DynexCorp Currency Debt Management

Investment Process and Strategy

Instead of looking at fundamental information such as expected direction of interest rates, PPP (Purchasing Power Parity), budget deficits and monetary policy, we are looking elsewhere to an area of inefficiency in currency pricing which seems to be consistently reliable. Our key equation for turning points in currencies, as in all financial markets, is: extreme consensus + extreme speculation = extreme price.

The recurrence of certain behaviour patterns at price extremes is most significant. We know from long experience of the financial markets what these behaviour patterns are like. In continuously gauging them, we diagnose the market by locating its fluctuations all the way up the time scale from days through weeks and months to years. In practice we are limited by the availability of hard data: for instance some of the behavioural data sets we use exist on a daily basis, some only weekly, but most only irregularly.

We rely on four sentiment gauges, which are designed to help identify these price extremes which are also extremes of consensus and speculation. They are:

1) IMM Open Interest
2) Consensus
3) Perception of the trend
4) Reaction to news.

Two of the four sentiment gauges - consensus and open interest - locate extremes in consensus and speculation, hence peaks and troughs in the dollar. They are used in a contrarian manner. They are early warning indicators which tell us to cut back exposures or eliminate exposure altogether. The other two - reaction to news and perception of trend - tell us when the correction or reversal has started.

Price cycles in the dollar can be analysed exclusively in terms of the ebb and flow of sentiment among participants. The investment process described helps us gauge where we are in the behavioural cycle.

Trading Parameters, Time Horizon and Risk Management

TRADING PARAMETERS:	OPEN INTEREST (IMM) CONSENSUS PERCEPTION OF TREND REACTION TO NEWS
TIME HORIZON:	WEEKLY
RISK MANAGEMENT:	DIVERGENCE CUTS OUT OF HALF OR FULL POSITION
STOP LOSS POLICY:	STOP LOSS ARE USED ON A "CLOSING BASIS" - AFTER CLOSE BEYOND A LEVEL WE EXIT AT MARKET

OPEN INTEREST (IMM)
Speculation can be measured statistically in the open positions held at the IMM which accounts for a very small fraction of activity in the world's currency markets. Yet it is significant out of all proportion to its relative size, because it is a distillate of speculative activity. The Open Interest is effectively speculative interest. Traders, as noted, can be divided into two categories, 'price-led' traders, and 'value-led' traders. It is the 'price-led' speculators who buy the rise and sell the fall. We have our price extreme when the number of these parties peaks.

CONSENSUS
Data sources: Market Vane and Consensus Inc and various others. Our strategy is to look out for a consensus of opinion that is not confirmed by price action. When we diagnose a situation where the consensus is not confirmed by price, or if the open interest is extended in relation to certain parameters developed by us, then we cut back our exposure, or cut out completely.

PERCEPTION OF THE TREND
Our perception of the trend gauge is designed to measure conversion flow. What we are interested in is the change in perception. When a trend is ready to change - from up to down, say - everyone is 'facing' up: everyone is projecting higher prices. Normally it takes time for the perception to change. The perception of the trend does not change at the extreme of the old trend, but progressively after it. We have been alerted to the extreme by our open interest gauge. When our monitoring of trader sentiment tells us that a shift is taking place then the consensus is being converted from bullish to bearish.

REACTION TO NEWS
An early sign of a change in the perception of the trend is the way the market reacts to news. During the bullish phase, prices tended to rise on good and bad news alike. Then there is a change and good news fails to help the market. Finally, prices fall on good and bad news alike, and the trend has well and truly changed from up to down. What we are proposing is not original: this sentiment gauge is second nature to all old hands in financial markets. When traders say "the market is acting badly", this is what they mean: they are not as resilient as they should be in the circumstances. And conversely, when prices rise on bad or indifferent news, traders say the market is acting well. If we are facing the wrong way, it should be second nature to all of us to cut back when the market is reacting the wrong way to the news or to the circumstances - and to be reassured when the market is acting right. In certain cases, market action is about all we have to go on - not just in alerting us to major speculative peaks.