent mentor. One more interesting thing Mr. Percival wrote in his book, which he later said he wished he left out [which I like] was this:

Active traders have little to lose and much to gain by observing the following maxim: distrust price action ahead of a full moon, trust the action after it.

Last night was a full moon in this part of the world. ☺

Rationalize it as you please: the impression is that market action tends to be primitive, dim, and emotional before full moons, and more collected and rational after them; and that there is sometimes a periodicity in currency fluctuations which can be almost as reliable as the tide!

Loony sounding I know, but there is a key point we shouldn't miss here....

...successful trading is not about being a genius, but about constantly exploiting 'the little edge.'

So, back to the "funny story" I started with earlier... when I first got started focusing on currencies, I did my best to think only about what Percival talked about in his book and push out all the "smart rational analytical skills" I was confident I had already learned. At the time I didn't realize the quality of this little book I stumbled upon; it was a true gem in the world of investment book wasteland where most reside, or should. I went on to do extremely well with my first account. However, I cringe in retrospect thinking of how much risk I was taking on and had no clue. But we all know the end of the story.

The most dangerous moment comes from sudden victory, to paraphrase someone I once read. Bingo! After the "big success" I realized I could just as easily replicate it trading German bunds, and French Pibor, and orange juice (after being lock-limit down in my OJ contracts for a couple of days I realized just because I grew up in Florida I knew nothing about orange juice; but did start to get a better feel of this stuff called "risk.") In less than six months, I gave back most of my "big success" and then some...I was well on my way to eventually blowing out the account entirely.

Anyway, my smart rational side of analysis took over once I got cocky. Nothing new there for any of us that have been down this long path of learning and re-learning and re-learning. We tend to come full circle after barking up and down the trees of dead ends.

So, to end this long ramble, I guess we need to sum it up like this: We all can and should have reasons and rationales in our mind about why we have taken our positions; it is a must in order to have that bit of confidence to push us over the edge so we can take a position in the first place, i.e. pull the trigger. But we need to understand our beliefs, whether based on induction or logic, are subject to being destroyed by the market at any moment. And that moment

usually happens at the time we too fervently argue said beliefs (guilty again as charged, your Honor).

Mr. Market, through the magic of the price system, is always there for us, teaching us the same lessons we should have learned a long time ago. And so it goes.

Happy full moon Friday and have a great weekend!

Regards,

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