Liquid Insight

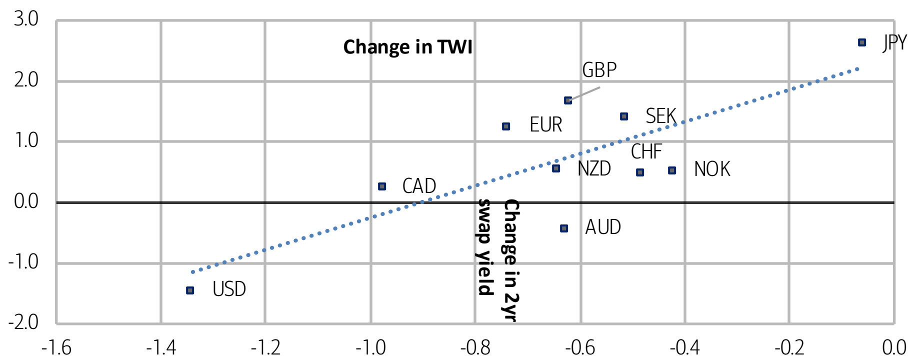
The FX/Risk Disconnect

Key takeaways

- Fault-lines are fueling the "something must break" narrative but markets are using a sledgehammer to crack a nut
- Price action has been indiscriminate & creating an FX/risk disconnect. Deleveraging of favourite trades has so far dominated
- Next phase likely to see G10 FX revert back to traditional framework where the basic balance matters

By Kamal Sharma

Chart of the Day: Scatter chart of change in 2yr swap yields versus change in TWI in March
Repricing of the front-end has been a good guide to FX performance through March



Source: BofA Global Research, Bloomberg

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The Ides of March strikes again

The curse of March has once again hit the markets against the backdrop of a tightening in global financial conditions. The "something must break" narrative has been frequently used over the past year to describe market concerns that a higher rate environment will expose faultlines in the macro economy. Sectors such as housing, credit and commercial real estate among others have been touted as potential weak points but it is hard to make the case that markets had expected a regional bank on the West Coast of the US to provide the catalyst for the current episode of global financial stability concerns. The market appears split on whether this could morph into something bigger or whether central bank actions will be enough. In G10 FX, price action has looked at odds with some of the markets prior on how currencies should react to vol events: both GBP and SEK have outperformed despite being two high-beta currencies with basic balance deficits. For now, G10 FX price action is more indiscriminate than textbook but we think this is about to change.

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Rolling out the playbook

Central banks have had significant experience over the past 20 years addressing the challenges of financial crises. Many of these measures were first implemented through the Global Financial Crisis (GFC) as officials have identified two major areas of concern: liquidity and solvency. To date, many of the measures taken by officials have been textbook: enhancing USD liquidity swap lines; emergency backstops for distressed assets, among others. So far, central banks have been keen to emphasize separation between financial stability and the policy mandate: all G10 central banks that were expected to hike did so last week (Global Economic Weekly: Central banks continue to follow the playbook and so do we 24 March 2023. But a common strand through communication has been acknowledgment that recent events have led to deterioration in credit/lending standards and a tightening in financial conditions.

However, while the reaction in the rates market has been textbook – bull steepening of the yield curve – the performance of G10 FX has been somewhat at odds with our prior understanding of how FX responds to risk-off events. Exhibit 1 plots G10 FX performance versus USD through the early stages of market turmoil (07/03-21/03) and gives a sense of the indiscriminate nature of how G10 FX performed. Both SEK and GBP, two currencies statistically proven to have a high beta to volatility both performed better, if not on a par with JPY. Both currencies would not be at the top of the list for many investors in a high vol environment.

Exhibit 1: G10 FX Performance vs USD (07/03-21/03)

G10 FX performance has been indiscriminate rather conforming to rules

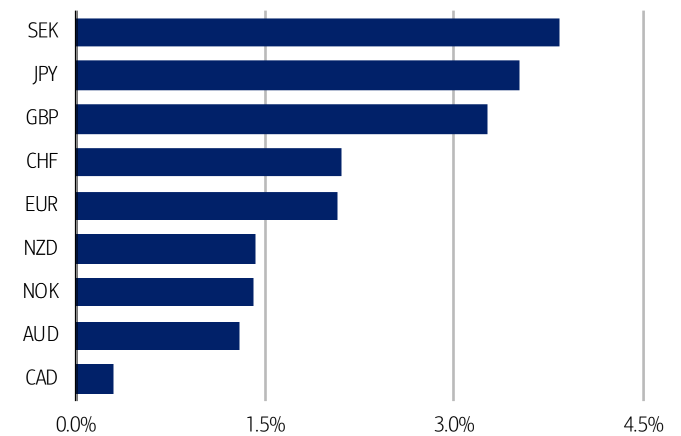

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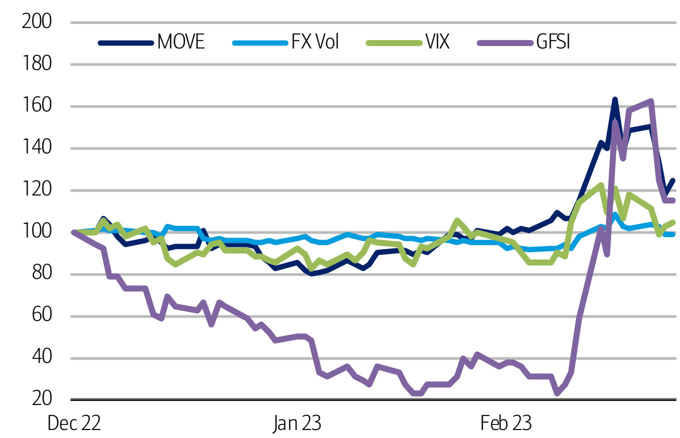
Exhibit 2: Indexed performance of market vol measures

FX Vol has not reacted to the current wave of turmoil



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In answering the question on why G10 FX price action has been so indiscriminate, Exhibit 2 provides a useful anchor. On an indexed basis (Dec 31st = 100), the chart shows that FX volatility has barely reacted to recent events and particularly relative to bond market volatility. In this context, relative price action in FX is easier to contextualize: the first casualty in a dysfunctional market is overcrowded positioning and a rush to delever. We observe that this dynamic may initially insulate currencies from responding as one would expect.

Exhibit 3 plots the correlation between G10 FX TWI and GFSI using two windows: past month and 2010-2022. The purpose here is to show that for many currencies, recent price action has been at odds with longer-term correlations: under-performance of USD and EUR relative to history, overperformance of AUD, NZD and GBP in particularly (SEK to a lesser extent) relative to the long-term history.

Exhibit 3: G10 TWI FX correlation to GFSI
1mth correlations stand at odds with longer term for some G10 FX

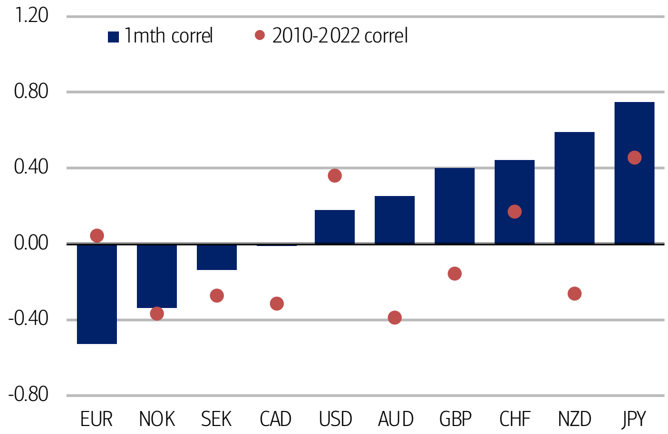

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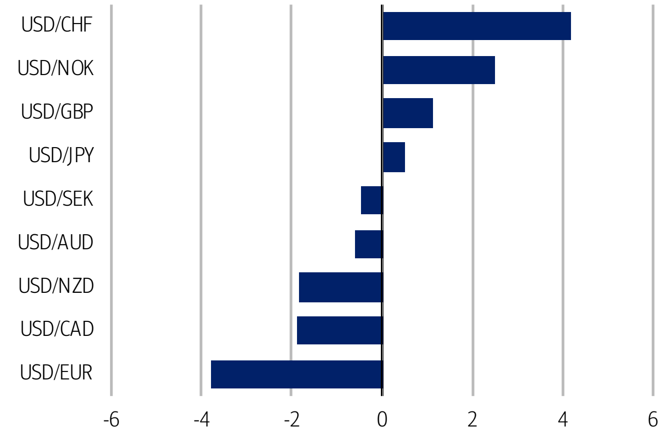
Exhibit 4: 1mth Carry/Vol for USD/G10 (bp) through March
Carry/vol has been stable due to steady FX volatility



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That GBP should meaningfully outperform EUR or NZD perform similarly versus AUD, appears to be consistent with our view that the first phase of FX adjustment has been driven by deleveraging rather than the properties of currencies will be the ultimate judge of FX performance. NZD is a notable example: its positive performance came at a time where it witnessed a record current account deficit (8.9% GDP). This will be increasingly important as we discuss below.

It's more than just Carry/Vol

Exhibit 2 shows how the adjustment in fixed-income markets has been more significant than in FX in response to the recent turmoil. It has been clear to us that positioning within the rates market was perhaps more significant than positioning in G10 FX. But the importance of rates positioning has also fed into G10 FX positioning. We have used the phrase "indiscriminate" to describe how the recent adjustment in FX stands at odds with how we think FX should react in a dysfunctional market. The stability in FX volatility has been an important feature of the recent dynamic and in some ways has provided an offset to the moves in global rates. Exhibit 4 shows USD/G10 1mth carry to vol in bp. The key takeaway here is how stable carry/vol has been in comparison to previous market tumults. EUR/USD 1mth carry/vol, for example, moved over 50bp through the March 2020 pandemic move. This compares to the current +4bp through March.

Repricing of the front-end of the curve has played some part as our Chart of the Day highlight but does not answer the fundamental question of why some G10 currencies have been more robust than their historical betas to risk would imply. FX positioning and the rush to delever are an important overlay to front-end repricing. Though overall positioning has not been at extremes, there have been some popular trade expressions this year (see: Liquid Cross Border Flows: When something breaks 20 March 2023). USD/JPY has book-ended the rate repricing narrative and is easier to reconcile against the current market backdrop. However, GBP, NZD and SEK outperformance should be set against these currencies having been popular RV shorts in 2023 – via higher EUR/CHF, EUR/GBP, higher AUD/NZD and higher NOK/SEK and broad-based demand for EUR crosses.

Momentum has been an important driver to explain the disconnect between FX and global risks. Exhibit 5 plots the 6mth change in EUR TWI relative to +/- 1.5 standard deviations. The pricing out of EUR risk premium and the fading of the terms of trade shock pushed EUR into overbought territory, according to our metric. EUR/GBP has been a popular expression and has been a key focus for us (see: FX Viewpoint: GBP: And so it begins 15 March 2023).

Exhibit 5: EUR TWI Momentum, 6mth change
EUR/XXX has been a popular long since this start of this year but looks overstretched

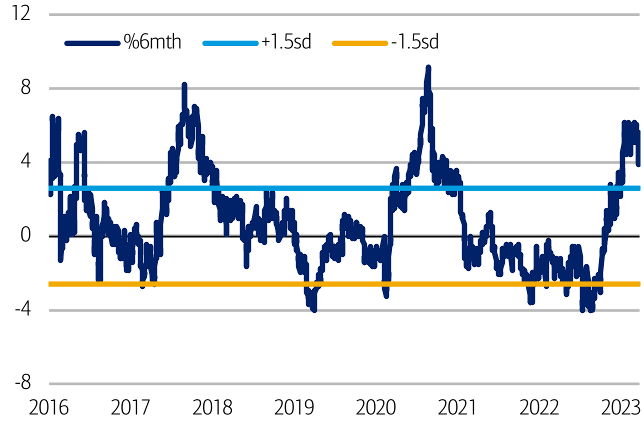

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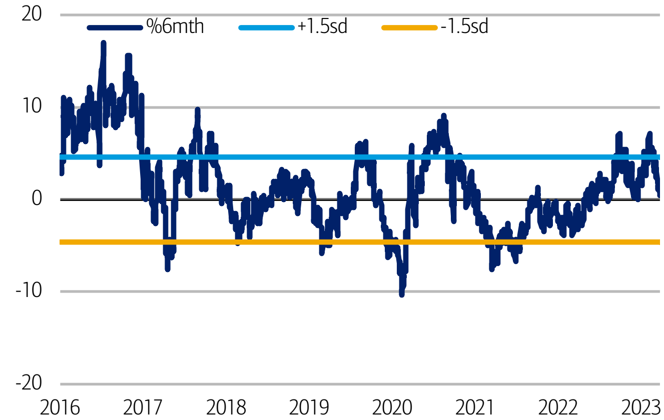
Exhibit 6: EUR/GBP Momentum, 6mth change
Higher EUR/GBP has been a popular expression for higher EUR.



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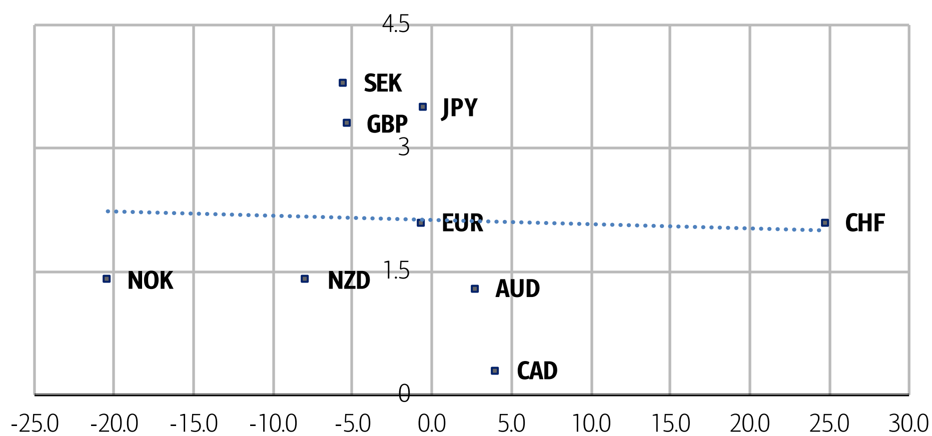
What does this all mean?

For G10 FX, a cross check of our momentum indicators suggests to us that the deleveraging phase is coming to an end, allowing currencies to better track some of the longer-term fundamentals that we have been discussing. We have made the point for GBP which can be extended to the broader G10: market turmoil which compromises the cross-border capital flow channel cannot be a positive for currencies which are either high beta or rely on cross-border investment flows to finance current account deficits. Exhibit 7 plots G10 basic balance positions (current accounts adjusted by investment flows) versus FX performance through March. We are focusing on the left hand side of this chart – currencies with basic balance deficits will be vulnerable as the market transitions to a textbook FX response in an evolving and broad-based crisis.

Exhibit 7: Q4 G10 basic balance (%GDP) vs FX perf vs USD 07/03-21/03
Currencies in the left hand side of chart are vulnerable to classic FX risk-off move



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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- This was not the Q1 you may have expected, **Global FX Weekly**, 24 Mar 2023
- Bonds Ahoy **Global Rates Weekly**, 24 Mar 2023
- When something breaks, **Liquid Cross Border Flows**, 20 Mar 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: This was not the Q1 you may have expected 24 March 2023

Global Rates Weekly: Bonds Ahoy 24 March 2023

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