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Currency Traders: The Fed Has No Clothes!

(Or, in other words: What's Going To Happen With the US Dollar?)

I recently spoke at The New York Traders Expo and once again, one of the most frequently asked questions was: 'have we seen the bottom in the dollar and if not, won't the Fed step in soon and stop the decline of the dollar against the major currencies?'

Before I tell my answer, let me go back a little over twenty years and tell you how the idea that the central banks stop and start trends in the currency markets became a popular myth. In the mid-1980's, I was one of the four or five largest currency traders in the world. When the Fed wanted to intervene in the currency markets in the US time zone, they rang my desk and got instant execution. I regularly intervened for the Fed in both the cash FX markets and the currency futures markets. Intervention then was not a new idea or concept-it was a normal part of the markets. The institution I traded for regularly intervened for the Fed in the currency markets, the interest rate markets, the debt markets, the stock indices futures markets and even the foreign debt markets. The thinking at that time was that the Fed would generally help smooth market moves, because disruptions were viewed as a bad thing.

If you want to know what it's like being one of the four or five largest cash currency traders right in the middle of a world wide economic event, keep reading! If you want to know why the central banks are unable to put together meaningful coordinated intervention packages these days, as they did in the Plaza and Louvre Accords that rocked the currency world in the 1980's, read on!

In the summer of 1985, I was not only running the cash FX trading operation but I was also the Head of Execution for the Risk Committee for the bank's proprietary trading portfolio. I carried a satellite phone around with me any time I was not at the bank-they were very heavy and were housed in a bulky box, but the reception was always great. I also had one installed in my midnight blue Jaguar, even though the antenna had to be drilled through the trunk and stuck well above the convertible top. I was a slave to the bank's directive that I always be available.

I loved to fish back then; in fact, I still fish every chance I get. I particularly like to fish for trophy musky and walleye in the fall so in late September of 1985, I drove up to a large lake in northern Wisconsin on a fishing trip with my wife. We had time to check into the house we had rented for the two week vacation, get something to eat and we were just packing our fishing gear to go out and unwind after a seven hour drive when the satellite phone rang. My wife gave me a glare that would have melted a steel bar, but I picked the phone up-I had to! It was the President of the bank I worked for and he told me he needed me back at the bank first thing in the morning. I reminded him I had just gotten here and I had not taken a vacation that summer. And of course, I'd have to drive most of the night just to get home. He told me to forget all the excuses, get in the car and get back to the bank.

'Something has come up.'

I tried one last time: I told him I was on vacation with my wife-we'd only been married two years and hadn't taken a honeymoon-and she wasn't going to like riding back home all night on a Sunday night.

'Let her stay and fish', was his reply. 'I need you here in the morning.' Then he hung up.

I started to explain to my wife but she told me she had heard the conversation and she wasn't going to stay if I was heading back. We packed quickly, got in the car and spent most of the night getting back. I had enough time to take a long hot shower, dress, and then get back into the car and head to the bank.

I got to the bank around 5 am and parked in my spot underneath the bank, then took the elevator up to the trading floor. The trading floor was usually dark at this time of the morning and today was no exception: there were a few eerie halos of light here and there shining in the dark where a few managers sat and talked but the floor that normally housed over 350 noisy traders was nearly empty and you could hear a pin drop. If there was a crisis, it wasn't evident by the state of activity on the trading floor. I went into my office and dialed the bank president's office. He answered on the second ring and told me he was glad I had gotten back safely and that he'd be down to see me later in the morning. He didn't tell me what was up, nor did he give me any instructions.

I was a bit puzzled but I assumed he would not have told me to drive back from vacation in the middle of the night unless I was needed, so I assumed when he wanted me to know what was going on, he'd tell me. I sat down at my desk and began preparing for my trading day. The trading floor slowly began filling up over the next few hours and by 7 am, the floor was bright and noisy-it looked and sounded like the beginning of any normal trading day.

There were economic numbers out at 7:30 am and again at 8:30 am that morning and these brought out a little extra volatility but all in all the day had settled down to its normal rhythm by a little after 9 am. After my normal pre-market preparation, I began selling US dollars against the German mark, initiating a new position purely based on the technical analysis tools I use in my trading. I got up from my seat at the trading desk, handed my trading sheet to my assistant and told him I was going to my office to grab a diet coke and get a few minutes of quiet time. As I stood up and turned around, I caught eye contact with the president of the bank up in the 'news ticker' area. This was a raised platform area that oversaw the entire trading floor and held a huge screen that scrolled the latest news throughout the day and when we had visitors, it was a great place to take them to give them an overview of the large trading floor. He was standing with another gentleman and he motioned me over.

As I approached the pair, I recognized the second man as Hans Tietmeyer, Finance Minister for the Bundesbank or the 'Buba' as we called it back then. He was a close friend of the president of the bank, so he visited the bank whenever he was in Chicago. As I approached the pair, he smiled briefly and after greeting me warmly, he said he understood I had cut short a fishing trip to get back today to trade. I admitted I had driven all night to get back today to trade but so far, the trading seemed rather subdued. Although the US dollar had rallied to all time highs earlier in the year, it had already given back more than twenty percent of its recent gains over the spring and summer and there was no indication anything explosive was in the works.

Dr. Tietmeyer asked me if I had a view on the German Mark and I told him I was currently long Deutsche Marks. He nodded his head at the president of the bank and then said to me quietly, 'we are quite fond of the German Mark. I like your position.' I smiled and then we continued with some small talk about his trip and my shortened fishing trip. Then he reached out, shook my hand and said again, pointedly, 'we are quite fond of the German Mark. Be well.' Then he and the president of the bank left.

Several hours later, I got a call from upstairs, confirming that I was still long German Marks against the US dollar. Then I was told the bank was interested in adding onto this exposure for the Risk Committee and I had complete discretion regarding size and timing but that they wanted me to be aggressive, since they agreed with the German Finance Minister. I was told in no uncertain terms that I had the full use of the bank's risk limits if I wished. I was not to discuss the position with any of the other traders or managers but at the end of the day, I was to call and report the size and P&L of the position.

I ended up the day with a very healthy profit on my original position and I also bought a sizeable amount of German Marks against the US dollar for the bank's Risk Committee that were also profitable at the end of the day. I called upstairs, reported my position and profits and was told that I should continue to be aggressive with the bank's position until they told me their views had changed. It had been a very long day, so after balancing my positions, I headed home, ate a nice dinner and went to sleep.

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I woke out of a sound sleep that evening when the phone rang. It was the Head of Trading at our Tokyo office. He had just had a visit from the bank of Japan's Finance Minister [The BOJ as we called them]. Their conversation sounded very much like the conversation I had had earlier in the day with the 'Buba' Finance Minister. I had been instructed not to pass on the details of that conversation to any traders or managers nor was I to speak about the bank's currency position, so I did not tell him about my earlier encounter or the bank's current long German Mark position. He updated me on current prices, then wished me well and I went back to sleep.

I managed to sleep the rest of the night without interruption and then headed back to the bank. When I arrived on the trading floor at 5 am, it was dark and quiet. I turned on a screen, checked prices and noted that both my own position and the bank's position had appreciated overnight and then began my pre-trading preparations.

Around 10 am, my secretary walked out onto the trading floor to find me, which was a rare occurrence. My wife knew that talking to me during the trading day was relatively useless, since getting me to concentrate on anything other than trading during the day was futile and my secretary did a great job of screening everyone but my wife. My secretary told me the president of the bank had a visitor and he would like me to meet him at his private dining area for lunch around 11:30.

The visitor turned out to be a Minister from the bank of Japan. He was 'passing through Chicago' and wanted to stop by and speak with his good friends. As lunch progressed, he asked me what I thought about the US dollar's recent fall from all time highs. I told him I had been very favorable to the dollar during the run up, but its turn down had been quite impressive and orderly and I felt it would likely continue for some time. He agreed and told me that the 'BOJ liked the yen' and then continued eating. At the end of lunch, we shook hands and he again told me the 'BOJ liked the yen'. I told him I agreed and lunch was quickly ended.

Several hours later, I got the same phone call as I had the day before. Before he even asked, I told him I was now also long a good amount of yen against the US dollar. I told him I had not taken profits on any of my German Mark position, but I had added to the bank's German Mark position earlier in the day when it briefly pulled back. The president asked for a P&L number and then told me the bank Risk Committee would also like to have a significant long yen position against the US dollar. I was also told that if at any time I wished to take profits on my current positions, I should simply transfer the position to the bank's position. I was reminded again not to speak with the other traders or managers about either the bank's or my own position in either currency; nor was I to speak to anyone about the two meetings I had been in and what had been said.

The US dollar continued to trade lower against the major currencies the rest of the day but there was little excitement in the market. My instincts told me something was going on in the background but there were little if any signs that whatever it was had started, except for the two visitors in the past two days delivering a similar sounding message. Once the trading day was done, I balanced my accounts and went home to make dinner. I slept through the night with no phone calls, which gave me much needed rest.

As I pulled into the bank parking lot at my normal time, I noticed there were a few more cars than normal in the lot for that early in the morning. And when I got to the trading floor, I noticed that there were quite a few pools of light scattered around the still-darkened trading floor and I could hear other traders already discussing the markets. I put my briefcase in my office and walked down to the trading desk. I stopped one of the senior traders and asked why he was in so early and he replied he had heard from a friend in London that something was up-something with the central banks-so he decided to come in early and see what the market was doing.

I walked around the trading desk and talked to a few other traders and managers and there was now a definite buzz in the market that something was up, but no one seemed to have a real idea what it might be, just that the central banks were involved. I continued to keep my information to myself but listened intently, wondering where and when the 'buzz' had started.

About 9:30 that morning, my Canadian dollar trader walked over and told me quietly that she had heard from her contact at the Bank of Canada that 'a lower US dollar' against the major currencies was favored by all the central banks. The statement wasn't anything new, I told her, but then she told me that her contact had called her 'out of the blue' and offered the opinion. It seemed strange but it wasn't much to go on, I told her.

By then, my short US dollar position against the German Mark and Japanese yen had grown to about US$ 10 billion and the total size of the position I was trading for myself and the bank's Risk Committee was approaching US$ 50 billion. I had a good amount of profit in both positions and it looked like things were just beginning to heat up.

Several minutes later, the head of our marketing desk called me over and told me he had just gotten off the phone with a good client of ours, a central banker from one of the South American countries that had good sources within the larger central banks. He called and sold a good amount of US dollars against both the German Mark and Japanese yen, then told my marketer that he was very bearish on the US dollar against the major currencies. We generally heard from this small central bank trader when real news was about to take place-he was the sort that had good information and loved to piggyback off it for profits, so I took his phone call as a real sign that something official was likely to happen, and probably sooner rather than later.

I walked into my office and called upstairs. Fifteen minutes later, we assembled all the senior currency traders in the trading floor conference room and vaguely described the rumors going round and the Risk Committee's opinion on the situation. We did not recount our visits from the Finance Ministry officials-because if something 'official' did end up happening and we leaked the information that would be the last time we got a visit prior to the event. We then told the senior currency traders that their position limits had been tripled until further notice as long as they were short US dollars against their currency.

As I walked out of the conference room, one of my best traders gently grabbed me by the elbow and held me back in the room until it emptied. Then he asked me if I could tell him what was going on. I told him that we'd just told him all there was to tell and he smiled and said, 'this must be a big one. The whole desk has been watching you sell dollars continually since Monday. You haven't bought back a single buck! Now the rumors are starting and I got a call this morning from one of my mates in London telling me there was going to be an announcement this afternoon by the central banks. The dollar's been falling for six months-what are they going to do?'

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I told him I honestly didn't know what they were going to do, but my position should tell him where I thought the dollar was headed. We walked out back to the trading desk together and watched as the rest of the senior traders started to build short US dollar positions against their own currencies. I asked him if he was going to sell any dollars. He just laughed and told me he had been limit short since I started selling Monday and he had started selling more this morning after his mate in London called. He already had a nice sized short position.

Near the end of the trading day, we got a call from a friend that traded at a Swiss bank. His name was Bernie and when Bernie called and told us he was 'on maneuvers for the Swiss Army,' that was his way of saying that he was dealing because he had 'inside information'. He didn't tell us anything other than that he was 'on maneuvers' and then asked for a price. He sold US$ 5 million to us so we would know he was bearish on the US dollar against the German Marks. To all of us that had been around and seen Bernie operate right before 'official' announcements' or surprise government actions and laughed at his rumors, only to see he generally took positions right before abnormally large moves occurred, Bernie's call was the final confirmation: If Bernie was calling, something official was likely to be announced soon.

After the US stock market closed that afternoon, the rumors began to get specific: there was going to be a meeting of all the key central banks in New York this coming weekend and they were going to make a major announcement concerning the dollar. There was no official confirmation, but the rumors were now persistent and we saw a steady flow of selling by customers that usually had inside information.

There was very little for me to do at this point. I had been short dollars since Monday morning and had added at every opportunity. I was as short as I wanted to be and at a price that was well above where the cash market was currently trading in both the German Mark and the Japanese yen. And I had finished building the bank's short US dollar position the day before; it, too, already had a tremendous profit in it. But if these rumors proved to be true, the current profits would be small change after the weekend.

Later that evening, there was official confirmation that the world's largest central bankers would be meeting in New York and they expected to release a communiqué after the meeting's conclusion concerning a new coordinated economic policy, particularly targeting the value of the US dollar.

Although the US dollar continued to slip against the major currencies the rest of the week, the official announcement that there was going to be a meeting in New York by the world's central banks seemed to take some of the frenzy out of the markets. A sort of eerie calm settled over currency markets and the volume going through the markets on both Thursday and Friday was much less than the volume on Monday, Tuesday and Wednesday. On our currency desk, our traders all had their positions, and because their positions were at much better averages than the current rate, there was little stress or pressure on them; the traders had all settled in to wait for weekend's announcement and its implications.

The details of the Plaza Accord came out over the weekend, with a spokesman from each of the G-5 countries presenting their own statement. The focus of the coordinated policies was indeed the value of the US dollar. Now we all waited for the Asian markets to open, to see what effects the statements would have on the currency markets and whether the central banks would match their words with actions.

The cash currency markets open with trading in New Zealand and Australia at roughly 3 pm Sunday afternoon in Chicago. The central banks of both of these countries openly sold US dollars aggressively against the major currencies on the open and announced that they were actively intervening to lower the value of the dollar—something that was unprecedented. Those traders that didn't believe the rumors of an important central bank meeting and change in policy going into the past weekend were now believers and tried to jump on the bandwagon by aggressively selling US dollars against the major currencies.

When the Japanese markets opened, the Bank of Japan ['BOJ'] aggressively sold US dollars against the yen and also sold dollars against the German Marks—and following the lead of the Australian and New Zealand central banks, the BOJ made press announcements with each fresh round of coordinated sales of US dollars. As the markets opened one by one, the rate of decline of the dollar accelerated, as more and more traders tried to chase the trend.

There were similar rounds of fresh selling throughout the night and announcements each time by the central banks involved. It was obvious they wanted the most 'bang for their buck' and they were intervening as noisily as possible, hoping to draw in more and more sellers of dollars. And of course, the dollar was in a literal free fall for days.

The handful of traders that got the visits from the Finance Ministers on Monday and Tuesday were unofficially told later that the strategy had been to identify four or five major traders and make certain they were interested in creating large short US dollar positions early in the week. They then hoped that at least some of these traders would clue in a few of their larger clients or contacts once they had built their own sizeable short US dollar positions. And of course, human nature being what it is, these contacts or clients would then tell others and the message would then rather quickly become disseminated. Looking back on that week, the central banks were alarmed early on because the traders they had chosen didn't do much talking—it became clear early on they'd have to make a few phone calls and do a little leaking themselves, and so they called the second tier central bank traders and gave them just enough information to get them initiating new short US dollar positions. And it was this activity that ultimately started the rumors that continued to build all week long.

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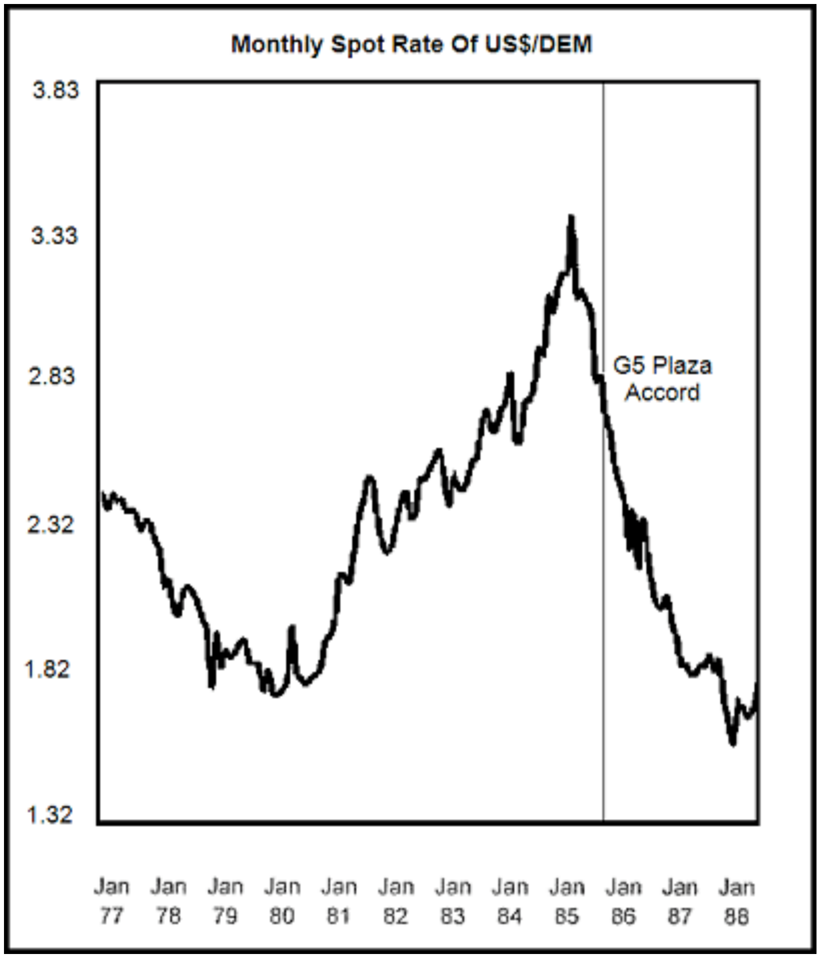
For the next three years, the central banks intervened aggressively in the currency markets, and they made it a habit to try to get the most 'bang for their buck' by confirming their intervention and usually leaking their intent to intervene before the markets even opened to a select few traders. And so it seemed to many traders that the central banks 'called the shots' and had complete control over this market. And when traders today talk about those three years and talk about the Fed and the other major central banks in general, they seem to feel they are fairly invincible when they want to take action. But nothing could be further from the truth.

Like all things in life, if you use a trick too often for too long a period of time, people get used to it and it begins to lose its effectiveness. The dollar had fallen so far, traders that tried to sell as soon as they heard the central banks were intervening usually found themselves short US dollars at poor levels, because they had jumped in and sold the break out to new lows. After several years of seeing the same announcements and watching the central banks pummel the markets, traders simply got smart: when the central banks intervened, they simply stepped out of the way.

Once the general market stopped jumping on the bandwagon when the central banks announced they were intervening, the traders the central bankers were using also quit initiating their own new short positions—instead, when the phone rang and they got the order to sell dollars, they'd simply execute the order and then go back to what they were doing. This indifference to the central bank sell orders quickly highlighted the truth: without a trend, the central banks were just market participants. The size of the cash FX market is so large, no one player or even five or six players—even five or six or seven central banks—can turn a major trend around in the cash FX market. The trends in the cash FX markets come from huge capital flows and only long-term changes in the policies that cause these flows eventually stop and turn the trend.

When traders these days think about that three year period, they believe the Fed and the other central banks changed the trend in the dollar and sent it reeling lower; time gave the central banks 'super hero powers' they never had in real life. The dollar had been falling for more than six months and had declined more than twenty-five percent from its highs before the central banks even started to plot the Plaza Accord in 1985.

When they finally acted, they jumped on a fast moving train: The dollar was already in a very strong down trend and they simply advertised their blessing of the existing trend. Here's a chart that shows where the US dollar peaked and just how far it had fallen before they began to blatantly sell dollars:


Monthly Spot Rate Of US$/DEM
3.83
3.33
2.83
2.32
1.82
1.32
G5 Plaza Accord
Jan 77
Jan 78
Jan 79
Jan 80
Jan 81
Jan 82
Jan 83
Jan 84
Jan 85
Jan 86
Jan 87
Jan 88

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Let me explain the state of the currency markets in the 1980's: More than ninety-five percent of all cash currency transactions were made through banks. Brokerage firms did not offer cash FX prices, companies had to deal through banks and cash brokers only dealt with banks and a select few Investment Firms. The banks controlled the flow of all the cash currency transactions and other than outright position limits and cash FX trading was basically unregulated in the bank arena.

Today, only roughly fifty-five percent of the transactions in the cash FX market go through banks. The rest go through exchanges, FCMs that make markets in cash currencies to retail and institutional customers and through the electronic brokerage service, a brokerage clearinghouse that allows very large net-worth individuals, corporations, banks and investment firms to deal direct. These days, General Motors can sell dollars directly to a large private speculator through EBS. The days when the handful of large banks in the world controlled the cash FX markets and could really influence flows are gone. Banks no longer have the risk tolerance to carry the huge speculative positions we routinely carried in the 1980's—they have credit risk and mortgage portfolio problems to worry about. Risk has shifted largely to the speculating crowd and the central banks don't have control of that crowd. For better or worse, control of the cash FX market has shifted from the few to the masses and that has greatly diminished whatever power the central banks had, IF they ever had the power over the cash FX markets traders attribute to them in 'the good old days' of cash FX.

The dollar is currently in a very strong down trend. Until that long-term trend changes, the central banks know that buying US dollars against the major currencies is throwing money away. They do not have the reserves or the sheer power to turn these long-term trends in the cash FX market. And in the case of the United States, the Federal Reserve has so many other urgent matters it needs to address, the dollar's level is not even on the list of policy items worth pondering.

Currency traders shouldn't spend any time or emotion worrying about whether the central banks are going to stop the dollar's slide. The truth is quite simple: when the flow of capital out of the United States ends, the slide of the dollar will stop. It's well known amongst the larger market participants that the countries that had traditionally held the majority of their reserves in US dollars have been diversifying their reserves out of US dollars and into other currencies. China and Japan have sold a huge amount of US Treasury Instruments and then sold the US dollars they received from these sales—many insiders estimate that China now holds less than 1/3 the US assets it held three or four years ago.

With the emergence of several new large economies [Europe, China and India] that are beginning to rival the US in buying power, investors around the world realize that 'flight to quality' may not necessarily mean a move into US denominated assets. As little as six months ago, when I mentioned it might soon take three US dollars to buy one euro, people generally felt I was overreacting to a short-term down trend in the dollar. But these days, it's become clear that the United States is not in the driver's seat when it comes to determining the level of the dollar, the level of their own interest rates and the capital flows in and out of their own country. The markets will take the currencies where they take them and the central banks, like all other traders, can go with the flow or stand aside—anything else will result in losing positions that eventually will be liquidated.

I wish you all good trading!

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