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Testing new strategies to cope with changing market conditions

EMERGING FEARS
SLJ Partners' Stephen Jen explains his emerging market fears

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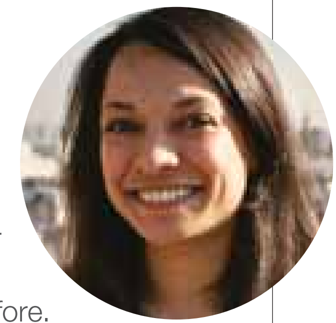


EDITOR'S LETTER: EMERGING CHALLENGES

With little resolved in 2012, a growing number of currency managers expect cracks in the emerging market credit cycle to come to the fore.

Already in the past year, some of the most profitable trades have been those that short EM currencies such as the Brazilian real and South African rand. Similarly, the Indian rupee has disappointed EM bulls by failing to implement the right policies as expected.

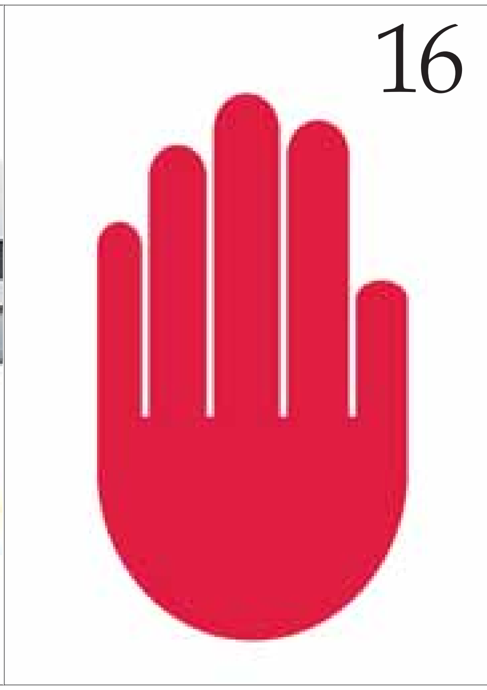
Stephen Jens, co-portfolio manager at SLJ Macro Partners in London, says all the focus on GDP has taken away from the very real dependence emerging markets continue to have on the US growth cycle – with a mismatch in local currency financial assets. In *A reality check for emerging markets* (see pages 34–35), Jens claims that with the continuation of what began as the US financial crisis likely to spill over into emerging markets, the winners and losers in fund management are also set to change.

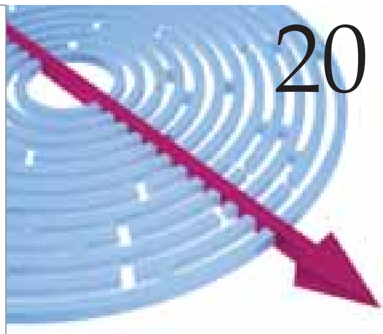
But as well as a shake-up in broader market risks, there is also the challenge of operating within a new market structure. In *Taking HFT to task* (see pages 16–18), we investigate whether high-frequency traders are wrongly being accused of disruptive behaviour, and whether they aren't also required to commit pricing during times of stress, as banks claim.

And in our cover story for this edition, we look at the on-going need to have a holistic view on exposures for effective risk management. In *Integrate to accumulate* (see pages 12–14) we review the different strategies being employed by corporate treasurers to combine cash management and foreign exchange to increase operational efficiencies.

SAIMA FAROOQI, EDITOR

INSIDE





Irish Central Bank says derivatives regulation designed to kill over-the-counter market

> "We are trying to push OTC to futures as much as we can"
> **GIUSEPPE INSALACO, CENTRAL BANK OF IRELAND**

Rule-makers have developed new derivatives regulation with the intention of killing off the over-the-counter derivatives market in its current form, according to Giuseppe Insalaco, senior adviser on clearing and settlement regulation at the Central Bank of Ireland.

Speaking during a panel discussion at an industry event in London in November, Insalaco was asked whether the reforms had been designed specifically to kill off the OTC market. "Isn't that obvious?" replied Insalaco. "We are trying to push OTC to futures as much as we can. The signs are all there. It is not a secret."

Other regulators have been less open about this aim but Insalaco said the absence of central counterparties (CCPs) in Ireland meant he could be more forthcoming.

"This is the good thing about having a regulator that doesn't have a domestic CCP or domestic clearing members. Therefore, we don't have to defend any domestic vested interests. If you look at what regulators are trying to do, then clearly if it is not completely kill it, it is definitely to reduce it to where it is absolutely essential."

The new rules include the European Market Infrastructure Regulation, which will require standardised OTC derivatives contracts to clear through CCPs, and Basel III, which, among other things, introduces a new credit valuation adjustment capital charge. Taken together the regulations will increase the cost of trading derivatives significantly, say participants.

Many derivatives users are looking to adapt their businesses to meet the new rules. But Insalaco says this misses the point.

"What regulators are bringing about is something akin to a new ice age. London will be under a new ice sheet and there will be mammoths in France but people are trying to figure out how to protect their rose beds from frost. This is not the point. The point is we want to change how things are done because the way they were done before is clearly wrong."

Other panellists claimed they had received slightly different messages from other regulators, which prompted speakers to complain about the lack of a joined-up approach from supervisory authorities.

"We have intergovernmental squabbling and intra-governmental squabbling, so we have part of the teams in the regulatory unit saying we need to clamp down on things and hoard liquidity, and the other half saying we need to expand money supply and increase growth," said John Wilson, an industry analyst in London.

"Consequently, we have chaos. It is so complicated that I'm not sure the architects of policy have a clear view of what they are trying to implement, or if they do they're not really good at writing it down to achieve the desired objectives."

Michael Watt

MAS moves to bolster payments supervision

The Monetary Authority of Singapore (MAS) is seeking to strengthen its role as supervisor of the most important payment systems in the country with new legislation introduced into parliament on November 12.

Singapore's Payment Systems (Oversight) Act (PSOA), originally enacted in 2006, outlines the responsibilities of operators or settlement institutions of 'designated payment systems' – those viewed to be important to financial stability or public confidence – to the MAS.

The Bill seeks to amend the Act in three ways, and introduces provisions that "enhance MAS' oversight" and "aligns it with international standards".

First, the central bank wants to reconcile its role as supervisor and as the operator of the MEPS+ (MAS Electronic Payment System), by granting itself exemption from two sections of the PSOA that otherwise give the MAS power to impose conditions and restrictions on an operator or settlement institution.

"It would not be practical for MAS to take action and impose legal penalties on itself for any non-compliance," said an explanatory brief published by the MAS. Under the exemptions, the MAS would no longer be obliged to appoint an auditor nor to submit periodic reports.

A second amendment dictates that any reports conducted into an operator or settlement institution must be kept confidential, unless disclosure is in the duties of the officer/auditor, or if written permission from the MAS is obtained. The amendment lays out the scope of the punishment for violation: three years' imprisonment or a $102,200 fine for an individual, or a fine of $204,400 in any other case.

Finally, the Bill would enable the MAS to move directly and faster in an emergency. Currently, the central bank must first submit a letter to "direct" the troubled operator or settlement institution to act in a manner it deems appropriate. If this direction is ignored, the MAS may then intervene further through, in some cases, assuming control of the operator or settlement institution, or ordering it to cease operations altogether. This amendment will enable the MAS to bypass the letter and take more direct action as soon as it deems fit.

The Bill was submitted for its first reading on May 12, and will undergo a second at the next available parliamentary sitting.

Christopher Jeffery

> *People throw their hands up and say 'we don't need this, we are sophisticated investors who do a fair amount of our own due diligence and request increasing amounts of transparency from the fund and the fund manager* **JULIAN YOUNG, ERNST & YOUNG**

Regulation fatigue hits hedge funds as institutional investors fail to see how new laws will benefit them

Increasing numbers of institutional investors fail to see how hedge fund regulations will benefit them or protect their interests, according to research by Ernst & Young.

Eighty-six percent of investors think current regulations will not prevent the next crisis, according to the Global Hedge Fund and Investor Survey 2012.

Only 10% of investors think regulations will protect their interests while 49% say they will be ineffective in this respect.

This is a marked shift from 2010, when 41% of investors thought the regulations would be effective at protecting their interests. Just 21% thought they would be ineffective and 38% were neutral.

Julian Young, a partner and head of hedge funds for Europe, Middle East, India and Africa at Ernst & Young says there is a view that retail-style regulation is being applied to a wholesale industry. He cites the EU alternative investment fund managers (AIFM) directive as unnecessary and intrusive.

"People throw their hands up and say 'we don't need this, we are sophisticated investors who do a fair amount of our own due diligence and request increasing amounts of transparency from the fund and the fund manager. If we don't like what we see, we can vote with our feet'," states Young.

There is regulation fatigue among managers and investors, according to Young. They are sceptical that the regulations will benefit them while pointing to the substantial cost to meeting regulatory requirements.

On costs, 68% of managers want to pass regulatory registration and compliance costs on to the funds they manage. In contrast, 46% of investors think those costs should be covered by management fees.

For marketing expenses (82%), trader compensation (78%) and costs of shadow accounting/processing (80%), most investors think the costs should not be passed onto the fund. Only a few managers pass these costs on to the fund, with the percentages shrinking since last year's survey.

The survey also shows differing opinions between hedge fund managers and investors when it comes to compensation structures. When asked how well the company's compensation scheme aligns risk and performance of individual managers and traders with investors' objectives, 87% of hedge funds responded 'very well'. Only 42% of investors responded 'very well' when asked the same question about hedge funds, with 44% neutral.

"Investors would like to see more [compensation] set aside as equity in the fund or equity in the overarching partnership, and for that to have some sort of timeframe around it so that it's not immediately withdrawable," says Young. "Going even further, in an extreme situation where there has been a high degree of performance in one year and then subsequent underperformance, that it can be clawed back."

Currently, 74% of senior executives' annual compensation is paid as cash. Investors think only 38% should be paid this way. Young says nearly a third of investors think 20% or more of assets in a hedge fund should be owned by its management and other employees. Only 9% of hedge funds said they own that much of a fund. Most (37%) own anything up to 5%, a level only 9% of investors thought was reasonable.

Despite increased institutional allocations to hedge funds, Young says serious investment will not happen until performance improves. "Among big investment committees, there is a fear that alternative investment managers carry greater risk and they are expensive. In order to address that, you need to demonstrate on a risk-adjusted basis 'shoot the lights out' returns to justify the investment," says Young.

"Over the past five years, with some notable exceptions, the returns have been fairly ordinary on a risk-adjusted basis, which doesn't make the investment compelling," he adds. Only 20% of investors say they plan to increase their allocation to hedge funds in the next three years, with 67% planning no change.

Throughout the survey, there is a theme of businesses facing significant compression on margins. "Because of the regulation and because of the cost of trying to win business, the sector is less profitable than it was in the past. Managers now need at least $1 billion in order to have the right scale to make efficiency savings," Young says.

One of the biggest developments in the coming 24 months will be consolidation, says Young. This view is shared by 43% of hedge funds who say it will be the biggest development over the next couple of years.

Young believes this will manifest itself as talented people congregating around a few successful funds. "Looking at the industry, there is a large number of constituents serving a small pool of investable assets," states Young. "It makes sense for there to be fewer firms in the industry. I think the way that is achieved is by less successful firms deciding not to continue and the more successful attracting more than their fair share of the emerging talent."

Only 28% of investors believe this would be a trend.

Young also agrees with the 39% of managers who thought increased regulatory/compliance oversight and costs would continue to be a theme. However, he disagreed with the 28% of investors who thought there would be downward pressure on fees, saying that was "wishful thinking".

Clare Dickinson

StanChart launches renminbi index

Standard Chartered has become the latest bank to launch an index to track the performance of the offshore renminbi market, with the introduction of the Renminbi Globalisation Index (RGI).

RGI is a monthly index that tracks the progress of renminbi-based performance globally, initially covering three markets that dominate the offshore RMB business: Hong Kong, London and Singapore. It measures business growth in four key areas: deposits, dim sum bonds and certificate of deposits, trade settlement and other international payments and foreign exchange. Weight of each of the four parameters is inversely proportional to their respective variances.

As RMB internationalises, there is capacity to include additional parameters and markets, aligning the index with future development, the bank said.

The index works by sourcing data from several industry and official sources and leading providers of market data with data dating back to December 2010. The bank said that was the point from which sufficient meaningful information became available to produce a reliable measure.

The RGI shows that between December 2010 and September 2012 the internationalisation of the RMB saw a seven-fold increase. All four parameters and the emergence of new markets contributed to the impressive growth, with trade settlement and other international payments being the key driving force behind the increase, the bank said.

The index shows Hong Kong dominates the offshore RMB business, with a four-fifths share, while Singapore and London are emerging as the upcoming centres, each taking up a tenth of the market. Taipei and New York are expected to join this club in the coming years, the bank said.

In March, HSBC debuted its first offshore renminbi bond index, known as the CNH index, to act as a benchmark for yuan-denominated and yuan-settled bonds in the international market. The index tracks total returns of yuan-denominated and yuan-settled bonds issued outside of China.

Meanwhile, in July 2011, Deutsche Bank launched the first investable benchmark index for offshore renminbi (CNH) bonds, allowing sizeable passive fund flows to enter the market for the first time. Known as the Deutsche Bank Offshore Renminbi Bond Index Tracker (DB Orbit), the rules-based index is publicly quoted on Bloomberg.

Benjamin Hung, chief executive at Standard Chartered (Hong Kong) said: "With the growing global relevance of the Chinese currency, we expect to see more offshore RMB centres developing in different regions, complementing each other to support the exciting growth of RMB activities around the world. Hong Kong will continue to play a nexus role in the internationalisation of RMB, and stand to benefit from its strategic position as China's window to the world."

Saima Farooqi

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Banks suspend dual-currency deposits in Japan

Banks in Japan have stopped offering dual-currency deposit products, in the wake of a ruling from the Financial Services Agency (FSA) that leaves premium generated by the instruments outside the country's deposit protection scheme. The ruling initially caused confusion among dealers, with some believing the deposit principal would also not be insured. That could have threatened the future of a market dealers say has an outstanding notional size of anything from $5 billion to $10 billion.

"If I'm a retail investor in Japan who wants to put some money in a structured deposit, then why would I use one that doesn't get a deposit guarantee when I could use one that does? Banks now have to re-document and make it very clear these deposits are not insured, but the business might never start up again," said one London-based foreign exchange trader in the days after the mid-October announcement from the FSA.

The industry has since taken a closer look at the rules, and those worries have faded. The head of forex options at one large international bank says it is just the yield that is uninsured, and believes demand should resume once the deposits reopen for business. "Some customers may be put off by dual-currency deposits now only the principal is protected. However, I'm not sure this will have a massive impact on the market for this product in Japan," he says.

It has already had a big impact in the short term, however, forcing banks to shut the business down as they take stock. On October 22, for example, Citi's Japanese business told customers it was temporarily suspending its dual-currency deposit product – Premium Deposits – from 3am on October 24, "to review its product nature".

That is shorthand for a re-documentation exercise, says the international bank's forex options head. "Banks in Japan will want to pause for a while so they can update the term sheet of the contract with their customers to reflect this change," he says. The ruling affects not just Japanese banks that offer the product, but international banks that make it available from their Tokyo branches.

Dual-currency deposits involve a customer selling a short-dated forex option on top of a basic money-market account, allowing retail clients to deposit in one currency and take a view on the exchange rate with another. At maturity, the customer is paid in the weaker of the two currencies, but earns a higher interest rate during the life of the product. These small-ticket options trades can still amount to a big daily flow for some dealers – hundreds of millions of dollars in notional, says the London-based forex trader.

Michael Watt

Aima appoints Casey to replace Groome

The Alternative Investment Management Association (Aima), the global hedge fund industry association, has appointed Kathleen Casey (right) as a new non-executive chairman. Casey, whose appointment will last for two years, replaces Todd Groome following the expiry of his term.

Casey will lead the new Aima council, on which she will be joined by: Olwyn Alexander, partner at PricewaterhouseCoopers; Mark O'Sullivan, partner at Ernst & Young; Phil Schmitt, president of Summerwood Capital; and Henry Smith, global managing partner at Maples and Calder. Six other council members continue their directorships at Aima, while five directors are stepping down.

Prior to taking the chairman's role, Casey was a Republican commissioner of the US Securities and Exchange Commission (SEC), having been appointed by president George Bush in 2006. Throughout her tenure, she acted as the SEC's principal representative in various international regulatory dialogues and forums, including the International Organization of Securities Commissions and the Financial Stability Board. In that role, she also served as chair of the Iosco technical committee and led various international regulatory workstreams.

Prior to being appointed commissioner, Casey spent 13 years on Capitol Hill, most recently as staff director and counsel of the US Senate Banking, Housing and Urban Affairs Committee.

Gottex opens first US office

Gottex Brokers has opened its first office in the US, focusing on brokerage services in the secondary market for alternative investments through its specialised entity Gottex Brokers Alternative USA.

The LA-based entity will be an intermediary between US institutional investors buying and selling secondary interests in hedge, private equity and real estate funds. Bruno Bardavid will run GBA USA. He previously developed the credit trading markets for Mizuho International and West LB, London.

Rosborough joins Reserve Bank of New Zealand

Lauren Rosborough, forex strategist at Société Générale has relocated to New Zealand to work for the Reserve Bank of New Zealand as senior adviser in the financial markets department. Rosborough joined the French bank in London in January this year, having previously worked at Westpac, where she was a senior currency strategist.

Brevan Howard partner departs

Klaus Oestergaard, a partner at London-based hedge fund manager Brevan Howard, has left the firm.

Oestergaard joined in 2004 as a fixed-income portfolio manager, and was promoted to partner in 2007.

Prior to joining Brevan Howard, he worked with the firm's founder Alan Howard on the proprietary trading desk at Credit Suisse. Oestergaard's plans are not yet known.

Meanwhile, execution trader Philip Valori and trade analyst Ben Bristow have also left Brevan Howard. Bristow had been with the firm since 2003, according to information held by the Financial Services Authority. Their plans are not known.

The departures come several months after it emerged that one of Brevan Howard's founding partners, Chris Rokos, would also leave the fund.

Brevan Howard declined to comment.

BoE shakes up management structure ahead of new role

The Bank of England has created a new management position, in anticipation of the increased workload for the governor and deputy governors as they take on new prudential regulation responsibilities in the coming year.

The new chief operating officer will work alongside the deputy governors, assuming responsibility for the day-to-day management of the Bank of England's operations, including oversight of finance, human resources and IT functions. "This will allow the governor and deputy governors more time to focus on their policy responsibilities," the central bank said in a statement.

The chief operating officer will be appointed in 2013, after a successor has been chosen for governor Mervyn King, whose second term is due to end in June next year. The decision will be made in "close consultation" with the prospective governor, the Bank of England said. Executive search company Odgers Berndtson has been selected to conduct the first phase of recruitment.

Other changes are also taking place among the Bank of England's directors. Warwick Jones said on October 22 he will retire as finance director at the end of June 2013, the same date King will leave the central bank. "It has been a fascinating and rewarding experience working at the Bank, if a little more exciting than I anticipated when I joined in 2006," Jones said. "I have enjoyed the support of exceptionally talented colleagues, and I now look forward to spending more time at the Oval [cricket ground] and, of course, with my family."

The chief operating officer, once chosen, will lead the search for Jones' replacement. The Bank of England declined to elaborate on the timescale for either appointment.

BNY Mellon extends Lewin's leadership

BNY Mellon has named Marina Lewin as head of sales for its asset servicing business in the Americas. Lewin is based in New York and manages teams in several US cities as well as in Dublin, London and Hong Kong. She reports to Samir Pandiri, chief executive of Americas asset servicing and alternative investment services.

Lewin will continue to lead global sales for BNY Mellon's alternative investment services (AIS) group. BNY Mellon brought together its two investment services businesses – global custody and hedge fund administration – earlier this year.

Hong Kong insurers hedge out their US dollar exposure

Insurers in Hong Kong are revising their long-term policy of not hedging out their US dollar exposures

A combination of fear of a de-peg between the Hong Kong and US dollar and favourable levels in the forward market has encouraged insurers in Hong Kong to hedge out more of their dollar currency risk.

Hong Kong insurers have historically either been unhedged or just hedged a smaller proportion of their foreign currency bond investments due to the Hong Kong dollar's peg to the US dollar, which insulates insurers from the effects of currency fluctuations.

"In the past, it was not worth hedging due to the peg, and any yield pick-up achieved from buying foreign assets like dollar bonds was wiped out by the forward rate being at a discount," says Kenneth Lau, trader at Standard Chartered in Hong Kong.

There is also an additional incentive for insurers insulating themselves against a de-peg between the Hong Kong and US dollar. Hong Kong authorities have committed to maintaining a peg between HK$7.75 and HK$7.85 since 1983. However, at the end of October the Hong Kong Monetary Authority (HKMA) was forced to intervene by flooding the market with dollars to defend the peg, as the Hong Kong currency touched the upper levels of 7.75. This saw the HKMA inject a total of HK$14.4 billion into the market on October 20 and on the morning of October 24.

With the currency testing the upper limits, it is a nervous time for insurers, which have significant amounts of US dollar debt backing their portoflios of Hong Kong dollar-denominated liabilities. This would leave them with a massive asset-liability mismatch in the case of a de-peg.

"It is a good time to hedge the dollar currency risk given that the cost has reduced and is nearly free"
Will Chen, ING

"Events earlier this week reaffirmed the good rationale behind having a strong hedge in place," says Will Chen, chief investment officer for Hong Kong life insurance at ING.

Helpfully for insurers, now is a good time to hedge, as for most of this year the discount for doing so has turned into a premium, meaning insurers can hedge their currency risk at no cost. The five-year Hong Kong dollar forwards reached a high of 4.5 basis points in June this year.

According to Lau, the curve has changed because of new market dynamics. "In the past, corporate borrowers could easily borrow from banks and would issue in the HKD bond market, but because investors have reached concentration limits for these names in their books, blue chip companies have increasingly issued US dollar bonds and Singapore dollar bonds. As they swap the proceeds back into HKD, the discount has turned into a premium, providing an opportunity for insurers to hedge their risk for little or no cost."

Chen at ING agrees that conditions have become favourable to put on such a hedge. "It is a good time to hedge the dollar currency risk given that the cost has reduced and is nearly free. For medium to long term investors, the five-year tenor makes sense and there were several opportunities to get paid for putting on the hedge earlier this year."

He adds: "Previously, hedging dollar assets back into Hong Kong dollars using currency forwards at the five-year tenor would cost 20–30 basis points per annum (reducing income). This year, the same hedge could be entered into at breakeven or slightly better (getting paid)."

According to Peter von Richthofen, director of structuring and client solutions at Bank of America Merrill Lynch in Hong Kong, while many insurers risk putting on rolling short-term hedges, some insurers have seized the opportunity to term out hedging at five years – something that also protects against a de-pegging event.

"If you are rolling six- or 12-month forwards as your hedging programme, you are hedged on paper but in an actual HKD de-pegging event you don't know what happens to your roll cost at the point of de-pegging," he says.

"In 1992, when sterling exited the exchange rate mechanism, the cost of the 12-month sterling forward fluctuated between –1,300 and –300 forward points, so the timing of the roll date would have had a big impact on the hedging cost. Nobody knows what would happen in an equivalent situation for the HKD but it is conceivable that a rolling hedge will become less effective just ahead of a de-pegging event."

Viren Vaghela

INTEGRATE TO ACCUMULATE

Increased volatility, lower availability of credit and emerging market expansion is accelerating the integration of cash management and FX, says **Laurence Neville**

For corporates, the post-crisis era has been a period of adaptation to new challenges, such as increased currency volatility and lower availability of credit from banks. It has also been about exploiting new opportunities, such as the growing importance of emerging markets to the global economy. All three trends have accelerated the integration of cash management and FX, which until just a few years ago were clearly distinct for many companies.

The tighter credit environment – initially a direct result of the financial crisis and more recently a reaction to regulatory efforts to raise banks' capital adequacy – has prompted companies to focus ever-more forensically on cash management. By improving efficiency and lowering costs related to payments and collections, internally generated cash can be used instead of scarce borrowed capital.

"The use of multi-currency notional pools allows companies to make use of their funds in a single currency without performing any FX trades**"**
Lee Swee Siong, Standard Chartered

Meanwhile, the roller-coaster economic ride of the past five years has resulted in higher FX volatility, which has shone a spotlight on the need to manage FX-related risk. The increasing volumes of business done in emerging markets – by multinationals and rapidly growing emerging markets firms – has further emphasised the need for FX risk management, given the greater volatility of emerging market currencies.

"Many companies are growing fastest in emerging markets and, as a consequence, have greater FX exposure than in the past and can find themselves with multiple currency accounts that are difficult to manage, can have expensive overheads, and create risk management challenges," says Steve Everett, global head of cash management at Royal Bank of Scotland in London. "By thinking about cash management and FX in an integrated way, those challenges can be overcome."

FX risk and cash management

When a company makes a payment or receives a collection in a currency other than its home currency it necessarily faces FX risk. How that FX risk is addressed should be determined by circumstances and the needs of the company, says Eric Mueller, head of global network banking and cash management, corporates, global transaction banking at Deutsche Bank in Frankfurt. "Corporates' most important choice is whether to open a local currency account or to convert currencies as necessary," he adds.

Having a local currency account only makes sense if there is sufficient transaction volume to justify it, notes Mueller.

"Multinationals may receive collections in as many as 80 currencies, but the vast majority of those will have low values and volumes," he adds. "The costs of operating such accounts – and the risk management challenges they create – mean they are unlikely to be advantageous for a company."

As a result, the majority of corporates instead choose to trade FX when a payment is required or a collection received. "Usually, companies will have a standing instruction with their banking partner to trade when balances reach a pre-set level," says Mueller. "However, the trade itself is usually completed manually, either via the telephone or online. As a consequence, it can be cumbersome and may lack transparency."

Lee Swee Siong, global head of global corporate products at Standard Chartered in Singapore, agrees that such manual management of FX is highly inefficient – particularly for companies dealing with bulk payments. He says that in response, larger corporates have moved towards embedded FX with pre-negotiated rates based on a set spread over a reference price or fix (which can be tiered to reward transaction volume) in recent years.

While automating FX conversion into payments and collections can be advantageous in terms of margin savings, Lee says most companies are primarily motivated by the overall processing and cost efficiency that can be gained as well as the rate transparency benefits of such a solution. "In any FX transaction, transparency in relation to FX rates is critical," adds Everett at RBS.

The next step

With payment and collections increasingly integrated with automated FX conversion at many corporates, larger multinationals have looked for additional ways to improve FX risk management related to cash management processes. "As companies build up their shared service centres and payment factories, there is more they can do on the FX front, such as multi-lateral inter-company netting and multi-currency notional pooling – FX efficiency has become a more important issue as a result," says Lee at Standard Chartered.

The use of a netting centre can reduce the need for multiple cross-border payments between multiple entities, which can produce huge transaction and FX cost savings, according to Lee. "The use of multi-currency notional pools allows companies to make use of their funds in a single currency without performing any FX trades," he explains. "It's a very powerful tool, according the treasurer much greater flexibility in utilising their multiple currency positions optimally."

Everett at RBS agrees that the most sophisticated multinationals now have treasuries that manage both cash balances and FX risk in an integrated way on a day-to-day basis. "Most frequently, they net between all their global subsidiaries to arrive at a single position in each currency at the end of the day," he says. "They are then in a position to make an informed decision about whether to hedge those positions or run them based on an assessment of their forthcoming needs. For example, they may choose to open renminbi accounts because they expect their suppliers to increasingly want to be paid in renminbi."

Patrick Coleman, regional general manager, Central Europe, Middle East & Africa at treasury management systems vendor IT2 Treasury Solutions in London says "more businesses are seizing the advantages of a centralised treasury model that integrates cash and FX exposure management". He adds: "Central forecast reporting, netting, pooling, in-house banking and a payments factory make costs and external risk much more visible and manageable. A centralised model overall reduces both group-wide demand for costly FX transactions, and the need for worldwide subsidiaries to take on external debt and banking relationships."

However, Greg Edwards, head of FX e-commerce sales Europe at Deutsche Bank in London, says effective cash management-related FX risk management does not necessarily require companies to have a centralised treasury structure. "Provided treasury policy (detailing processes and the choice of FX provider above a certain threshold, for example) is set centrally, the same visibility and risk management benefits can be achieved even if FX is transacted at local subsidiary level – margins [can be] standardised across a given region or even globally," he says.

Indeed, companies can continue to use local banks – and maintain local relationships and access to funding as a result – for FX transactions below a set threshold, notes Edwards. "However, by ensuring that FX trading (beyond that threshold) and hedging is managed centrally, local businesses can be freed up to focus on operations," he adds. "Meanwhile, technology can allow the global treasury to monitor local transactions and exposures for effective risk management."

Regardless of the extent of centralisation at a company, it is essential for companies to understand the inter-connectedness of a broad range of cash management functions and FX. "Today's technology solutions reflect the natural connections between FX and cash management workflows," says Coleman. "As examples, FX transaction settlements crystallise as receipt and payment cashflows in the component currencies; multi-currency bank account balances are potentially significant components of an organisation's FX exposure; future value FX settlements are essential components of cashflow forecasts. All these are compelling reasons that justify close levels of integration, leading to higher overall levels of control and risk visibility, including counterparty exposure management."

> "By ensuring FX trading and hedging is managed centrally, local businesses can be freed up to focus on operations"
> **Greg Edwards, Deutsche Bank**

RECONSIDERING BANKS' CAPABILITIES

The role of the treasury within companies has been considerably enhanced since 2008. "Treasury has become more visible and accountable for the organisation's management of risk," says Patrick Coleman, regional general manager, Central Europe, Middle East & Africa at IT2 Treasury Solutions.

"Over and above managing treasury transactions accurately and effectively, treasurers are focused on generating timely risk analysis and reporting. Critical questions may need to be answered at any time: Does the organisation have enough cash to finance its commercial operations? What is its future funding position? Is it properly hedged against FX, interest rate and commodity exposures?"

This wider role and the increasing sophistication of cash management-related FX risk management – as companies move towards inter-company netting, for example – means companies may need to re-think which providers best meet their needs. Excellence in cash management is no longer enough – a bank must also offer a formidable foreign exchange operation.

The consensus is that companies' increasingly ambitious FX-related goals elevate the importance of banks' currency coverage – particularly of exotics. "There are banks in the cash management market that are limited to G-10 currencies," notes Lee Swee Siong, global head of global corporate products at Standard Chartered. "While banks can overcome that by relying on another bank for FX contracts and settlement, corporates need to be mindful that cost and cut-off time may not be as competitive as banks with direct access and presence in these markets."

Steve Everett, global head of cash management at RBS, agrees the companies need to focus on the range of currencies their bank offers, and adds that companies need to consider how other aspects of their bank's business may benefit them. "Because we work with financial institutions as well as corporates, our trade flow is sizeable, which has benefits for all clients in terms of liquidity," he notes.

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TAKING HFT TO TASK

As a small group of high-frequency traders (HFTs) rise to prominence as market-makers in spot FX, the reliability of their prices during times of market stress has been called into question – so much so that electronic trading platforms are taking steps to maintain market integrity. **Joti Mangat** reports

When New York-based broker FXCM acquired London-based proprietary trading group Lucid Markets in June, the firms' regulatory filings lifted the lid on Lucid's market presence, with an average daily trading volume of $35 billion and a total volume of $13.4 trillion for 2011.

Taken in the context of the $100 billion average daily turnover on multi-dealer trading platform EBS, and a total annual market turnover of around $208 trillion according to the *Euromoney* 2012 FX Poll, Lucid's disclosure highlights the essential role non-traditional market makers now play in providing liquidity to FX markets.

Indeed, fuelled by heavy investment in risk management and high-speed trading technology over the past decade, proprietary trading firms such as GSA, Allston Trading, Citadel, Getco, Gelber Group, Penson Worldwide, and RGM Advisors now compete effectively with the largest market-making banks. The dynamic has led some banks to reconsider where and when they provide liquidity, and to internalise a growing proportion of their FX trading business.

"For clients to get the best out of a market that is growing and fragmenting, it's essential to have simultaneous access to as many microstructures as possible"
Svante Hedin, JP Morgan

According to a report published in September 2011 by the Bank for International Settlements (BIS), specialist trading companies could continue to gain market share in spot FX as they increase participation in multi-dealer trading platforms and electronic communication networks (ECNs).

Moreover, the BIS study raises the possibility that improved capitalisation, and strategic alliances such as the FXCM/Lucid merger, may allow the sector to grow its risk appetite and improve its access to client flows by feeding prices directly to market participants. Indeed some leading banks, are already taking price feeds from HFTs.

But while academic studies present evidence of the increased volumes, lower market volatility and narrower bid/offer spreads that have accompanied the growth in non-bank market-making as positives for market quality, European and US regulators fear the lack of obligation on non-bank players to maintain two-way markets in times of market stress could amplify liquidity crises and market swings.

For instance, on September 29, members of the bipartisan European Parliament Economic and Monetary Affairs Committee voted in favour of rules compelling trading venues and exchanges to require price contributors to hold orders in the market for at least half a second, and levy penalties for excessive volume of cancelled orders. Meanwhile, the Securities and Exchange Commission is running its own investigation into HFTs amid recent allegations trading companies benefit from unfair commercial and operational arrangements with trading venues at the expense of ordinary institutional investors.

Looming large in the debate is the equity market 'flash crash' of May 2010, when the Dow Jones Industrial Average dropped by 9%, or more than 1,000 points, only to recover within minutes. Commentators were quick to blame high-frequency equity traders for the unprecedented

collapse in prices, although recent studies have focused on the influence of a rogue algorithm, and FX markets maintained liquidity by comparison.

Navigating the mirage

HFTs' general strategy of contributing prices into as broad a range of trading venues as possible, where they update their prices every fraction of a second, has given rise to 'quote-stuffing', or the practice of showing far more prices than the trader has the intention to execute in order to 'test' market appetite for a given level. "A participant looking across all electronic markets may be mistaken into believing there is more liquidity than is actually accessible. Most public venues are intrinsically linked; for example, when a market-maker trades at one venue they may cancel quotes at others and liquidity will effectively disappear," says Svante Hedin, managing director and head of automated trading strategies at JP Morgan in London.

While some participants say that type of behaviour is to be expected while the electronification of markets is still in its expansionary and fragmentary stage, the reduction of quote life and quote size caused by the increased influence of HFTs can be detrimental to institutional investors that have historically tended to seek FX quotes in large sizes, relatively infrequently.

Given this changing market structure, Hedin says the challenge for FX market participants is to extend their reach into a wide range of venues to maximise their information around price formation. "For clients to get the best out of a market that is growing and fragmenting, it's essential to have simultaneous access to as many microstructures as possible," he says.

While the acceleration of price discovery and execution online has suited participants trading small amounts frequently, banks report growing demand among institutional investors for help in navigating the new environment. Banks have responded by offering algorithmic FX trading tools that will enable clients to optimise their selection of trading venue and liquidity provider, mirroring a trend already in place in the equity markets. "Clients are increasingly coming to us for our expertise on the best way to execute their business. We have successfully provided them with algorithmic execution tools that understand and leverage these changing market structures. They are also seamlessly integrated with JP Morgan's own liquidity. For us, this is a client-focused business that we expect to grow very significantly in the future," he says.

Flash crash evidence scrutinised

Beyond the general observation that HFTs post more prices than they intend to execute, HFT critics suggest that as highly risk-sensitive institutions that only hold intra-day positions, HFTs will withdraw liquidity from the market as soon as spreads widen and prices begin to gap. In other words, HFTs will tend to amplify market dislocations during times of market stress, rather than act as stabilising forces, as traditional market-makers are perceived to do. Against this, HFT supporters argue that superior risk management mechanisms make non-bank market-makers less likely to exit during periods of heightened volatility than traditional sell-side participants. Furthermore, HFTs argue that they often have the ability to switch between algorithms designed for specific volatility conditions.

As noted in last year's BIS report, EBS data on the day of the 2010 flash crash in US equities shows that algorithmic execution accounted for more than 53% of total market activity on the day – higher than both manual execution, and the average rate of algorithmic execution. Although there is no refined data on the behaviour of HFT market-makers as a subset of algorithmic traders, raw data around the EUR/USD pair on May 4 reveals that as EUR/USD plunged from 1.262 to 1.252 over the space of five minutes, the number of both algorithmic and manual orders was sharply higher than the previous average. Moreover, algorithmic orders saw a larger increase than manual orders. "While the EBS data does not provide a discrete look at HFT activity itself...they are at least consistent with anecdotal suggestions that HFT players remained active throughout the session," the BIS said in its report.

According to Josh Levy, investment manager and executive director at Tactical Asset Management, a New York-based algorithmic FX trading firm that does not make markets, the gaps in liquidity are a structural feature of FX, rather than an artefact of HFT market-makers. "FX markets have for decades suffered from pockets of illiquidity following an unexpected news result, or an unexpected demand or supply shock. The RUB and BRL crises, and the collapse of the USD/JPY in 1998 all happened years before the advent of programmatic traders. There were gaps in liquidity then, and there will continue to be in the future. This cannot be blamed exclusively on HFTs," he says. Pointing to increased volumes, compressed spreads and lower volatility across emerging markets crosses, as well as the majors, he says it's hard to argue that liquidity has suffered. "We've had flash crashes and we will have them again as the market is moving quicker and can be more volatile on certain days. One trader's flash crash is another's volatile day in the market. It's the new normal," he says.

Self-regulatory routes

Forex trading shops are confident that self-regulating mechanisms provide an effective incentive for market-makers to show only prices they intend to trade, and to honour the prices they show. Levy notes that market participants – chiefly trading platforms and prime brokers – already have sufficient measures to achieve this outcome. "If we are repeatedly shown a price that our models aren't able to lift, we address the issue with the relevant executing broker or ECN. Typically, if market-makers are not pricing aggressively enough, or not honouring prices regularly enough, they are given a penalty," he explains. Repeat offenders can have their pricing feed temporarily shut down – a fairly regular occurrence in the OTC spot market. "The market has effective self-regulatory measures at its disposal," he says. With many participants preferring to trade on an anonymous basis, however, platform operators may have limited ability to identify offending counterparties once they are admitted to the platform.

Prime brokers in focus

Non-bank market makers can only access the OTC market via their prime brokerage relationships, giving the prime brokers perhaps the strongest incentive to monitor and regulate the HFT's market behaviour and risk management practices, participants say. Indeed, traders who have suffered cancelled bids tend to seek redress through the prime brokerage channels. Indeed, prime brokers' own risk management servers must be real time and co-located with their clients within each trading hub to minimise latency, while the risk management system must be at least as sophisticated as their HFT clients'.

An electronic trader at a London bank says prime brokers are increasingly focused on the risks associated with lending their name, credit and reputation to sub accounts. "From an exposure and credit perspective it's important for the prime broker to ensure they have the right systematic controls in place and stay constantly engaged with trading platforms so that they manage risk on a real-time basis," he says.

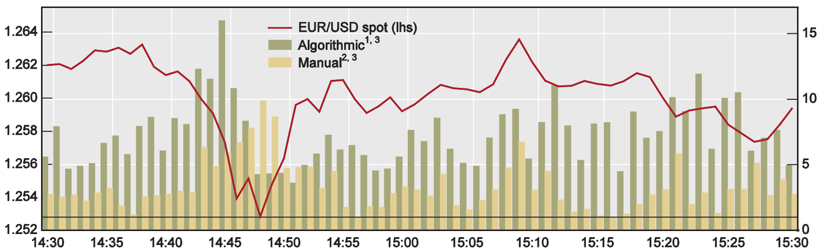
For example, last year New York-based post-trade processing firm Traiana partnered with prime brokers Citi, Deutsche Bank, JP Morgan and Morgan Stanley, and ECNs Bloomberg, Currenex, EBS, FXCM, Hotspot and Thomson Reuters to launch an industry-wide initiative to centrally monitor and manage FX trading on ECNs. By connecting prime brokers and ECNs in real time, the service provides the industry with the control and real-time risk management capabilities to manage risks from algorithmic and high-frequency trading, the vendor said. Essentially, the system allows the prime brokers to monitor their clients' risk across different platforms by aggregating positions in real time and providing a 'kill-switch' to terminate specific clients' access to the market if the client accumulates an unacceptable position.

Notwithstanding the increased use of circuit-breakers by prime brokers in trade-processing architecture to mitigate credit risk concentrations, it's not yet clear how these initiatives address the concern that prime brokers may be undercharging for FX prime brokerage, relative to the risks they are incurring.

Behind the debate around the quality of HFT liquidity versus traditional providers is the assumption that banks effectively have some kind of binding obligation to provide liquidity to their clients that non-bank providers do not share. However, anecdotal evidence suggests increased competition from non-bank players is leading banks to favour business that can make money for the FX transactions amid spread compression, lower volatility and reduced profitability.

"We see a trend towards myopia in some sell-side dealing desks that, instead of looking at the overall client relationship, have unrealistic profitability expectations. We are happy for our liquidity providers to look at profitability over the span of a month, for example, but we are not comfortable with the expectation that every single one of our trades, every single day must be profitable for them," Levy says.

ALGORITHMIC AND MANUAL QUOTE SUBMISSIONS ON MAY 6 RELATIVE TO PRIOR PERIOD AVERAGE



[1] Number of EUR/USD quotes submitted by algorithmic traders on 6 May divided by the average number of EUR/USD quotes submitted by them during the same time of day on the prior 25 trading days. [2] Number of EUR/USD quotes submitted by manual traders on 6 May divided by the average number of EUR/USD quotes submitted by them during the same time of day on the prior 25 trading days. [3] A ratio of greater than 1 indicates higher than average activity.

Source: EBS.

BREAKING THE RULES

Many European hedge funds count as US persons under proposed cross-border guidance from the Commodity Futures Trading Commission – potentially forcing them to comply with trading rules on both sides of the Atlantic. That looks impossible. **Lukas Becker** reports

Of all the unappetising choices to come out of over-the-counter derivatives market reforms, European hedge funds face arguably the worst – whether to break their local rules or those in the US. The way new OTC trading rules in each jurisdiction are written, it appears they will be subject to both, but will only be able to comply with one or the other.

The problem arises because many European funds are expected to be treated as US persons for the purposes of the Dodd-Frank Act, requiring them to trade on a swap execution facility (Sef). At the same time, they will be expected to use the European equivalent of these new OTC trading platforms – multilateral trading facilities (MTFs) or organised trading facilities (OTFs). Given the US and European platforms are intended to do more or less the same thing – provide a public, transparent venue for OTC trading – the elegant solution would be for US regulators to accept MTFs and OTFs are as good as Sefs, with European regulators reciprocating. But in guidance on the cross-border application of its Dodd-Frank Act rules, the Commodity Futures Trading Commission (CFTC) does not put trading rules under the umbrella of its so-called substituted compliance regime, in which it allows offshore entities to follow their local rules if they are sufficiently similar to those in the US.

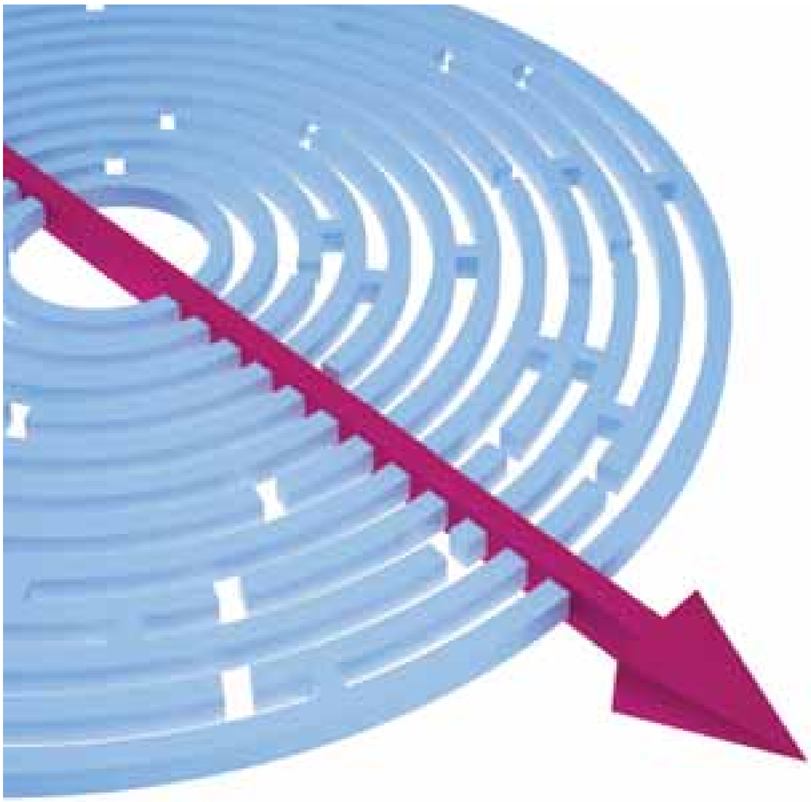
"If you put a European hedge fund in a situation where it has to choose between complying with US or European rules, it may avoid the swap transaction altogether because it will not want to risk being non-compliant," says Wayne Pestone, chief regulatory officer at FXall in Washington, DC. "Putting hedge funds in this position just doesn't make any sense."

Technologically, it would be possible for a trading venue to satisfy both the Sef rules and the MTF/OTF rules, says Matt Woodhams, head of e-commerce at GFI in London. Unfortunately, however, users would still have to choose between them when executing because the detail of the two regimes differ. "Theoretically, they're going to be breaking one set of rules," he says.

So, why might European hedge funds end up between a rock and a hard place? Under Dodd-Frank, swap dealers, major swap participants (MSPs) and entities classed as US persons have to use a Sef for certain OTC trades. The CFTC uses a broad definition of US persons in its June 29 cross-border guidance, roping in any company that would be required to register with the National Futures Association as a commodity pool operator (CPO) under the Commodity Exchange Act. And the scope of the CPO definition was broadened in a February 9 rule-making from the CFTC – the upshot being that non-US investment managers that have at least one US investor and trade in regulated commodities markets in the US, including OTC swaps, would be caught.

At the same time, the draft text of Europe's Markets in Financial Instruments Regulation (Mifir) – one half of the review of the Markets in Financial Instruments Directive (Mifid) – requires entities

> *"If the CFTC permits Mifir and Mifid II as* ***suitable substituted compliance****, then almost certainly Europe will reciprocate"*
>
> **DAN MARCUS, TRADITION**



regulated by European authorities to execute trades on MTFs or a new category of venue, the OTF.

The irony is that the two sets of rules are fairly similar – but market participants say there are a host of hidden complications that means getting regulators on each side of the Atlantic to accept the other's version of the trading regime may be tricky.

As it stands, the Mifir draft allows trades to be executed on approved third-country execution platforms such as Sefs, but because the CFTC's substituted compliance regime does not extend to trading rules, it means swap dealers, MSPs and US persons – including CPOs – all have to transact through Sefs. This lack of reciprocal recognition could prompt a tit-for-tat response from the European Commission (EC). In a comment letter to the CFTC on August 24, Jonathan Faull, director-general of internal market and services at the EC, said the application of multiple sets of rules to the same transaction undermines financial stability and may lead to trades migrating to other jurisdictions. Under those circumstances, he warned the EC may not recognise the rules of other jurisdictions as equivalent to Europe's own.

"The power and ability of the European Commission to adopt an equivalence decision to avoid all these profoundly negative effects is subject to one important condition: the rules of the third country concerned must be applied in an 'efficient and non-distortive' manner. If this cannot be determined and the rules of a third country are considered to result in an unbalanced state of affairs which creates a discrimination of treatment between two jurisdictions, the European Commission could be prevented from granting equivalence," Faull wrote.

Ultimately, market participants believe sense will prevail. Given that Mifir is unlikely to force European entities to execute on MTFs and OTFs before 2015 at the earliest, the CFTC has time to extend its substituted compliance regime to the new execution rules, and Doug Friedman, general counsel for Tradeweb in New York, says the firm has urged the CFTC to do exactly that.

"If you're regulated as an MTF, as we are in Europe, and we then apply as a Sef in the US, it seems more logical to have the market participants located in Europe access the Sef through the affiliated MTF with comparable regulation – in essence, a substituted compliance regime – rather than require Sefs to register in each local jurisdiction," says Friedman.

Tradeweb and other commenters have yet to hear back from the CFTC, but Mark Wetjen – one of the agency's commissioners – said in a September 13 speech to the International Swaps and Derivatives Association's North America conference that the regulator was revisiting its cross-border guidance.

"The commission is fully engaged on issues related to the definition of US person, the conduit test for transaction-level requirements, the aggregation of overseas-dealing activities, and the competitiveness of certain legacy business structures. I am confident the commission's final releases will be able to answer and clarify many of the relevant questions and concerns raised in the comment letters on these issues," said Wetjen.

Dan Marcus, managing director of strategy and business development at interdealer broker Tradition in London, says if the US recognises Europe's execution rules, Europe is sure to follow. "If the CFTC permits Mifir and Mifid II as suitable substituted compliance, then almost certainly Europe will reciprocate. Bearing in mind Dodd-Frank implementation is in 2013 and Mifir is likely to be in 2015, this is something Europe can resolve by then," he says.

However, that still leaves a two-year gap where the US execution requirement is in force but there is no European legislation the CFTC could consider for substituted compliance. Even when the European rules are brought into force, there could be a further lag while MTFs and OTFs wait for regulatory approval to start operating. In other words, European CPOs may be forced to use Sefs in the absence of local alternatives that are subject to rules deemed acceptable in the US.

And that means Sefs will have to

bear the burden, says Friedman at Tradeweb – ensuring non-US clients are properly catered for and keeping the platform open for business during European hours.

As a solution, Tradeweb has proposed that the CFTC should temporarily allow US persons to use MTFs if the operator of the platform also has a Sef affiliate, is registered in a European Union member state as an MTF and also meets certain minimum standards. The extension should be no more than six months from the effective date of the equivalent legislation, Friedman says.

"Our proposal was MTFs that operate with the appropriate infrastructure could facilitate the swap transactions while the CFTC and foreign regulators are sorting out how best to implement the extraterritorial guidance," says Friedman. "That's distinct from someone in the US with no affiliate and no appropriate regulated regime overseas. We're not looking for them to just allow anyone into the market-place – you have to have the appropriate infrastructure," he adds.

"We have to address the more immediate implementation deadlines first, so our clients can comply with the rules and continue trading"
Wayne Pestone, FXall

For now, FXall's Pestone says the company is concentrating on the Sef requirements with an eye to being able to meet European rules down the line once Mifid II is in place. "The real question for us would be: how similar will Europe's OTF and MTF categories be to the US's Sef regime? That's the best way for us to approach it at the moment, given the differing time frames for decision-making and implementation around the US and European regulations for swaps. We have to address the more immediate implementation deadlines first, so our clients can comply with the rules and continue trading," says Pestone.

LEGAL HEADACHES FOR SEFS

If the US and Europe do not recognise each other's trading rules, it would not just be a problem for users of the platforms, but also for the platforms themselves. Local laws in some European countries – on topics such as data protection and privacy, for example – conflict with requirements facing swap execution facilities (Sefs) under US rules.

For instance, the Commodity Futures Trading Commission's (CFTC) proposed Sef rules require the platforms to collect data from participants and share it with other Sefs and exchanges. In addition, it gives Sefs the authority to collect information and examine participants' books, force traders to keep trading records for the Sef and the CFTC, and to conduct inspections of information maintained by members for audit requirements.

In an August 27 comment letter to the CFTC, Icap warned these requirements would clash with data protection laws in certain jurisdictions. "Particular concerns arise in France, where a number of privacy and information laws, such as the Blocking Statute and Banking Secrecy Statue, could impact transmission of data to the Commission [CFTC], a point that has been highlighted in comment letters from the French authorities and Société Générale," it said.

Rules regarding the transfer of a Sef registration – for example as a result of a merger of a Sef operator or a change in its corporate ownership – could also clash with certain countries' existing regulations. Under rule 37.3(d) of the proposed US Sef rules, a Sef must submit a request to the CFTC to transfer all the platform's assets to another legal entity at least three months before a corporate event. If the Sef doesn't or couldn't know that far in advance, it has to file the request "as soon as it knows of the change". But according to Icap, this could clash with notification requirements in Section 191F of the UK's Financial Services Markets Act 2000, for example, which makes it a criminal offence to acquire or increase control in a UK authorised person – which a Sef must be if it wants to offer its services to UK clients – without first notifying the UK Financial Services Authority.

RESPONDING TO CHANGE

Purnur Schneider and **Christopher Cruden** at Insch Capital Management in Lugano, Switzerland, use the Black-Litterman model to test strategies designed to work in changing market conditions

Early in the millennium, active currency management was perhaps a little easier. Remember the days when carry and purchasing power parity (PPP) were the main rival strategies and trend was a cool alternative, as a combination of the two?

Then the financial crisis and the credit crunch changed the game. Choppy markets and a roller-coaster of bumps in investor risk appetite decimated the performance of naive strategies of either kind. While sophisticated strategies that perform can still be found, there is no consensus over the profitability of simple trading rules.

Other markets may have found consensus strategies, such as the Markowitz market portfolio in equity investing (suboptimal, both in theory and practice, but popular for its tractability), and extrapolating past returns in the guise of expectations (a poor strategy in most cases; see the bond market for an excellent illustration).

A good indicator of the FX environment can be gleaned from the performance of a family of DB naive strategies' indexes (formerly RBS indexes). In figure 1, one can get an inkling of the succession of risk tolerance regimes and their impact on the FX market during the past five to six years. As the financial crisis deepened, elevated risk expectations proved beneficial for volatility strategies and shattering for carry (DB G10 Carry Index, see box, overleaf).

When volatility started to fall, both these indexes' performances reversed. Recently, volatility in FX has fallen to almost pre-crisis levels, despite the financial crisis not being completely over yet, so plain carry may have a chance – but who can tell that volatility may not spike again?

Since the start of 2007, none of the naive strategies have performed satisfactorily, except for brief periods. Sophisticated and large investors may find ways to extract information from market prices and events or collect arbitrage returns. Where simple strategies fail, what can the un-sophisticated investor do, absent computing power and analyst manpower? Is there an easy shortcut to a satisfactory trading strategy? In the following, we illustrate the application of a possible solution – the Black-Litterman model, which combines a naive strategy with an investor's private views – and test it with real forex market data.

Black-Litterman model

The Black-Litterman allocation model generates a portfolio by starting from a set of neutral weights (therefore called baseline portfolio) and tilting it in the direction of the investor's views. The size of the tilt depends on the investor's conviction. In its original form, the model updates the prior expectations resulting from an equilibrium market model with the investor's private views obtained from a proprietary model.

In the Black-Litterman portfolio, the weight of an asset is higher than its analogue in the baseline portfolio if the investor is more bullish than the market on that particular asset, and vice versa. In addition, the weight increment is higher as the investor's confidence in the view, also called the view strength, grows.

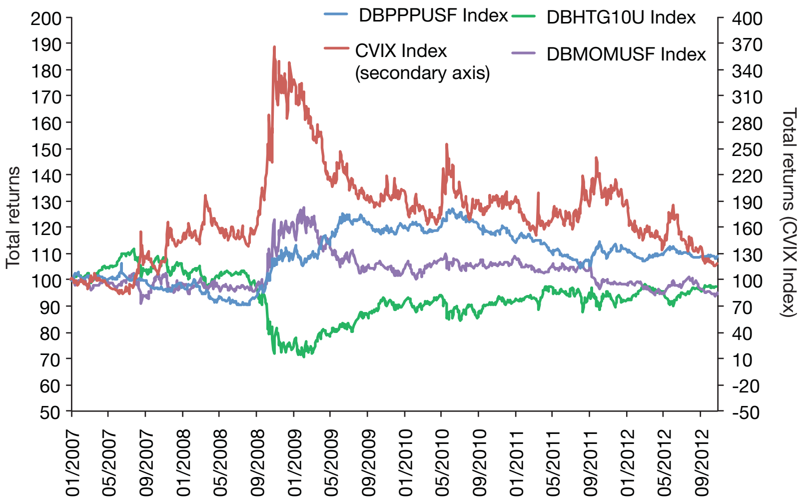
We start by specifying the baseline model and calculating prior baseline expectations. Then we construct private views and the investor's confidence in the views (strength). Finally, we update the baseline expectations with the private views tempered by their strength.

A. Baseline portfolio

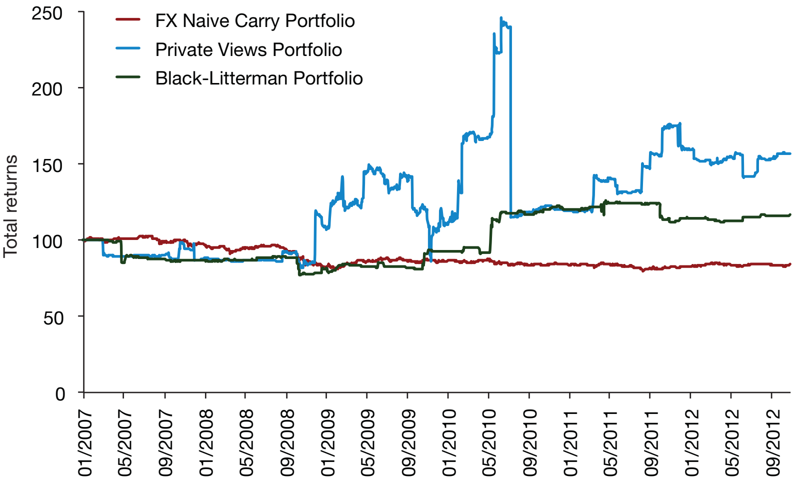
In the following, we shall apply the model to the G-7 FX market. We do not make use of a market portfolio of G-7 currencies.

"Recently, volatility in FX has fallen to almost pre-crisis levels, despite the financial crisis not being completely over yet, so plain carry may have a chance – but who can tell that volatility may not spike again?"

1. NAIVE SYSTEMATIC DB STRATEGIES –TOTAL RETURNS



2. BLACK-LITTERMAN PORTFOLIO VERSUS NAIVE CARRY



Instead, we will use as baseline portfolio a naive carry strategy, whereby the investor buys long a currency pair if it is associated to a positive interest rate differential. For example, if the key interest rate in AUD is 4.5% and in CHF it is 2.0%, the investor will allocate a portion of its trading portfolio to the AUD/CHF pair, that is, long AUD and short CHF. In the naive model, the proportions allocated to each currency pair are equivalent.

The advantage of this baseline portfolio is its simplicity and ease of construction. Besides, in "normal" times, such a portfolio may even perform, as empiricists have shown. However, in times of turmoil, the currencies used for funding carry trades quickly become "safe havens" and carry profits reverse. Returning to the DB G10 Carry Index in figure 1, we see that the index lost about 30% in the bleak autumn of 2008. While it has performed relatively well since 2009, there is no guarantee that bad times will not occur again (just consider the ongoing euro crisis and the possibility of a black swan event).

Entering private views in the portfolio through a Black-Litterman model may shield the investor from ruin or substantial drawdowns in such eventuality.

Our naive portfolio is a buy and hold allocation beginning in 2007 and carried until October 26, 2012. According to the average sovereign interest rates at the beginning of 2007, such a portfolio would have allocated equal parts to the following 17 currency pairs: AUD/JPY, AUD/CHF, AUD/EUR, AUD/CAD, GBP/EUR, GBP/CAD, GBP/CHF, GBP/JPY, USD/EUR, EUR/JPY, EUR/CHF, EUR/CAD, CAD/JPY, USD/CHF, USD/JPY, USD/CAD and CHF/JPY. Interest rate differentials have changed since then, but our baseline strategy does not take the changes into account.

Given the naive weights and the observable covariance matrix of the currency pairs held in the portfolio, the implied or reverse return expectations of the naive investor can be calculated. We will call these baseline or prior expectations.

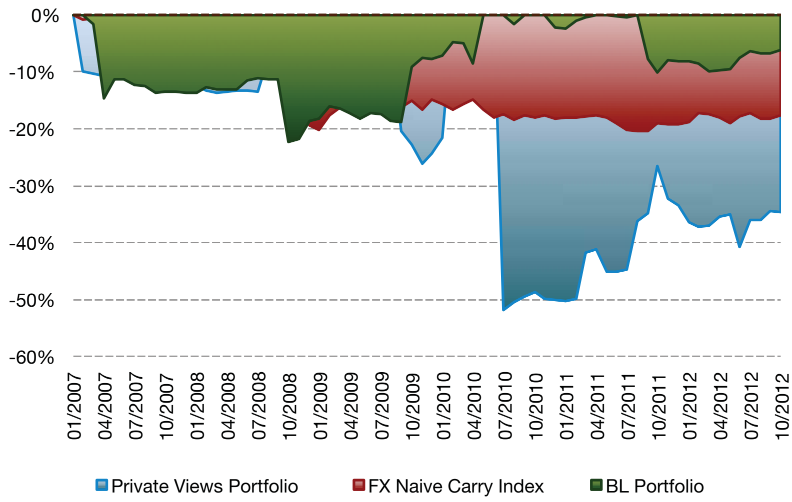
B. Private views

The original Black-Litterman model provides no guidance in setting the private views. These views may come from anywhere: media, analyst forecasts or factor models. We prefer the latter. First, because we are adept at systematic trading. Second, because econometric estimations produce not only expected values (views), but also standard errors of estimates (view strengths).

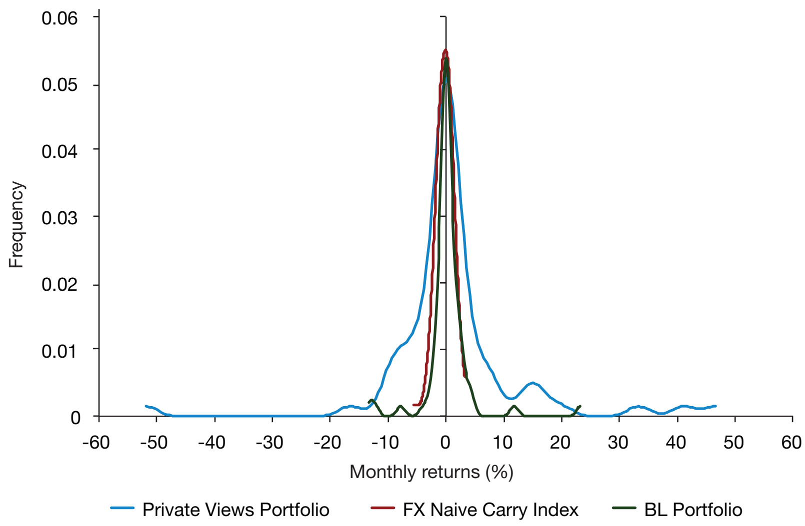
To keep things simple, our factor model uses a single factor the past 22 working days' returns series in each currency pair. The private views consist of extrapolations of the daily rolling 22-day average and they have a confidence matrix attached in the form of the standard error of the 22-day average estimates. In our example, the views on a currency pair are independent from the views on other currency pairs, but this assumption can be relaxed.

A mean-variance investor having full confidence in this view would allocate the portfolio entirely according to the views, the risk aversion (which we infer from the realised returns of the baseline portfolio, assuming the expectations are realised) and the covariance matrix between the currency pairs.

3. DRAWDOWNS



4. KERNEL DISTRIBUTION



C. Updated returns and BL portfolio

Both portfolios obtained at A and B result in unacceptable return patterns (for any sane investor). As shown in figure 2, the baseline portfolio accumulates losses, while a portfolio built solely from the private views is extremely volatile. One is too naive, while the other ignores the degree of uncertainty contained in the views. Luckily, an improved allocation can be achieved by combining the views with the baseline model while taking into account the views' strength.

The Black-Litterman asset allocation model uses the Bayesian approach to infer the assets' expected returns. The inference starts with a prior belief, embedded, here, in the naive allocation (originally, the prior beliefs were market equilibrium returns). Additional information is derived from the private views and used along with the prior beliefs to infer the posterior distribution of expected returns. We may also call these expected returns posterior views.

The posterior views are in the form of updated expected returns and an updated covariance matrix. These are used in conjunction in order to construct optimal portfolio weights, using a Markowitz mean-variance optimisation.

Black-Litterman model results

We have tested the procedure using the methodology outlined in the paper *Global Portfolio Optimization* by F Black and R Litterman and in the *Investments* book by F Bodie, A Kane and AJ Markus. A number of

HOW THE INDEXES ARE CONSTRUCTED

The indexes proposed by the Deutsche Bank Index team are constructed in the following ways:

The DB G10 Valuation Index (DBPPPUSF Index) trades long/short on the extreme departures from the PPP prediction. The strategy buys the three most undervalued currencies according to this measure, and sells the three most overvalued currencies. The exposures are reassessed every three months.

The DB G10 Carry Index (DBHTG10U Index) ranks each quarter the G-10 currencies by their three-month interest rates. The strategy buys the top-three yielding currencies and sells the bottom-three yielding currencies.

The DB G10 Momentum Index (DBMOMUSF Index) ranks currencies by their 12-month changes in spot exchange rates. The top-three performers are bought and the bottom-three currencies are sold. The ranking is reassessed every month.

The DB Currency Volatility Index (CVIX Index) is not a strategy *per se*, but a representation of investors' expectation of future volatility. The index is calculated as the arithmetic weighted average of the 3-month level of implied volatility of major currencies, based on the 4PM London BBA fixing.

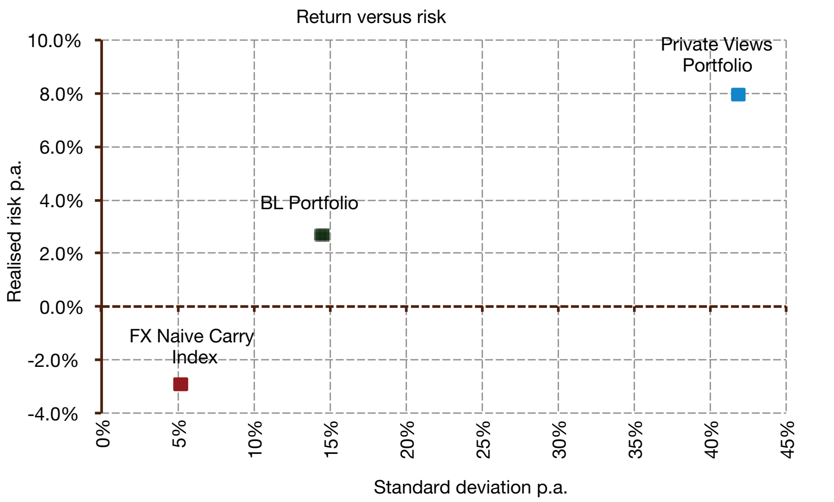
RANKING

Strategy	Ranking	Avg ranking
BL Portfolio	1	1.82
Private Views Portfolio	2	1.94
FX Naive Carry Index	3	2.24
Compounded average return p.a.		
BL Portfolio	2	2.70%
Private Views Portfolio	1	7.96%
FX Naive Carry Index	3	-2.93%
Cumulative return		
BL Portfolio	2	16.79%
Private Views Portfolio	1	56.31%
FX Naive Carry Index	3	-15.95%
One-year holding period return		
BL Portfolio	2	6.01%
Private Views Portfolio	1	14.34%
FX Naive Carry Index	3	-3.49%
Standard deviation p.a.		
BL Portfolio	2	14.47%
Private Views Portfolio	3	41.84%
FX Naive Carry Index	1	5.23%
One-year holding period std. dev.		
BL Portfolio	2	3.71%
Private Views Portfolio	3	11.62%
FX Naive Carry Index	1	1.49%

Return/risk ratio		
BL Portfolio	2	0.19
Private Views Portfolio	1	0.19
FX Naive Carry Index	3	-0.56
One-year holding period return/risk		
BL Portfolio	1	1.62
Private Views Portfolio	2	1.23
FX Naive Carry Index	3	-2.34
Average return positive months		
BL Portfolio	2	2.36%
Private Views Portfolio	1	7.39%
FX Naive Carry Index	3	1.00%
Average return negative months		
BL Portfolio	2	-1.53%
Private Views Portfolio	3	-4.95%
FX Naive Carry Index	1	-1.34%
Skewness		
BL Portfolio	1	1.76
Private Views Portfolio	2	0.33
FX Naive Carry Index	3	-0.50
Excess kurtosis		
BL Portfolio	3	15.50
Private Views Portfolio	2	8.90
FX Naive Carry Index	1	1.36

Best month return		
BL Portfolio	2	23.25%
Private Views Portfolio	1	46.64%
FX Naive Carry Index	3	3.25%
Worst month return		
BL Portfolio	2	-13.25%
Private Views Portfolio	3	-51.84%
FX Naive Carry Index	1	-5.54%
Historical VAR (5%)		
BL Portfolio	1	-1.47%
Private Views Portfolio	3	-7.84%
FX Naive Carry Index	2	-2.01%
Compounded return p.a. / VAR		
BL Portfolio	1	1.84
Private Views Portfolio	2	1.01
FX Naive Carry Index	3	-1.46
Largest drawdown		
BL Portfolio	2	-22.31%
Private Views Portfolio	3	-51.84%
FX Naive Carry Index	1	-20.45%
Compounded return p.a. / largest DD		
BL Portfolio	2	0.12
Private Views Portfolio	1	0.15
FX Naive Carry Index	3	-0.14

5. NAÏVE CARRY, PRIVATE VIEWS AND BLACK-LITTERMAN PORTFOLIOS, RETURN VERSUS RISK



other papers such as TM Idzorek's *A Step-By-Step Guide to the Black-Litterman Model"* were of great help in understanding the Black-Litterman methodology as well.

We find that the portfolio obtained by applying the Black-Litterman procedure outperforms both the baseline portfolio and the private views portfolio on average for a number of criteria, displayed in the table above. Drawdowns are significantly improved both in size and duration, as displayed in figure 3. The Kernel distribution of returns in figure 4 shows the Black-Litterman portfolio distribution of returns has volatility comparable with that of the baseline portfolio, and significantly lower than that of the private views portfolio.

In figure 5, it becomes even more obvious that the Black-Litterman portfolio outperforms the other two portfolios. In fact, it acts as a diversified portfolio made of the two strategies – naive and private views. The crucial improvement respective to other diversified portfolio constructions is that in the Black-Litterman portfolio each period's weightings are determined by the strength of the private views.

The results are not excellent but satisfactory, considering the fact we started from a very naive baseline portfolio and a very basic rule for constructing the private views. The results can be improved by refining these views. Nevertheless, we find there is great value in applying the Black-Litterman model to reduce the calamitous effect of misguided private views.

Christopher Cruden established Insch Capital Management SA in Switzerland during 2004. He has been involved in the alternative investment industry for more than 30 years. Purnur Schneider joined Insch as an Associate Director in 2011 and is responsible for the company's security and market research notes and commentary, quantitative and qualitative analysis of investment products, performance reviews, internal and client reports

THE CASE FOR GOLD

Axel Merk and **Kieran Osborne** at Merk Investments believe recent financial shocks and ongoing turbulence provide major incentives for those considering gold, not just as a safe haven, but also as a protection against inflation

Two distinct reasons typically cited as critical decision-making factors supporting an investment in gold are inflation protection and the need for a safe-haven investment. In the context of the current economic environment, we believe there are strong arguments supporting both of these investment theses. Indeed, the case for investing in gold may be as compelling as ever. Expectations for inflation have become elevated, ongoing leverage throughout the economy may result in continued market volatility, and uncertainty remains over the future trajectory of the global economy. We believe these trends are likely to underpin continued strength in the price of gold over the foreseeable future.

Inflation risks elevated

Risks to expectations for future inflation levels can underpin a decision to invest in gold. Importantly, it is not the current level of inflation that drives this investment decision. Future inflation levels can be calculated by assessing the difference in yields between Treasury Inflation Protected Securities (TIPS) and equivalent maturity Treasuries; typically referred to as implied inflation expectations. Indeed, the US Federal Reserve (Fed) utilises implied inflationary expectations as a key metric in gauging the risks to future inflation.

Figure 1 outlines recent movements in a commonly followed inflation expectations metric – the expectations for average annual inflation over a five-year period beginning five years from today. The jump in inflation expectations in response to the Fed's QE3 announcement is noteworthy.

Monetary policy fanning inflation concerns

It shouldn't be surprising that inflation expectations are elevated. With central bankers around the world seemingly dedicated to keeping the world awash with freshly minted currency, the case for an investment in gold based upon inflationary concerns may be strong. Globally, central bankers are either putting their money where their mouth is (quite literally) or strongly insinuating that continued accommodative policies are needed to prevent another significant downturn in global economic activity.

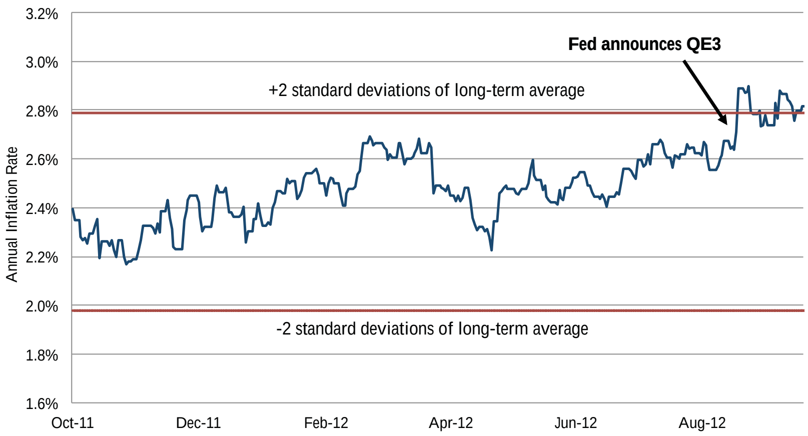
While all the excess printed money may or may not have the desired effect of stimulating the respective economies, the money does find its way somewhere – unfortunately, central banks simply cannot control where. Case in point: Fed chair Bernanke's Achilles' heel has been the housing sector. Despite spending trillions of dollars on mortgage-backed securities (MBS) purchases, housing prices have continued to stagnate. In our assessment, such accommodative policies only serve to inflate the value of assets that exhibit the greatest level of monetary sensitivity: commodities and natural resources. These are essential in the manufacture and production of goods and services purchased by US consumers on a daily basis. As such, inflated commodity and resources prices ultimately put pressure on consumer price inflation, as the consumer's "everyday basket of goods" becomes increasingly expensive.

Weak US dollar creates inflation pressure

The decline in the US dollar over time, particularly against Asian currencies and currencies of commodity-producing countries, has compounded the inflation-

> *"Expectations for inflation have become elevated, ongoing leverage throughout the economy may result in continued market volatility, and uncertainty remains over the future trajectory of the global economy"*

1. 5YR FORWARD, 5YR INFLATION EXPECTATIONS



Source: Merk Investments, Bloomberg, U.S. Treasury
Calculations based on constant maturity treasury yields sourced from the U.S. Treasury

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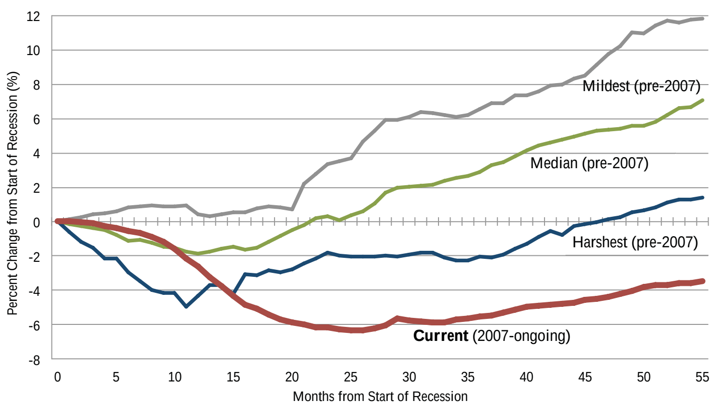
2. CHANGE IN US EMPLOYMENT THROUGH 55 MONTHS: 2007–09 RECESSION VS SUMMARY OF 10 POST-WAR RECESSIONS*



Source: Merk Investments, Federal Reserve Bank of Minneapolis
*Mildest, median, and harshest lines reflect the smallest, median, and largest declines as of each month; they do not reflect specific individual recessions.

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ary pressure brought about by natural resource and commodity price increases. The US imports a great deal from abroad; every time the dollar depreciates against a currency of a country from which the US imports, the price of those imports rises unless the exporter absorbs the higher cost of doing business.

Many high-profile American importers, such as Walmart, have noted price pressures in goods sourced from Asia in particular. All of this creates upward inflationary strains.

Gold: the ultimate hard currency

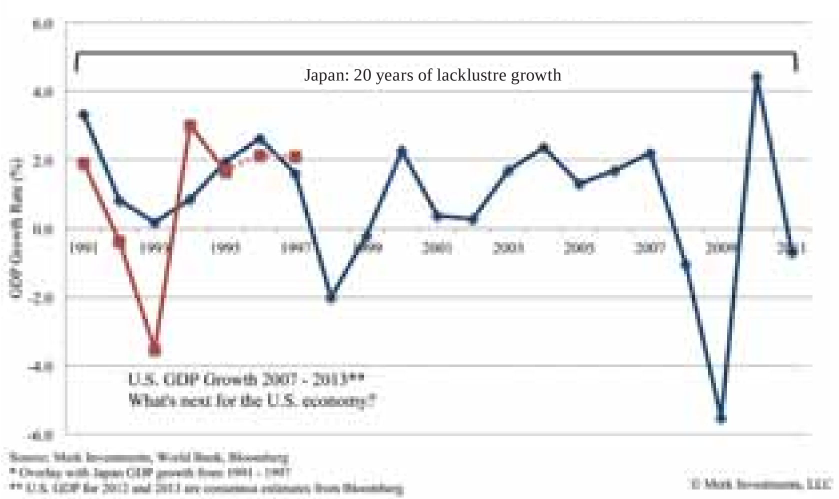
Gold has historically demonstrated value both as a commodity, primarily for its desirability as jewellery, and as money – a role for which it is naturally suited due to its unique attributes: its scarcity, durability, divisibility, and transportability. Unlike fiat currencies, gold has a limited supply that cannot be easily influenced and an underlying commodity value, which allows gold to retain its purchasing power over time. Production of gold is very hard to ramp up, whereas the creation of new fiat currency takes a simple stroke of a keyboard. As noted above, central bank keyboards have been working overtime of late, which has arguably deteriorated confidence in fiat currencies. As a result, gold may become an ever more attractive alternative to holding investment wealth in one's domestic currency.

Global leverage underpinning gold as a safe haven

The performance of gold during broad market downturns and periods of heightened uncertainty underpins its safe-haven value. Looking ahead, holding gold in this capacity may once again be validated. Global economic activity remains at risk and appears to be slowing. Unfortunately we don't expect to see major improvements any time soon; we believe financial markets will continue to exhibit heightened levels of volatility for an extended period of time, largely due to the ongoing high levels of leverage throughout the global economy.

Over the past five years, average implied daily market volatility rose by more than 50% compared with the level witnessed during the preceding five-year period. We believe increased leverage globally was a leading contributor, and consider that continued leverage is likely to underpin uncertainty going forward. Through current monetary policy, policy-makers are discouraging consumers from deleveraging (through ultra-low interest rates, for instance), incentivising ongoing high levels of consumer leverage. Despite recent

3. US GDP GROWTH (2007–13*) VS JAPAN GDP GROWTH (1991–2011)



improvements, ongoing high leverage is likely to contribute to continued sluggishness of the US consumer and disappointing headlines.

Worrying levels of government debt

Ominously, the use of leverage has spread to national governments. While government debt is nothing new, we consider the levels seen today are reason for serious concern. Gross general government debt in the G-7 nations has exceeded 100% of GDP, and Japan's public debt is already over 200% of GDP. As any investor who has utilised leverage knows, when the tide turns, it can be extremely painful. Unfortunately, when the tide turns against governments, financial catastrophes can ensue. Greece is a prime example. However, problems may extend to many developed economies.

Compounding matters are rising interest rates imposed on profligate governments, which makes it increasingly difficult to service expanded debt levels, therefore threatening a vicious cycle of indebtedness. Europe has been the market's focal point, where policy-makers continue to muddle towards a solution to support weaker nations. In the US, markets have yet to impose such fiscal oversight on the US government, where Treasury yields remain close to historic lows. These dynamics do not reflect the current US fiscal situation, which is arguably in worse shape than many European nations. Rather, we believe the Fed's expansionary policies and a lack of a suitable substitute for the US Treasury market have contributed to the present situation.

In many respects, the US faces a lot of the same challenges Europe does. According to the Congressional Budget Office (CBO), if nothing is done to address the looming fiscal cliff, the US annual budget deficit is expected to be approximately 5% of GDP through the year 2022. Even if meaningful policies were enacted, which would broadly equate to European-style austerity measures, it is hard to foresee the US fiscal deficit turning to a surplus, particularly when factoring in a slowdown in economic growth as a result of such measures. However, one point of difference does seem apparent: the Fed may be more willing to deploy the printing press than the ECB, which we believe may be positive for the price of gold.

> "Gold's use as a protection against **inflation** and as a **safe-haven** investment appear to remain as relevant as ever"

Outlook for US economy murky

A lot of risk remains surrounding the future trajectory of the present recovery, particularly given a backdrop of still too much indebtedness at both the consumer and government levels. The US is yet to regain the level of employment experienced prior to recession, and the current recovery significantly trails even the harshest pre-2007 monthly change (see figure 2, previous page).

Some have propositioned that the US may be in for an extended period of sub-par growth, not dissimilar to that experienced in Japan (see figure 3, left).

Monetary policy creating uncertainties

We consider monetary policy is also inherently increasing financial market risk. Fed chair Bernanke believes the Fed's non-standard policies since 2008 may have lowered 10-year Treasury yields by more than 1.5%. In doing so, the Fed has taken away a key metric in gauging the economy: free market interest rates. Historically, the Fed has relied in part on long-term yields as part of its assessment of the overall health of the economy. In manipulating those yields, the Fed can no longer rely upon them to provide valuable information in setting appropriate monetary policy. In other words, there is an increased risk that the Fed gets monetary policy wrong, creating additional levels of financial market uncertainty.

It is evident that significant risks remain regarding the strength of the economic recovery. We consider the high levels of government debt, not just in the US, but the world over, are likely to contribute to elevated levels of volatility in financial markets for years to come. Monetary policy has also increased the risks to financial markets and the economy. Expectations for future inflation have become elevated, while continued weakness in the US dollar versus foreign currencies and heightened commodity and natural resource prices are only likely to compound inflationary pressures. Such dynamics should help underpin strength in the price of gold, as its use as a protection against inflation and as a safe-haven investment appear to remain as relevant as ever.

Q&A
BUY-SIDE PERSPECTIVE

Saima Farooqi asks industry experts to describe their experiences during 2012, and what they are looking forward to in 2013

Q What has been the most successful trade of the year?

Paul Lambert, head of currency, Insight Investment: The most successful trade of the year so far was shorting currencies that are positively correlated with the global industrial cycle during the risk-off period in May. The fund correctly anticipated the risk sell-off and adopted currency positions that would benefit from such an environment.

Patrik Safvenblad, investment partner, Harmonic Capital Partners: Short BRL/CLP is a favourite trade this year. It was a fundamentally motivated trade with modest downside risk as we were on the same side as policy-makers. Having profited from long BRL positions in the past, the profitability of a short position is also a welcome test of our trading models.

It is also an important bellwether trade. We see how several emerging market currencies leave simple risk-on/risk-off patterns and reflect more of the local fundamentals.

Q What has been the biggest risk you faced this year and how did you manage it?

Lambert: The biggest risk faced this year has been the often binary outcome from political events, with large tail risks particularly associated with the negative outcome. An example of such a moment was the Greek election, when a Greek exit from the euro area was a possibility. We have managed such risks either using trading stops or with the use of options. It is a key advantage of the currency market that we are able to do this effectively, where it would be less possible in most other markets. The comparative advantage of currency investing in this regard would

"The biggest **risk** faced this year has been the often binary outcome from **political** events"

PAUL LAMBERT, INSIGHT INVESTMENT

have been more obvious if more events had delivered the negative outcome.

Safvenblad: Markets were actually quite well behaved in 2012. The slow-motion resolution of the eurozone crisis provided a lot of reasons to worry, but little actually happened in terms of realised risk. The range-bound G-3 markets were a problem from a performance perspective, but were less of a risk issue. We were prepared for more violent 'risk-on/risk-off', but over the year those dynamics weakened.

Q What is your outlook for G-10 currencies and how are you positioning for it?

Lambert: The general direction of the USD continued to be dominated by risk appetite. In turn, risk appetite has been highly cyclical. The post financial crisis global up-swing gave way to a down swing that recently has been arrested by monetary easing. The pace of growth in the global economy appears to be just above stall speed. We believe immediately ahead flexibility is required while better evidence emerges of whether or not we are going to return to recession-like conditions. Once we have more conviction we will set up the portfolio accordingly.

Safvenblad: At this point we are largely neutral on G-3, so positioning is driven by peripheral currencies. At the moment (November 2012) we are bullish AUD and NZD versus G-3. We are also short SEK versus the EUR based on relative equity performance. All these positions are driven by local (AUD, NZD, SEK) fundamentals not G-3 fundamentals.

The periphery versus G-3 theme was very strong in 2012, and we do not see this changing in 2013. We have seen sentiment in peripherals shift rapidly from bullish to bearish and our positioning takes this into account. One interesting observation is that the SEK seems to have become more of a (relative) safe-haven currency, which could give rise to very interesting trades next year.

Q What is your outlook for the emerging markets and what impact will it have on your trading strategy?

Lambert: As above.

Safvenblad: We do not have a view on emerging markets versus G-10, but a lot of local views. During 2012, we saw divergence in emerging markets, and most importantly this divergence was driven by local factors. Unless there is a global meltdown we expect this trend to continue. In 2012, we successfully played short ZAR, and it would not be surprising to see a long ZAR recovery position at some point during 2013. This would mirror the way we took long HUF positions during 2012.

Q What is your biggest challenge in the year ahead and how are you risk-managing it?

Lambert: Our biggest challenge is that markets have been range bound, volatility has been declining and the global cycle appears stuck in a phase where upswing or downswing next, will have a profound effect on all asset markets. We are managing it by being patient until we see evidence, and when we do trade trying to ensure we are trading at the right end of market ranges. Our bias is that the next big move for markets will be a risk-off event, but we are not wedded to this view and we will be flexible if information emerges that challenges it.

Safvenblad: For our trading style, we are always worried about factors outside our models such as political decisions. We are sure Europe can provide more surprises during 2013.

Today, many investor portfolios are positioned for a continuation of bad news. Unexpected improvement in the US or eurozone economic outlook could have a dramatic effect on markets, particularly for peripheral currencies in both EM and G-10.

We use fundamental modelling to forecast markets, and seek to diversify as much as possible. When our positioning is wrong, we fall back on our tested risk management procedures. Disciplined reduction of any losing position is our main risk management tool. It has helped us survive 10 years in a difficult market-place, and maintaining the discipline is key to surviving the next 10 years.

"We were prepared for more violent 'risk-on/risk-off', but over the year those dynamics weakened"

PATRIK SAFVENBLAD, HARMONIC CAPITAL PARTNERS

Foreign commodity exporters to China seek RMB settlement after US fiscal cliff fears

Foreign commodity firms operating in China are settling via RMB to circumvent a potential weakening of the dollar

Foreign commodity exporters into China are increasingly requesting physical trade settlement in offshore renminbi (CNH), following fears that the value of dollar holdings will be hit by the US fiscal cliff in the coming months, according to market participants.

The standard transaction model is for a Chinese end-user to issue a three-month or six-month letter of credit (LC) in either USD or CNH. Whereas previously, government incentives led to Chinese firms asking for a proportion of their payments to be in CNH, foreign commodity firms have now been taking it upon themselves to request increased CNH settlement.

In the short term, the US's economic problems are behind the impetus, says a Singapore-based senior commodities source at a global bank. In particular, the major worry is the long-standing political deadlock that threatens to push the US back into recession if a series of automatic federal tax rises and spending cuts are triggered at the start of January 2013.

"There are a lot of trade flows – iron ore from Brazil into China, for instance – where the exporter has no assets in China and the trade is in USD, but they have some interest in diversifying their portfolio risk in terms of holding more RMB," says the source. "There have been requests from firms to settle more in CNH in emerging regions like Africa. There's some genuine concern around the fiscal cliff and the value of the dollar and there's still going to be a fair amount of volatility. You don't want to wake up on January 1 and find the value of your dollar holdings has gone down by 20%."

In the long term, China's role as the leading global commodity driver is also pushing the trend. One China-based senior management source at a major global trading firm says it began settling trades in CNH in 2010, and this now accounts for about 9% of all trade payments with Chinese firms – a figure he expects to increase. "This trend is irreversible: more and more of the cross-border trades between China and any particular Asian neighbours will be conducted in RMB."

However, not all foreign firms necessarily see the value of taking on more RMB risk in their portfolio. "We prefer dollar LCs, as our purchases are in dollars. Thus there is no currency hedging required," says the chief executive of a Hong Kong-based trading firm. "We don't try to make money on currency speculation."

China has actively been pushing for internationalisation of its currency for several years, and one goal is to make the renminbi the settlement currency for commodity trade in Asia. In April 2009, China launched a pilot scheme for cross-border renminbi trade settlement, and currently around 8% of the country's total trade is now settled in its domestic currency.

> *"The major worry is the long-standing political deadlock that threatens to push the US back into recession"*

Onshore CNY cannot move from the mainland, and while CNH is free to be traded globally, its repatriation requires regulatory approval. Hong Kong acts as the financial centre for the pilot scheme, although Macau and Asean countries are also areas covered by the scheme. Within these areas, non-mainland banks can provide services such as renminbi deposit-taking and currency exchange on those deposits for firms with a clear trading background.

Growth in this trade has been significant. According to the Hong Kong Monetary Authority, monthly trade settled through the RMB RTGS system in Hong Kong – excluding RMB flow relating to financial products – has grown from 10.6 billion yuan in July 2010 to 206.59 billion yuan in September this year, while Deutsche Bank forecast in 2011 that China would eventually match Japan in pricing 40% of its exports in its domestic currency.

Apart from trade payments, there has been a growing use of CNH in commodity financing, according to Gunnar Hoest, Singapore-based head of commodities Asia at Deutsche Bank.

"It is definitely true that there's been a lot of RMB paid offshore for import of metals into China over the past year. These imports partly reflect actual demand for metal in China and the widespread use of metal inventory held in bonded free trade zones in Shanghai for financing purposes. On the back of this activity, there's been a lot of issuance of RMB-denominated LCs, which then get discounted offshore by banks."

STEPHEN JEN > A REALITY CHECK FOR EMERGING MARKETS

Are things a little too good to be true in emerging markets? SLJ Partners' Stephen Jen thinks so, and warns that healthy GDP figures are not telling the whole story of what lies beneath. **Saima Farooqi** reports

The old adage that when the US sneezes the rest of the world catches a cold might be politically incorrect to say these days. But if a peak in risk asset pricing was really reached the day after the US Federal Reserve announced a third round of quantitative easing on September 13, arguably, we're all about to get very sick.

At least this is the thinking of Stephen Jens, co-portfolio manager at SLJ Partners in London, who defiantly claims that by buying into the façade of emerging markets independence, investors are in for a serious shock in the not-so-distant future. He predicts the next phase of the US financial crisis will extend beyond the eurozone public sector, and hit at the heart of emerging market fundamentals, specifically that of Brazil, Russia, India and China (Brics).

> "The risk is **rising**, and not just in Asia but elsewhere too"
>
> **STEPHEN JEN, SLJ PARTNERS**

Underlying his theory is the quality of credit going into the emerging markets not just post-2008 – which he says reflects capital being repelled from developed markets – but also pre-crisis. "We think a good part of the rise of the Brics was more beta than alpha and that people had probably given the Brics too much credit. Had it not been for a US consumer that was consuming in an irresponsible and unsustainable manner, it would have been very difficult for emerging markets to have risen the way they have," says Jens.

Signalling that a shake-up is due, Jens points to the fact that the Asian credit cycle has continued uninterrupted for more than 15 years. "The risk is rising, and not just in Asia but elsewhere too. You travel to all these countries and things are a little too good to be true. Sometimes you hear stories the same as you used to hear in 1996," he says. "We think potential growth is going to decelerate in EM and people will come to realise there has been a lot of beta rather than alpha in EM."

While he does not suspect problems on the scale of the Asian financial crisis of 1997–1999, Jens says there is already evidence of crisis-like price action as a consequence of the increased momentum of capital inflows to the emerging markets post-crisis. "Look at South Africa; Brazil earlier this year; how India could weaken so rapidly. There are more and more currencies that can travel a big distance without there being a crisis," says Jens. "Nobody will say Brazil went through a crisis, but the currency moved by 20% [this year]."

He explains that with a bigger fire burning in Europe, big price movements in EM might not appear as threatening. Chiefly, he argues, that after taking 10 years for markets to embrace the EM story, it will take a while for them to then start questioning it. "It's not politically correct to question EM, it's more so to question developed markets, but the reality is that beyond the façade, there are still a lot of

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STEPHEN JEN, SLJ PARTNERS

structural weaknesses. Infrastructure, the rule of law – a lot of things that have taken decades if not centuries for developed countries to layer and build over time on a trial and error basis haven't been done in many EM economies. So while they may appear to be muscular on a GDP perspective, if you take other measures you can very quickly come to a different conclusion," says Jens.

He cites the fact that Chinese A shares (shares in mainland Chinese companies listed on Chinese exchanges) are substantially lower than they were 10 years ago, while the economy has expanded 10-fold during the same time. "It's the lack of respect for shareholder value, rule of law, transparency, governance of corporation. Things like that are intangibles, they are subjective and qualitative," says Jens. "But there is one measure that's more objective and quantitative, that can be measured across countries, and that's GDP. Everyone is focused on GDP and they are mesmerised by the rise of the yuan because of GDP, they talk about the transfer of power from the West to the East.

But in terms of policies, when the Fed makes a decision, everybody in the world trembles. When Singapore makes a decision, nobody notices," says Jens. "This discrepancy of the real economy measured by GDP and everything else not easily measurable is really at the heart of the problem in the world now."

He adds that emerging markets have also failed to generate enough supply of local currency assets to match the rise of their real economies. "So you have a mismatch in the world where the West still commands and monopolises the supply of financial assets and therefore policies, and the East has grown, but they have not been able to do this in a balanced manner," he says.

The immediate implication is that the fund manager has become sceptical about EM currencies, although trading the view in markets not reflecting fundamentals is challenging. "Shorting them is trickier, but the reward is there as well," says Jens. "We have been long USD/BRL since 1.70 and USD/ZAR is another example. USD/INR has done a roundtrip."

With the performance of EM disappointing relative to developed markets this year, Jens predicts a reversal of fortunes for the beta-based funds that have fared so well in 2012. "The Sharpe ratio measures are just outrageous. If you look at the Sharpe ratio of equity returns, excess returns over and above risk-free assets, from 1928 until now, the average has been about 0.37. Warren Buffet has generated a career Sharpe ratio of a shade under 0.7, so 0.67," says Jens. "This year, the Sharpe ratio of equities was 1.6 and the average Sharpe ratio for the past year has been about 0. So there is an argument here that, yes, beta funds have done well and better than alpha-based funds so far this year, but we'll see what happens next year. Statistically it just doesn't make sense for this to continue."

He says much of the beta was generated from a culmination of a lot of QE aggression from three G-3 central banks. "The peak in risk asset prices was set on September 14, the day after QE3 was announced and everything is lower. So we'll see how effective the Fed can be in just inflating nominal prices unless the real economy validates what they have done," says Jens. "Our view is that a lot had already been priced in, so it's not that if the real economic fundamentals improve, assets should rally further – they are just meeting the high expectations. And if the recovery is not fast enough then we have a problem."

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