1

The Truly Modern Market

I love Asia: it smells of raw capitalism. Especially at night. Several years ago, I was watching Hong Kong in the evening as the city became a brilliant silhouette of pure commerce against the dark Communist backdrop of mainland China. The rickshaw drivers, rivers of neon lights, open-air markets, and steel high-rises always make me think of foreign exchange, the fundamental transaction of capitalism and the building block of modern globalization.

I couldn't speak Chinese, but as I approached a currency exchange booth on the Kowloon side of Hong Kong, I silently prepared to engage in an ancient conversation. I pulled out $100 in 20s, and the young man behind the counter smiled and said in broken

English, "I love LA, Hollywood. All right." He held his smile artificially long. "No," I said, "New York." "Ah," he replied, "Statue of Liberty. All right." And he smiled again. I was sure he could deliver a greeting in every language listed on the board behind him.

The electric board was black with red lights. It displayed the currency prices, a small flag for those who couldn't read the currencies, and a two-sided quote with a buy and sell price. The young man pulled out a beat-up calculator with masking tape holding down the screen and started to punch numbers. Exchange rate, buy side, times the number of U.S. dollars, 100, minus broker fee, equals 778 Hong Kong dollars. He looked up and I nodded in agreement. He unrolled a wad of colorful Hong Kong bills, counted them out carefully, and slid them over to me.

At that moment, it was hard to understand that in this little booth, lit by bad fluorescent lights, next to a vendor selling Peking duck and knock-off Chanel bags, I had access to the world's largest, most liquid, and most influential financial market—Forex.

A Market for the 21st Century

Since then, the Forex market has only grown more accessible, increased in size, and captured the public's attention. Spurred by investments in technology and communication over the past decade, the world is trading goods and services at ever-faster speeds, a process broadly called globalization. With the economic world drawing together faster, the Forex market has become its most critical market. And for the new breed of global trading and investors, the opportunities in Forex are just beginning (see Figure 1.1).

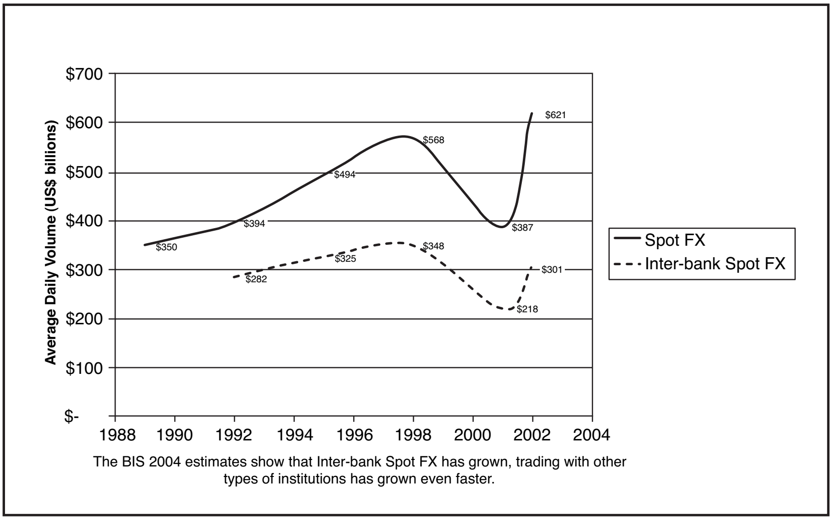

Figure 1.1—The increased popularity of retail Forex has assisted the sharp rise in trading volume.[1]

You can see globalization and trading today in cities around the world. Every morning at Grand Central Station in midtown Manhattan, tourists wait in line outside a well-lit and well-designed Travelers Money Exchange to trade their currency for dollars. With dollars in their pockets, they can dine out in Little India, buy cheap electronics in Chinatown, take a ride on the Staten Island Ferry, or do anything else money can buy.

This money fills up local cash registers, but it doesn't stay there for long. It is spent again. Perhaps it is used to buy some of the goods that are carried by ships into America's harbors. With their decks stacked impossibly high with containers, these ships steam past the Statue of Liberty and slide into docks bristling with giant cranes. The containers are whisked off the decks and hitched to tractor-trailers, which pull out onto the New Jersey Turnpike in an endless stream, carrying goods into the nation.

The goods are bought and the money flows back, much of it into New York again. Foreign corporations now look to trade the dollars they've made back into their native currencies. Far above the booths and lines of tourists, floors filled with brokers, traders, bankers, and trading terminals carry out these transactions.

Go to any major city in the world—New York, London, Tokyo, Bombay, Rio de Janeiro—and the same process is being carried out. This time, it may be British pounds or Japanese yen buying American goods and services, or foreign investors buying local stock or government securities. Billions of dollars flow back and forth across national borders every hour—sometimes passed by hand or voice, sometimes at the click of a button. At the end of each day, an average of $1.5 *trillion* has been traded, dwarfing the daily volume of the New York Stock Exchange, the NASDAQ, the FTSE, the DAX, and the Tokyo Nikkei combined.

It should come as little surprise that the volume is so high. Currencies bind the world together, form the bedrock of globalization, and are the means of exchange of world trade and investment.

But it isn't just the tourists and traders who participate in foreign exchange every day. So, most likely, do you. Take a typical day in the life of a Kansas resident. In the morning, he dresses in underwear made in China, a suit manufactured in Turkey, and a pair of shoes assembled in Italy. He brews a cup of coffee made of beans from Colombia. He drives a car with a transmission made in Japan and a steel frame from Canada. The gas powering the engine is refined from Saudi Arabian oil. At work, he turns on a computer fashioned with components made in Thailand, Indonesia, Taiwan, and China. The software is American.

All these goods were bought, and a portion of each purchase must be translated back into the currency of the country of origin. Although the Kansan may not be aware of it, his dollars are sent on a journey in which they are traded for yen, euros, baht, won, real, shekels, and yuan. We take this for granted, but without the currency market, our Kansan would be unable to get through the day unless his paychecks were issued in several currencies. Imagine trying to buy a hamburger in Kansas with yen! In short, foreign exchange has become woven into the fabric of our daily lives. It is impossible to be a resident of the modern world and avoid it.

After all, in these vast flows of money across borders lies an enormous investing opportunity. This market is old, but for the first time in history, due to a revolution in communication, technology, and credit, this market is available to small investors.

It's no coincidence that we are now seeing an enormous rise in Forex trading by both speculators and users. Forex is not a fad asset class pushed by analysts or created by an exchange to increase dwindling volume. It reflects fundamental market needs in today's environment.

A progressive market must meet two criteria today, and Forex has always met both. The market must be global, and it cannot be controlled by a single entity. The Forex market is truly global. It does not have a center and does not obey the rules of any one nation.

That applies especially to time. As different parts of the world move from darkness to light, trading activity comes to life. Currency is bought and sold in Tokyo while New York slumbers. When night descends on Tokyo, London offices are opening and starting to trade. By the time London approaches mid-afternoon, New Yorkers are arriving at their desks, ready to make money. The markets reflect these rhythms, with trading volume rising and falling depending on when workers are entering work or leaving to go home.

With this ability to trade the exact same currency at any time, the Forex can be called a 24-hour market that is open from late Sunday Eastern Standard Time, when the Forex week starts with the Monday morning open in Wellington, New Zealand, then on to Sydney, Tokyo, Hong Kong, Singapore, Moscow, Frankfurt, London, and then finishing the week on Friday at five o'clock in New York (see Figure 1.2).

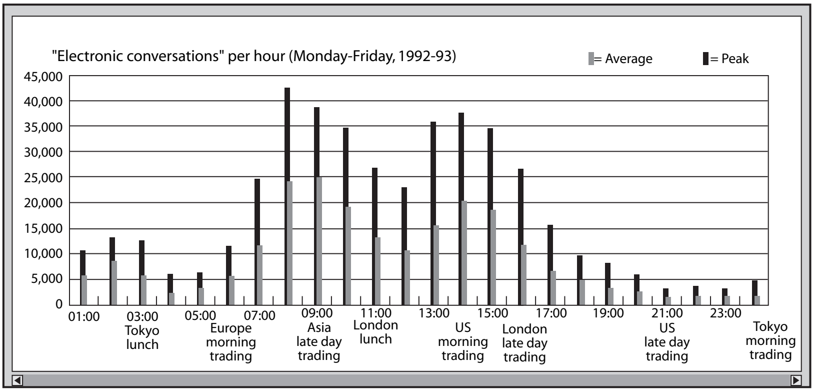

Figure 1.2—Daily trading activity of the foreign exchange market.

The Forex market also doesn't obey any one holiday schedule. New York banks don't close to celebrate May Day, but London does. London is open when Americans are sitting down to turkey dinners on Thanksgiving. Tokyo offices are filled on Christmas Day, when most Americans and Brits are at home unwrapping presents.

However, this vast market is united by two characteristics—ancient capitalism and new technology. At its core, the market is nothing new. The Forex market has roots that stretch back thousands of years, where cultures rubbed shoulders and merchants swapped goods at borders and in back alleys of ancient cities. This market grew out of itself—out of the human need to trade for goods that one society had but the other didn't. It grew out of the desire to make a profit.

For most of history, access was controlled by gatekeepers—merchants, bankers, industrialists—who wanted the profits for themselves. In the past 10 years, however, that has changed. Technology allows anyone with an Internet connection—via a terminal or cell phone—to not only trade Forex but also to have access to the information that gives traders a more level playing field.

Opportunity Is Knocking

Forex is an investing opportunity, one that can bring an investor profit or loss, provide a hedge for a portfolio, and be a source of critically important information—especially in a global investing environment where growth opportunities in the future will mostly be outside the U.S.

Forex is a volatile market intensified by leverage. Money is made (or lost) when investment values fluctuate. Although a market that moves up and down like a roller coaster can be nerve-wracking, it also offers more trading opportunities. Consider how the value of the dollar index changed between January 2002 and February 2004. The Australian dollar rose nearly 50 percent, the Euro almost 40 percent, the Swiss franc more than 30 percent, the British pound sterling 24 percent, the yen 22 percent, and the South Korean won more than 10 percent, according to *The Economist* (Feb. 9, 2004) (see Figure 1.3).

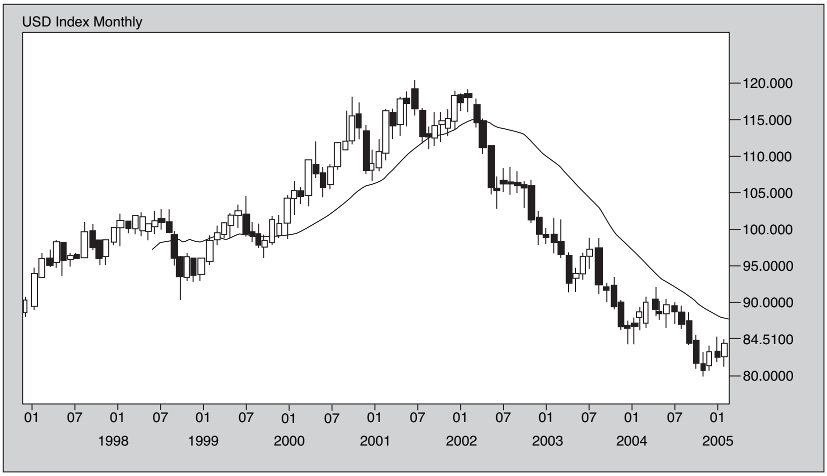

Figure 1.3—The Dollar Index is a weighted basket of G7 currencies used by traders to gauge relative strength.

Even if two currencies are not moving much against each other, investors can take advantage of small fluctuations through leverage. Compared to the wild tech days of the 1990s, trading a one-penny move wouldn't get anyone excited. But retail Forex is based on the power of leverage. This means that an investor can take a position with a small amount of money—say, $1,000—and leverage it into a position worth $100,000. This can be great when the markets move in a direction that benefits the original position, but losses pile up quickly when it does not.

An additional advantage of trading on Forex is that it offers investors invaluable education and experience—a "gateway" into the world of international investing. The oil shocks of the 1970s and the international economic crises of the 1990s taught many Americans that the U.S., even with its giant and diverse economy, depends as much on the global economy as the world depends on it. Combined with the weakening of the dollar's global dominance, high speculative returns from emerging markets, and the general sideways movement in the U.S. markets, savvy traders have expanded their search for investments. Any investor who does not have this perspective will miss opportunities. Taking part in the Forex market exposes an investor to the economic developments occurring around the world. With real money at stake, the investor will understand how political, social, and economic forces in other countries translate into profits or losses in the U.S. Thus, Forex offers not just portfolio exposure, but exposure for the investing mind. Over the next 50 years, most of the world's explosive economic growth is expected to take place outside the U.S. The Forex investor will be a part of it; the investor who stays home won't be. The new trading vernacular will be composed of terms such as bund, SET, and yuan.

Everybody's Talking About It

Another sign that the Forex market has come of age is that everyone's talking about it—investors, financial gurus, and world leaders.

Warren Buffet, whose Berkshire Hathaway fund has realized an average 22 percent increase in book value annually since 1965, announced in his 2003 letter to shareholders that he had, for the first time, entered the foreign exchange market on a large scale in 2002 and that he had increased his position in 2003.

Buffet attributed his move to the alarming increases in U.S. trade and government deficits. Buffet, one of the most successful investors in history, knows that weakness in the U.S. dollar could undermine the billions of dollars worth of assets he owns. "I feel more comfortable owning foreign-exchange contracts that are at least a partial offset to that position," he concluded.

In 2003, Morgan Stanley told its clients that they should take advantage of stock opportunities in Japan and Europe. The firm took that position because it believes stocks in those countries are undervalued and because it wants its clients to have a hedge against the further decline of the dollar. Stephen Roach, Morgan Stanley's chief economist in the U.S., warned that the dollar's value could not be sustained given the U.S. account and trade deficits. "America's massive current-account deficit cries out for a depreciation of the dollar," he wrote. (See http://www.globalagenda-magazine.com/2004/stephenroach.asp.)

The point here is not that investors should worry about the supposed imminent decline of the dollar (although a cautious, watchful eye would help), but that Wall Street believes investors should factor in currency fluctuations when planning their portfolios.

If the Forex market has drawn the attention of economists and market managers, political leaders have been incensed by it. Jacques Chirac, president of France, reportedly called aggressive foreign exchange traders the "AIDS of our economies."

Mahathir Mohamad, prime minister of Malaysia, blamed the economic troubles of the late 1990s in his country on "rogue speculators . . . anarchists wanting to destroy weak countries in their crusade for open societies, to force us to submit to the dictatorship of international manipulators." He openly called international financier George Soros a "moron."

Whether Forex is being touted by Wall Street or disparaged by politicians, there is little question that the market has arrived in the investing mainstream, and this role will only grow as globalization accelerates. As the world grows even closer together over the next two decades, the question every investor should ask himself is how he should handle the change.

Endnotes

1. Source: EBS.