

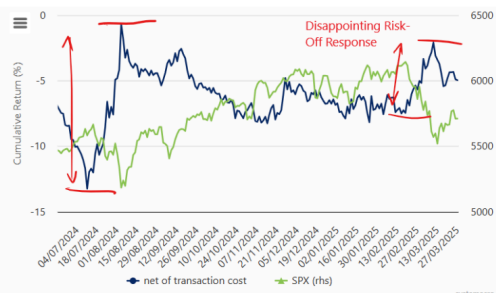
## Deep Dive – Risk-Off Correlations are Back in FX

2025-04-04

[\[https://www.systemacro.com/deep-dive-risk-off-correlations-are-back-in-fx/print/\]](https://www.systemacro.com/deep-dive-risk-off-correlations-are-back-in-fx/print/) After months of disappointing risk-off correlations in FX, the last 24 hours have seen a complete turnaround. It could be indicative that the real money community has finally reduced its overweight and FX unhedged exposure to US equities.

**Disappointing Risk-Off Correlations Until Yesterday.** Recently we discussed that risk off correlations in FX appeared to have broken down [\[fx-views-deleveraging-brakes-risk-off-logic-helps-valuation/\]](#). Despite a significant equity sell-off in recent months, traditionally negatively correlated FX crosses delivered very poor returns. One of the reasons was a change in positioning. Exposure to FX Carry had been significantly reduced since last year's sharp sell-off. And in fact, positioning was the other way round, with the IMM data showing very large long JPY exposure and significant short NZD risk, for example. Risk reversals confirmed this market reading. When equity markets sold off, we did not get the typical unwinding of FX carry positions. And those who were long the JPY, for example, were happy to hold on to their exposure. The left chart below illustrates how poorly our systematic SYMAP-Crisis portfolio [\[portfolio-overview/10002/\]](#) initially performed since the start of the sell-off in February (this chart had already been published in the **FX Views** [\[fx-views-deleveraging-brakes-risk-off-logic-helps-valuation/\]](#) referenced above).

SYMAP-Crisis:  
Cumulative Return (2025-03-27)



[\[https://www.systemacro.com/wp-content/uploads/2025/03/Disappointing-Risk-Off-response.png\]](https://www.systemacro.com/wp-content/uploads/2025/03/Disappointing-Risk-Off-response.png)

SYMAP-Crisis:  
Cumulative Return (2025-04-04)



[\[https://www.systemacro.com/wp-content/uploads/2025/04/Sympa-crisis-after-the-tariffs.png\]](https://www.systemacro.com/wp-content/uploads/2025/04/Sympa-crisis-after-the-tariffs.png)

**Risk-Off Correlation is Back.** In the last 24 hours, FX market correlations completely changed and the traditional risk off correlations have come back. The SYMAP-Crisis portfolio gained about 5% in a day, more than during the previous weeks of the sell-off (see right chart above). Traditional pro-cyclical currencies, which initially gained after the tariff announcement have gone into sharp reversal. Since midnight (GMT), AUD/USD has lost some 4.6% while the equity sell-off continued. The same pattern is visible across all other traditional pro-cyclical G10 currencies: SEK, NOK, NZD and CAD. What has changed?

**Have Pension Funds Liquidated their US Overweight?** We think one of the key drivers of this change may be the fact that large pension funds and insurance companies in these countries have finally liquidated their FX unhedged US overweight position. All these countries mentioned in the previous paragraph have large pension and insurance funds with significant overseas equity exposure. A significant part of this tends to be FX hedged, mainly for regulatory reasons, though with some scope to adjust the hedge ratio. At the turn of the year, as **annual reports** [\[https://www.ap1.se/en/news-and-publications/financial-reports/\]](https://www.ap1.se/en/news-and-publications/financial-reports/) and **official statistics** [\[https://nationalbanken.statistikbank.dk/statbank5a/default.asp?w=15367&w=15367\]](https://nationalbanken.statistikbank.dk/statbank5a/default.asp?w=15367&w=15367) suggest, many of these institutions likely had an overweight exposure in US equities with a lower FX hedge ratio than normal. They were effectively overweight "US exceptionalism" in line with market consensus. To give an idea of how extreme this view was, we can look at the monthly

ZEW survey from late November 2024 [\[https://ftp.zew.de/pub/zew-docs/frep/112024.pdf\]](https://ftp.zew.de/pub/zew-docs/frep/112024.pdf). In this report the balance of US equity market bulls minus bears was +53, with Dollar bulls outnumbering Dollar bears by +49.

**Selling unhedged US equities.** When Trump's erratic policy announcements started to weigh on market sentiment, these pension funds likely started to liquidate some of their overweight position. Evidence from the ZEW survey supports the view that institutional investors in Europe became significantly less bullish on the USD (latest **ZEW reading** [\[https://ftp.zew.de/pub/zew-docs/frep/032025.pdf\]](https://ftp.zew.de/pub/zew-docs/frep/032025.pdf) from March stands at -17.2) and on US equities (-13.8). However, being FX unhedged, selling of US equity likely also involved selling of Dollars and buying of local currency. We discussed this in a recent **FX Views** [\[fx-views-deleveraging-brakes-risk-off-logic-helps-valuation/\]](#).

**Back at Allocation and Hedge Ratio Target.** In addition to the outright selling, falling index levels and underperformance of US equities likely helped the US equity allocations getting closer to target. At the same time the hedge ratio mechanically increased, simply because the existing FX forward book covered an increasingly large portion of the declining US equity book. On average across the industry, we think the relevant benchmark allocation may have been reached only very recently, maybe even as a result of the initial post-tariff sell-off.

**Back to "normal" risk-off correlations.** Having reached the allocation and FX hedge ratio targets, the impact on FX markets flips. In this well-known mechanism, asset managers have to reduce their FX overlay when the value of the underlying asset declines. This is also called "over-hedged" and requires the liquidation of USD-selling forward contracts. In other words, the faster the underlying equity markets decline the more the asset managers in Sweden, Norway, Australia and Canada have to buy USD to align their FX overlay. It also means that they have to sell USD again and buy their own currencies when US equity markets rebound. We described this in some detail for Norway [\[fx-views-tariffs-has-anything-happened/\]](#) [\[https://www.systemacro.com/wp-content/uploads/2025/04/CHF-NOK.png\]](https://www.systemacro.com/wp-content/uploads/2025/04/CHF-NOK.png) before. Even Norges Bank has written a paper [\[https://www.norges-bank.no/bankplassen/arkiv/2024/fx-transactions-driven-by-institutionally-managed-savings-and-risk-management/\]](https://www.norges-bank.no/bankplassen/arkiv/2024/fx-transactions-driven-by-institutionally-managed-savings-and-risk-management/) on this mechanic. It is one of the key drivers of the pro-cyclical correlations of these currencies.

**Look at CHF/NOK!** We had highlighted this specific cross in late February [\[fx-views-tariffs-has-anything-happened/\]](#) as one of the most negatively correlated with equities – only to see the correlation disappear during the aforementioned asset allocation shift. But this case too, the correlation has come back with a vengeance. In just one trading session over the last 24 hours, the cross has rallied by more than 4%, recovering all the losses of the last two months when the correlation had become unusually positive with SPX.

**Real money may no longer be overweight US equities.** For investors interested in the outlook for US equities, one important corollary from this changing FX correlation is that US equity allocations are now likely close to benchmark for some of the bigger pension funds globally. This does not necessarily mean that the sell-off will stop anytime soon as there are many reasons why investors may want to reduce their exposure more. Still, the period of excessively high and FX unhedged exposure to "US exceptionalism" appears to be over – at least when judged by FX correlations.

Prepared for James HASSETT, © 2015-2025 SYSTEMACRO Research

S CHF/NOK long



### CURRENCIES & SUBJECTS

USD EUR JPY GBP TRY MXN CHF AUD CAD NZD NOK SEK ZAR CNH BRL HUF INR G10 PLN CLP KRW TWD

Business Cycle Interest Rates Quant Carry Inflation BREXIT Risk Management Fiscal Policy BoP Mean Reversion Global Macro Fair Value Correlation Cruncher SYMAP Update Momentum FX Hedging Politics EM Hurst Volatility Equities Commodities Positioning FX Reserves Demographics

# Active Systematic Crisis Mean Reversion Momentum FX Trade Ideas

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