Rates and Currencies Research | Global
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How to trade a government shutdown

Global Rates & Currencies Research
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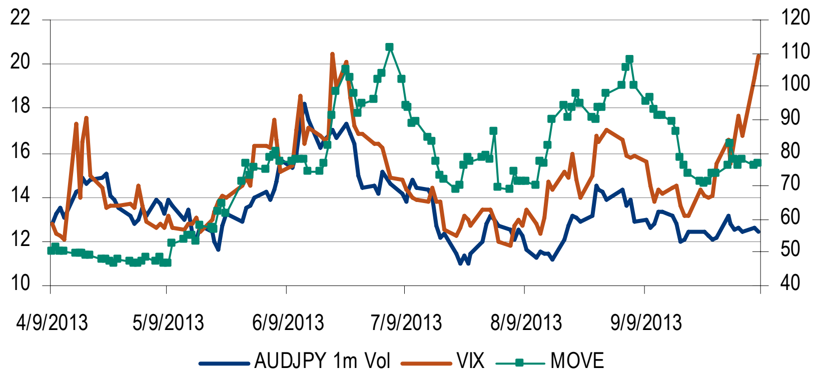
By John Hopkinson

- The suspension of data releases and increased uncertainty impedes Fed policy changes, and hence, increases the importance of positioning measures for trading currency markets.
- We explore a new source of options positioning from swap data repositories, creating put-call ratios, and evaluating liquidity.
- Strong demand for USDCHF puts suggests fading the Dollar rally. A spike in USDMXN option volume signals a potential turn in trend.

Chart of the day: Spike in VIX not matched by rates and FX vol



Source: BofA Merrill Lynch Global Research

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How to trade a government shutdown

The most direct consequences of paralysis in Washington are the suspension of US data releases and an increase in uncertainty. Higher uncertainty is not just a result of the lack of information, but also a reduction in the credibility of the government, as evidenced by the spike in 1m bill yields. As the chart of the day shows, equity markets are anticipating higher volatility ahead, but rates and FX markets less so. How can we explain this divergence?

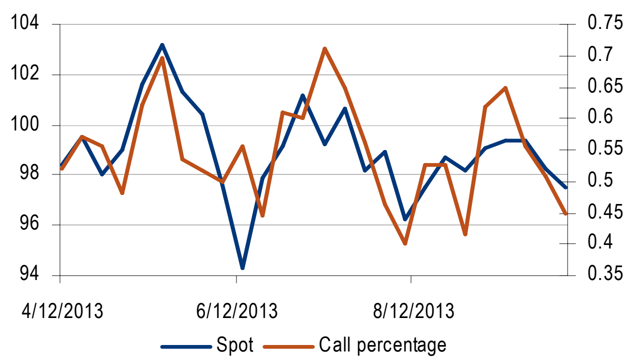
The lack of data reduces short-term volatility, simply due to the absence of market-moving events. Contrarily, uncertainty can increase tail risk, though this most likely requires a lack of clarity about fundamentals. By impeding any change in monetary policy, the shutdown arguably increases the clarity in the rates and FX fundamentals. We would, therefore, expect currencies to trade with low volatility and correlations up until a point when equity market turbulence creates liquidity demands.

A new options positioning database

With static monetary policy likely to result in range-bound currencies, tactical trading around positioning has enhanced importance. Our quantitative positioning framework (FX Quant Viewpoint, 13 February 2013) infers demand for short dated options directly from price action in the volatility skew. As a result of the implementation of the Dodd-Frank act, this inference may now be supplemented with information from swap data repositories. This new database effectively permits the creation of option volume and put-call ratio indicators for FX markets. As Chart 1 illustrates, the put-call ratio is likely to be a useful addition to the positioning toolkit.

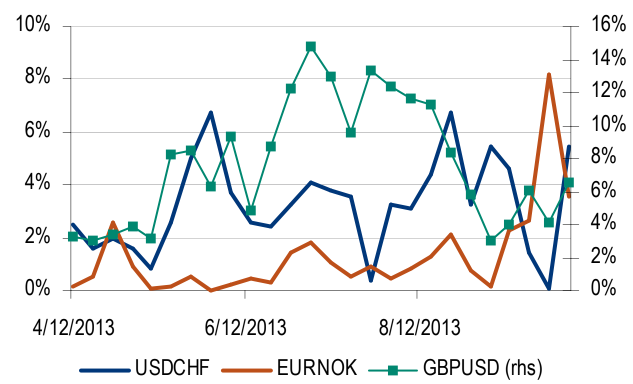
The most obvious limitation to this data is that it excludes trades between counterparties who are not subject to the reporting requirement. This would appear to result in a bias towards increased volume in USD calls, perhaps as a result of US investors hedging foreign denominated assets against USD strength. A secondary concern is that there is no differentiation between buying and selling interest, which leaves the intentions of the participants open to interpretation.

Chart 1: Put-call ratio in USDJPY correlated with spot changes



Source: BofA Merrill Lynch Global Research, DTCC
Call percentage is the volume of call options of maturity less than 1 month reported to the Swap Data Repository as a fraction of the total volume of options of maturity less than 1 month.

Chart 2: Spikes in volume may help to identify turning points



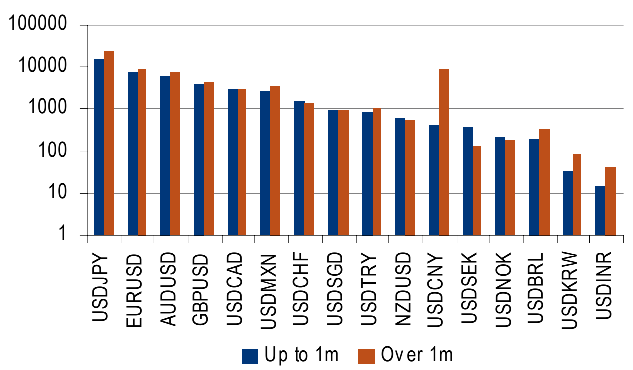
Source: BofA Merrill Lynch Global Research, DTCC
Chart shows the percentage of total option volume (among a set of 27 currency pairs) in maturities less than 1 month

What's hot and what's not?

Spikes in option volume may indicate turning points in trends, particularly if they signal capitulation. If the put-call ratio indicates that the activity was mostly hedging of positions then a temporary bounce is likely, but these positions remain at risk. The peak in GBPUSD option volume in July occurred with balanced demand for calls and puts, and this apex coincided with the low in spot. By contrast, the spike in USDCHF volume last week was mostly demand for puts, which, in our view, suggests that the rally this week is likely to reverse.

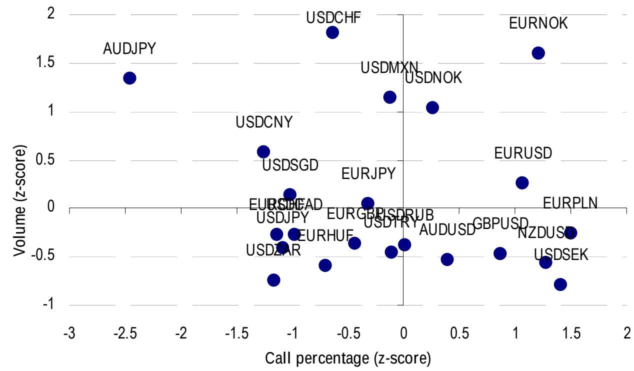
In EURNOK, the recent spike in volume was not on extreme demand for calls. The subsequent decline in volume and volatility suggests that this may well indicate a turn in trend. However, one caveat to all these observations is that for European currencies, the data may be missing a substantial portion of the actual trading. We reiterate that in our view, the best way to use this data is in conjunction with price-based measures to develop a more complete picture of the market.

Chart 3: Average weekly option volume in mmUSD



Source: BofA Merrill Lynch Global Research, DTCC

Chart 4: Relatively high volume in AUDJPY puts and EURNOK calls



Source: BofA Merrill Lynch Global Research, DTCC
Z-scores use 6 months of weekly data

How to survive a US default

During times of market turbulence, it is advisable to avoid positions with limited liquidity. While the swap data repositories are not a comprehensive indicator of option liquidity, the fact that market-moving events are likely to occur during US hours enhances the relevance of the information. Reporting only began in April 2013, but we can already learn some interesting facts about liquidity in options markets.

It is no surprise that USDJPY options have seen by far the greatest volume. Perhaps more surprising is that volumes in USDMXN have been equal in size to USDCAD, and both USDTRY and USDSGD have had significantly greater flow than NZUSD, USDSEK or USDNOK. There is also the curiosity that longer dated USDCNY options have been extremely popular this year.

The potential reaction of the market to a US default is very unpredictable, with the range of views being expressed varying from a repeat of the depression, to a virtual non-event. What we can say, however, is that based on historical volume averages, it would appear to be advisable to avoid being short USDBRL, USDKRW or USDINR options if you need liquidity during US hours. Indeed, there hasn't been a single USDINR option of maturity less than 1m reported since June.

Market implications

Given the apparent bias in directionality for reported option trades, we would favor using a z-score measure on the put-call ratio to indicate the relative demand for calls and puts. Combining with a z-score of option volume, we observe unusual volume of short dated AUDJPY puts over the past week. We would postulate that this was a result of the relative cheapness of AUDJPY to equity puts. Continued uncertainty is likely to steepen the AUDJPY volatility curve from the current relatively flat levels.

More notably, the last week has seen a sharp pick-up in activity in USDMXN options, with interest in both calls and puts. Our positioning indicators are flagging long USDMXN positioning as being stretched, so we would view this as a strong signal to sell USDMXN for a potential reversal of trend. Our EM strategy team remains positive on MXN and forecasts that USDMXN will trade at 12.50 by the end of the year.

Notable Rates and FX research

* USD weakness to remain – add to shorts, FX Quant Trader, 8 October 2013.

* Trading around US tail risks, Global Rates and FX Weekly, 4 October 2013.

* The "X" factor, US Rates Weekly, 4 October 2013.

* Can this be a different movie?, Liquid Cross Border Flows, 7 October 2013.

Key trade ideas

Existing open trades

FX:

Buy 5-week 1x2x1 USD/JPY put fly (96/93/90 strikes). Entry: 47bp, Spot reference: 97.45.
* Expectations for the UK economy are now very high, while China's economy is starting to temporarily base.

Buy 5-week CHF/NOK 1x2x1 put fly (6.40/6.25/6.10 strikes). Entry: 37bp, Spot reference: 6.4850.
* Improvement in global data should increase risk appetite, NOK looks cheap according to our quant models and monetary conditions point toward lower CHF/NOK.

Buy 6m 1.25 EUR/USD digital put, Entry: 14%, Spot reference: 1.3350, Current: 01.8%
* Higher US rates and higher US rates vol should be positive for the US dollar.

Buy 1y AUD/USD volatility and sell 1y USD/JPY volatility. Entry: -2.4%, Target: +3.0%, Stop: -5.0%, Current implied: -1.90%.
* Divergence in positioning outlooks and implications of tapering QE for currency volatility

Buy EUR/CHF, Entry: 1.2300, Target: 1.3300, Stop-loss: 1.1995, Current: 1.2298.
* Improvements in euro zone stability have reduced the requirement of CHF as a safe-haven - further haven unwinds should continue this year. We target 1.33, which is close to fair value for EUR/CHF

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Potential Risk at Expiry & Options Limited Duration Risk

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Macro

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