Forex: Yields vs. risk

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You do not need to be a currency trader to realize that 2008-09 was characterized by the inverse relation between the dollar and equity indexes. Equities in G-10 nations and most developed emerging markets tended to gain during dollar weakness as the lower yielding U.S. currency enabled portfolio managers to fund the global carry trade with cheaper financing.

Throughout this period, falling equities (risk aversion) proved to be the only way for the dollar to recover, as partial unwinding of long positions in risk assets (stocks, commodities and higher-yielding currencies) shifted cash back into the greenback.

But all established relationships and correlations in financial markets must dissipate and ultimately break. The key for traders is not only to notice these changes, but also to understand the reasons behind them.

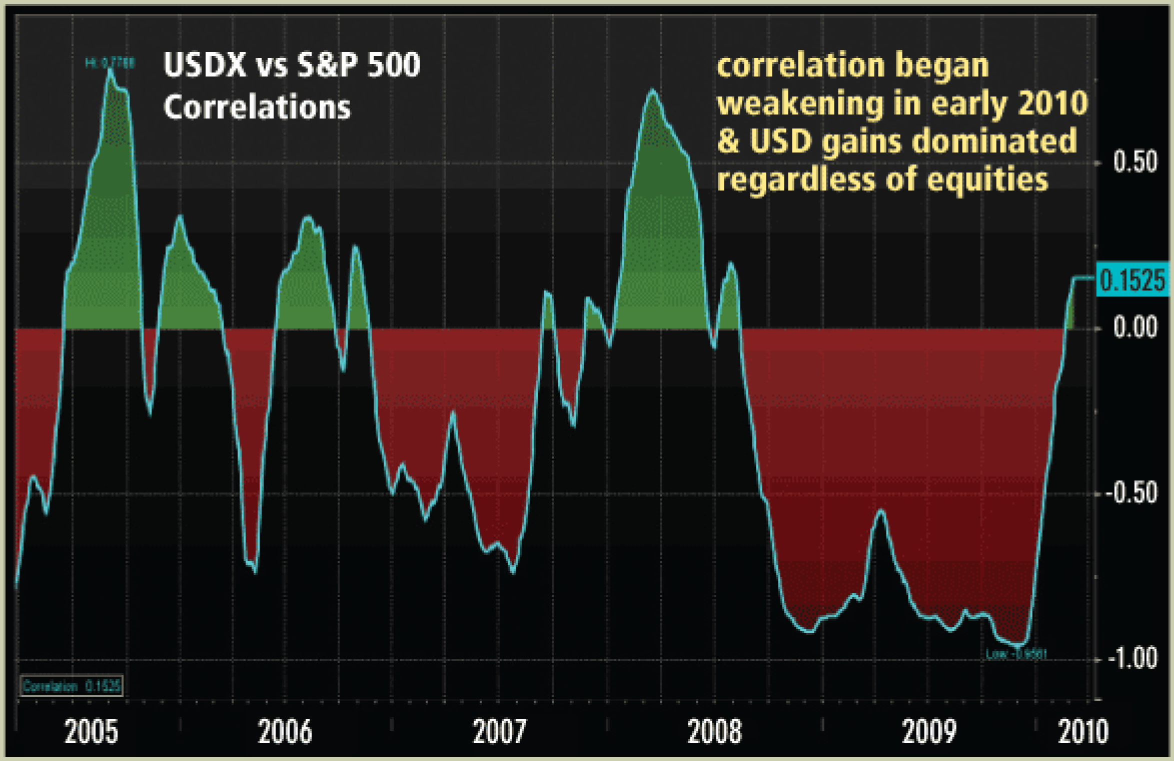
MARKET LINKS

The shifting correlation between the U.S. dollar index and the S&P 500 is illustrated in “Green with envy”. Note how the relationship became highly inverted in September-October 2008, coinciding with the accelerating sell-off in U.S. and global equities. The sell-off also coincided with a rapid unwinding of long gold and oil positions, prompting swift reduction in dollar short positions.
Forced deleveraging and margin calls played a key role in the dollar’s rebound.

But as most equity indexes started to bottom out and the dollar peaked in March 2009, global asset managers grew in confidence and so did fresh longs in equities, commodities and the risk currencies (Australian dollar, Canadian dollar, New Zealand dollar, euro, British pound). Fund managers tapped in their cash reserves (primarily denominated in dollars) and put them to work, while the Federal Reserve added liquidity to the financial system by injecting up to $2.3 trillion of financial assets.

GREEN WITH ENVY

The relationship between the dollar and S&P 500 became strongly inverted during the global sell-off in the equity markets.



Source: Bloomberg

“Green with envy” shows the negative correlation between dollar index and S&P 500 holding at a strong -0.90 during the de-leveraging period from October 2008 to March 2009. Once equities picked up the buying pace in April 2009, the negative correlation intensified into December 2009.

The relationship became one of the most dependable dynamics in financial markets, especially in August 2009 when the dollar-denominated London Interbank Offer Rate (Libor) fell below its yen counterpart for the first time ever. This meant that traders could borrow in dollars at even cheaper levels than in Japanese yen to finance their speculation in higher-yielding investments. The honeymoon of the dollar-carry trade went on for an additional four months, until things began to change. The chart shows the inverse relationship peaked out at an almost perfectly correlated -0.96 in mid-December after which it began to fade. By mid-February, the correlation dissolved to an irrelevant +0.01.

RELATIONSHIP BREAKDOWN

So what led to the end of the correlation? Year-end portfolio rebalancing prompted traders to reduce some of their dollar-shorts in December. But there were three crucial events leading to the reversal of dollar negativity: the Nov. 27 announcement by Dubai asking for a six-month moratorium of $5 billion in debt; an unexpectedly strong U.S. November jobs report (released on Dec. 4); and a triple downgrade assault of Greece's credit rating (Fitch on Dec. 8, S&P on Dec. 17 and Moody's on Dec. 22).

These fundamental catalysts not only spurred safe-haven buying of the dollar, but also led to a rapid exit in the euro. Speculative commitments of euro contracts against the dollar at CME Group tumbled from a net long balance of 22,151 contracts in the week of Dec. 1 to a net short balance of 33,797 contracts in the final week of 2009.

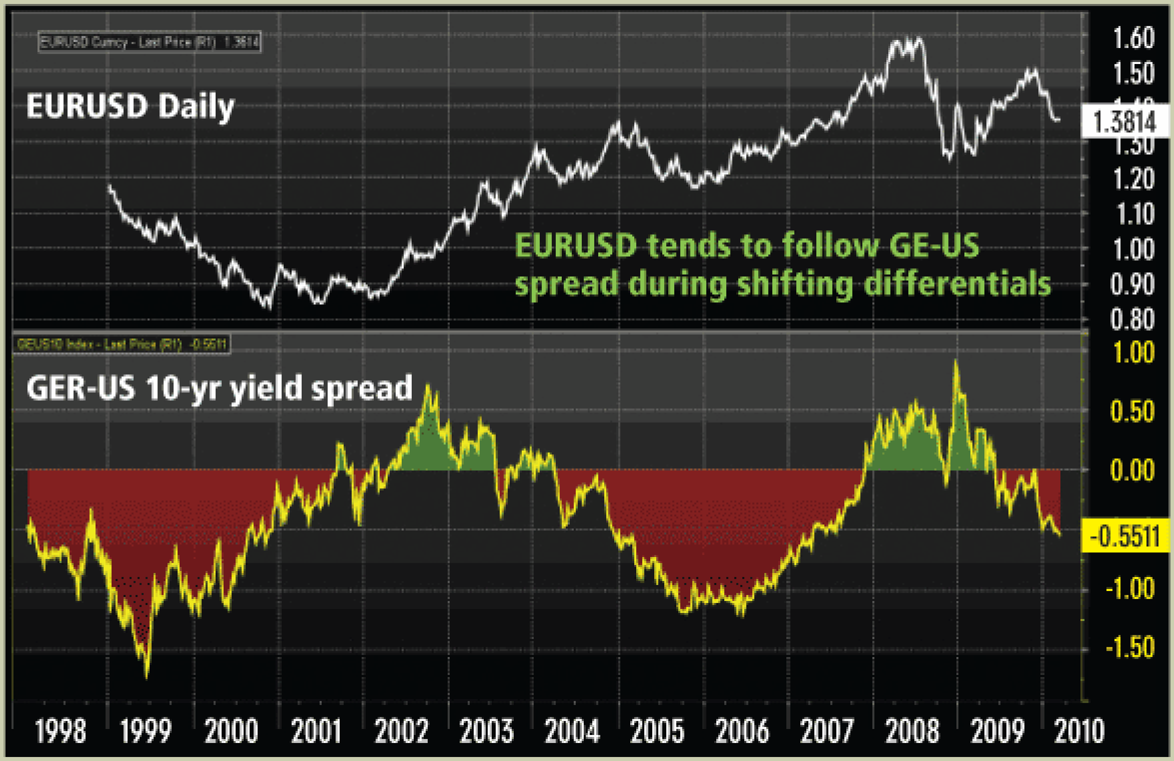
Although the once strong negative correlation between the dollar and stocks subsided, the implications remained significantly present. In mid-January, the combination of deteriorating fiscal Eurozone conditions and hawkish rhetoric from Federal Reserve officials helped trigger key technical developments in EUR/USD.

The dead cross formation was attained when the 50-day moving average fell below the 100-day moving average for the first time since July 2008 (when EUR/USD began an eight-month 20% decline). Conversely, the dollar index (dominated by a 57% weighting in euros) showed a golden cross formation as its 50-day moving average climbed above its 100-day moving average. These important developments confirmed the durability of the new dollar uptrend, prompting new dynamics in the forex-equity relationship.

Consequently, the dollar started to benefit from a win-win situation, whereby falling consolidating equities remained positive for the dollar, while rebounding equities led to neutral dollar positioning or short-lived declines in the U.S. currency. Such was the price interpretation of the new (weaker) correlation between the dollar and equities.

YIELDING BOUNTY

When the dollar/equity relationship began to fade, we had to look elsewhere for intermarket influences. They were found in the German-U.S. yield spread.



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YIELD SPREADS BACK IN THE GAME

As the relationship between forex and equities fades, the role of yield differentials could be strongly back in play, especially for the high profile EUR/USD rate. (The EUR/USD accounts for more than 23% of total daily turnover in spot forex trading.) “Yielding bounty” (above) illustrates the improving relationship between the German and U.S. 10-year yield spread and the EUR/USD exchange rate.

Note how the German-U.S. yield spread (German yield minus U.S. yield) becomes increasingly correlated with the EUR/USD rate, whereby a deteriorating German-U.S. spread becomes negative for EUR/USD. And, you guessed it, the yield spread became more relevant in explaining EUR/USD movements at the same time the relationship between dollar and equities started to fade — that is, December 2009.

Is this a coincidence? No. We mentioned how the combination of the unexpectedly positive U.S. jobs report and deteriorating fiscal conditions in the Eurozone conspired to drive down the German-U.S. yield differential to a two-1/2 year low of -0.50%. Currency traders do not always pay attention to yield spreads, but when the dynamics in both currencies are tipping onto the same side of the balance, the spread escalates and forex traders have no choice but to notice.

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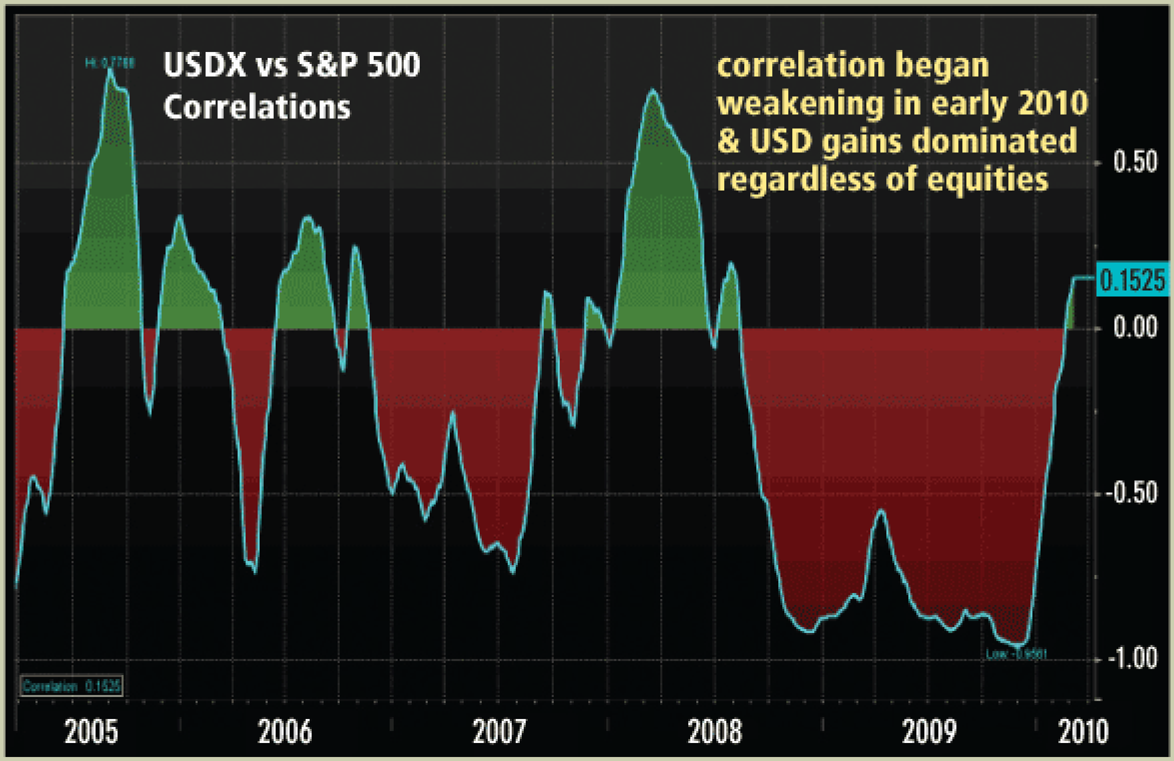

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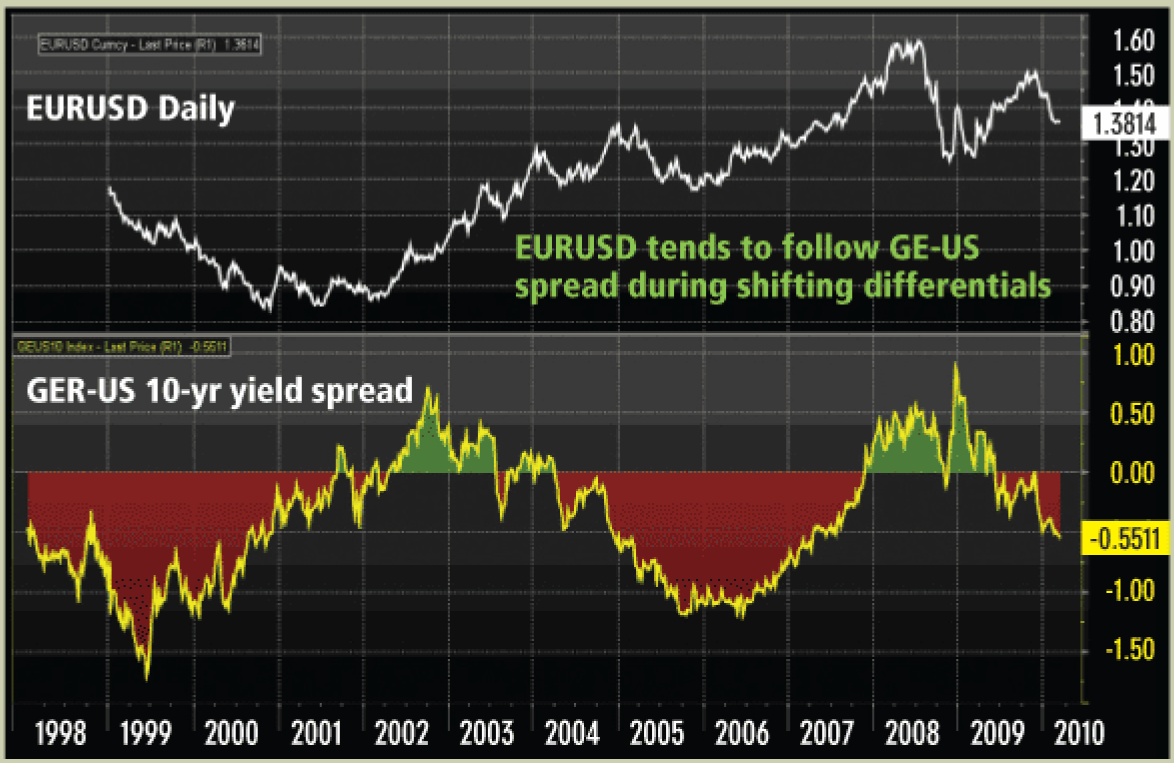

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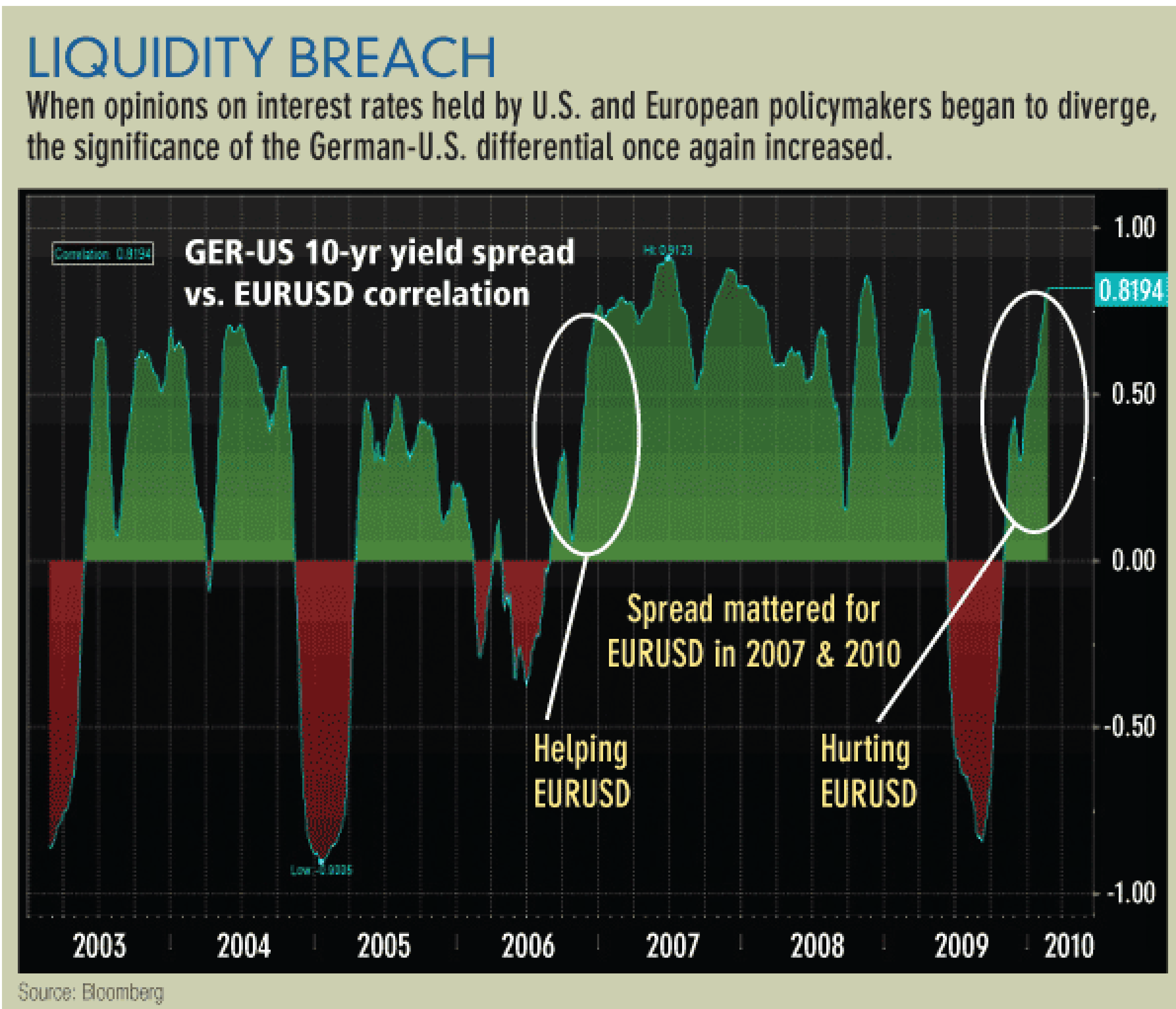
DIVERGENT VIEWS

One way to better grasp the improving correlation between yield spreads and the EUR/USD is shown in “Liquidity breach, ”which highlights the actual correlation between the German-U.S. differential and exchange rate.

Note how the impact of yield spreads grew especially relevant (highly correlated) in January 2010 when members of the Federal Open Market Committee started to voice hawkish concerns, favoring reduced liquidity. That was in contrast to the European Central Bank, which was expected to maintain generous liquidity (if not add more) to alleviate the risk of a liquidity shock stemming from any worsening of conditions in Greece and Portugal.



The February increase in the U.S. discount rate, the first since 2006, was largely seen as a prelude to higher interest rates in general. But even if the more relevant Fed Funds rate target remained unchanged into the

rest of the year at 0-0.25%, traders reasoned the yield differential remained well superior to that in the Eurozone.
Traders who are not well versed in the matters of recent fundamentals can simply relate “Liquidity breach” to “Yielding bounty” to reconcile correlation shifts to turnarounds in spreads. One example is how “Liquidity breach” illustrates the rise in correlation from late 2006 into most of 2007. Looking at this period in “Yielding bounty,” we find the German-U.S. differential has recovered more than 120 basis points from its lows of summer 2006 to neutral (0.0) in 2007.

Currency traders capitalized on this euro-positive development as German yields had nowhere to go but up. Fundamentally, summer 2006 marked the end of the Fed’s two-year tightening cycle in contrast to the European Central Bank, whose tightening cycle did not begin until May 2005 and extended into 2008, well after the Fed had ceased raising interest rates.

This contrasting picture was appropriately captured by an improving German-U.S. differential and a rising EUR/USD, hence a rising correlation between the two variables. Today, the correlation is once again picking up on the heels of a deteriorating German-U.S. yield differential and a falling EUR/USD rate.

Considering past cycles in the interrelationship between German-U.S. spreads and EUR/USD, expect the spread to near -100 basis points by mid-second quarter from the current -0.50 bps, thereby increasing the risk and dragging EUR/USD down to $1.28. The fundamental catalysts for this forecast are not only driven by contrasting dynamics (Fed hawkishness and ECB dovishness due to Eurozone fiscal woes), but also by the escalating risks to global risk appetite (excessive Chinese tightening, resurfacing debt crisis in Dubai, political uncertainty in the United States).

The U.S. fiscal situation is by no means fixed, but the immediacy of currency flows in a risk-averse environment and contrasting yield dynamics are likely to take precedence in favor of the greenback.

Ashraf Laidi is chief strategist at CMC Markets, author of “Currency Trading and Intermarket Analysis” and founder of www.AshrafLaidi.com.