

Currency Strategy Section 3

Ops Notes

To follow is section **three** of our *Ops Notes* on Callum Henderson's [Currency Strategy](#). In case you missed our previous *Notes*, here is [section 1](#) and [section 2](#).

Keep in mind, these *Ops Notes* serve as a great reference for those who already have a foundation in currency theory and application. This is pretty advanced stuff. In the future, we'll take each of these sections and dive deeper via separate *Vault* pieces.

Table Of Contents

3.1.1 Short-Term Flow Models.....	2
3.1.2 Medium-Term Flow Models.....	3
3.1.3 Option Flow/Sentiment Models.....	4
3.2 Speculative and Non-Speculative Flows.....	5
5.5 The Real World Relevance of the Exchange Rate Regime.....	6

Chapter 3: Flow - Tracking The Animal Spirits

The subject of this chapter deals specifically with the concept of “flow”, and therefore it is the inefficiency of market information that we are interested in here. If we accept that market information is imperfect, that not all information is available to all at the same time and therefore that the price does not reflect all information, then we must try and determine two things:

1. What specific types of information are “in the price” at any one time?
2. What types of information are important for price movement on a sustained basis?

3.1.1 Short-Term Flow Models

The IMM Commitments of Traders Report

1. The weekly IMM Commitments of Traders report collates trades made in currency futures contracts through the IMM trading pit in Chicago by various types of accounts. For our purposes, the most useful type of account that we are interested in is what the IMM euphemistically calls “non-commercial accounts”. In layman’s terms, this means speculators or accounts that trade currencies on their own with no attached underlying asset.

Table 3.1 IMM Commitments of Traders (non-commercial accounts) as of November 20, 2001

	EUR	JPY	CHF	GBP	CAD	AUD	MXN
Gross longs	17,899	13,491	8,473	3,162	3,288	3,729	16,393
Gross shorts	18,185	32,377	8,234	9,220	28,663	428	1,064
Net position	-286	-18,886	+239	-6,058	-25,375	+3,301	+15,329
Net position from prior week	+484	-4,231	+5,219	+1,755	-28,089	+12	+14,322
Five-year high (longs)	31,666 (28/08/01)	67,229 (08/31/99)	48,332 (10/19/99)	48,014 (10/19/99)	46,780 (11/12/96)	20,859 (05/11/99)	12,641 (03/20/01)
Five-year high (shorts)	34,328 (02/01/00)	69,715 (05/18/99)	54,553 (05/04/99)	43,767 (07/13/99)	41,327 (10/17/00)	11,484 (08/31/99)	4,159 (07/01/97)

2. As an analyst or as a currency market practitioner such as a corporation or an investor, one can use this information in the following ways:
 - **Analyst** — Review the flow and fundamental economic data to come up with an overall picture of the short-term flow and fundamental dynamics in the dollar–yen exchange rate and thus the ability or not of the prevailing trend to continue.
 - **Trader** — As the prevailing trend continues and increases in the dollar–yen exchange rate, position to take advantage of the reversal when it comes.
 - **Investor** — Use the combination of flow and fundamental data as a guide in determining yen exposure and hedging policy with regard to that exposure.
 - **Corporation** — Use the combination of flow and fundamental data as a guide for short-term hedging policy.

3.1.2 Medium-Term Flow Models

The US Treasury TIC (Treasury International Centre) Report

1. The second way we can approach this general issue of flow analysis is to look at the specific capital flows going into equity and fixed income markets. Here the availability and quality of the data vary widely. For instance, there are data reports focusing on what amounts of money are going into mutual funds. From this, we can of course break those mutual funds down into investment types — equity or fixed income, the destination of the investment and so forth.
 - a. Cross-border flows are also driven by fundamental considerations such as:
 - i. Portfolio diversification
 - ii. Maximizing total returns
 - iii. Specific investor risk tolerance levels
2. When it comes to investment, these are important incentives and guidelines. Our purpose here is to track not incentives but actions. Thus in our first example we look at the US Treasury’s “TIC” report, which examines portfolio flows by non-residents of the US going into the US equity and fixed income markets. The usefulness of this report is in explaining and confirming medium-term flow trends either in favour or against the US dollar in this case.
3. Looking at the regional breakdown, the largest swing in favour of Treasuries was by European accounts, though the largest absolute buying was by Latin American/Caribbean accounts, which are usually dominated by offshore hedge funds.
 - a. For the US dollar to trend lower requires that inflows to US assets also trend lower, and as of this report those conditions had not been met.
 - b. Thus, comparing the spot price action in dollar exchange rates to the table, we see a flow confirmation of what many in the market called the “surprising” resilience of the US dollar.
 - c. Subsequent TIC reports from the US Treasury confirmed the US dollar strength through early December, despite the accelerated deterioration in US economic fundamentals. The flow picture thus explained the strength of the US dollar where just using the fundamental picture did not.

Table 3.2 US Treasury "TIC" (Treasury International Capital) Movement Data as of August 2001

Net foreign inflows into long-term US assets (USD billions)						
Asset class	Monthly net flows			Quarterly average net flows		
	August	July	June	Q2-01	Q1-01	Q4-00
Treasuries	4.40	-11.49	-3.45	-4.69	0.97	-8.96
Agencies	11.91	12.48	16.91	13.11	14.09	15.49
Corporates	12.71	14.37	15.56	23.97	23.28	17.15
Total fixed income	29.02	15.35	29.02	32.39	38.35	23.68
Stocks	8.59	11.48	10.44	11.46	13.89	12.17
Total US assets	37.61	26.82	39.46	43.85	52.24	35.85

Asset class	Europe		Asia		Latin America/Caribbean	
	August	July	August	July	August	July
Treasuries	0.31	-8.22	0.58	-3.94	3.72	1.89
Agencies	1.92	4.60	4.83	6.80	5.55	1.02
Corporates	7.64	7.31	2.72	1.67	3.40	5.21
Total fixed income	9.86	3.68	8.12	4.53	12.67	8.12
Stocks	9.06	6.70	1.44	3.73	-3.06	0.07
Total US assets	18.92	10.39	9.57	8.26	9.61	8.18

The IMF Quarterly Report on Emerging Market Financing

1. Within the emerging markets, the International Monetary Fund produces a quarterly report on asset market-related flows, which is available on the IMF website.
 - a. As an example of this, we can take a look at the Q3, 2001 report which appeared to confirm that the events of September 11 significantly increased investor uncertainty and reduced risk tolerance at a time when market concerns were already high about global slowing, emerging market fundamentals and the potential for credit events in particular emerging markets. There was an across-the-board sell off of emerging market assets and at least initially an ensuing drought in new bond issuance.

3.1.3 Option Flow/Sentiment Models

Risk Reversals

1. In addition to flow indicators, there are also sentiment indicators. These do not reflect flows directly going through the currency market, but more indirectly by representing the market's bias towards exchange rates.
 - a. A very useful indicator of market sentiment or "skew" is the option risk reversal.

- a. Such currency cycles are not of necessity timed with the economic cycle. It depends why they start.
- b. After the bubble bursts, there is usually a period of consolidation and reversal; the longer the initial trend or cycle, the longer in turn the reversal.
- c. Trying to determine the top is for the most part impossible. It is more important to be able to understand the cyclical nature of the currency markets and to be able to plan accordingly ahead of that cycle ending.
- d. **Nominal interest rates are not the primary incentive for speculative capital flow, never have been and never will be. The exchange rate itself is the incentive. This is an important realization.**

Chapter 5: Exchange Rate Regimes — Fixed or Floating?

5.5 The Real World Relevance of the Exchange Rate Regime

1. Currency market practitioners within fixed or pegged exchange rate regimes need to consider the following points:
 - a. **Does the currency peg contribute to economic stability or instability?** Currency pegs can provide monetary credibility by using the exchange rate to force inflation lower, but they can also attract substantial and potentially destabilizing capital flows.
 - b. **To what extent is a country open to global capital flows?** If a country allows high capital mobility, a currency peg may not be appropriate unless it abandons monetary independence and adopts the hardest of pegs, such as a currency board. Capital flows are less easily anticipated than trade flows, but much more quickly reversed.
 - c. **Is the currency pegged at the correct level?** This has been an important question not just for emerging but also for developed economies, notably with the ERM. Currency market practitioners should use the lessons learned in Chapters 1 and 2 to judge whether the currency peg level is appropriate. Corporations with subsidiaries in the countries concerned are well placed to do this given local pricing and demand knowledge.
 - d. **Are there clear patterns of distress ahead of a peg's collapse?** Currency market practitioners can use the CEMC model as a test of market conditions.
 - e. **What do you do if a currency peg collapse appears imminent?** The trick of course is to try to anticipate this before the rest of the financial market does.
 - i. Remember the lessons of the Asian crisis, where the preceding depreciations of the yen and yuan helped make Asian currencies uncompetitive. Remember also that PPP and REER may not be useful

- over the short term, but they are useful over a long-term horizon in suggesting currency over- or undervaluation.
- ii. Also, don't ignore common sense! Did it make sense in 1998 for Russia, a country which was going cap in hand to the IMF for more money, to have some of the most expensive residential property in the world in Moscow? Every boom is characterized by incidents and anecdotes, which after the bubble bursts seem acts not of folly but of sheer lunacy. Look for signs of these.
- f. **Currency risk may not be the only consideration.** Within the emerging markets in particular, there may be other important considerations as well, such as convertibility and liquidity risk. Is a currency convertible on the capital account?
- i. Also, emerging market currencies are by nature much less liquid than those of developed economies. While USD200–300 billion may go through the Euro–dollar exchange rate every day (spot, forward, swaps and options), only USD10 billion goes through the South African rand, the second most liquid emerging market currency in the world behind the Singapore dollar.
 - ii. Finally, there is also political risk, which is a more important consideration in emerging markets.
- g. **Hedge when the market doesn't want to (and neither do you!).** When market conditions are benign is clearly when liquidity is best and pricing potentially most favourable. This is also the best time to hedge currency risk, particularly if one is potentially concerned about the sustainability of the currency regime.
- i. However, precisely because market conditions are benign this is not the time when markets are looking to hedge currency risk. The temptation to stay with the pack (or rather the flock!) should be strenuously avoided. If valuation considerations suggest a currency peg may be overvalued, hedging should be seriously considered.
 - ii. It is a question of cost vs. risk rather than risk vs. reward. For the cost of an option of around 1–2%, you hedge yourself against the potential risk of a devaluation of around 30–40%. Granted, options are not available in some markets, but in all markets there are benign and also malign market conditions and seasoned currency market practitioners should be able to tell the difference and take the opportunity when it is at hand.
- h. **When the market wants to hedge currency risk it is too late!** There is no use complaining about adverse pricing and liquidity developments when the market is scrambling to hedge currency risk. By that time, forwards have screamed higher and option risk reversals have blown out. Take the opportunity of favourable pricing and market conditions when it presents itself, based on valuation considerations.

2. Most of the ideas presented in the bullet points above focus largely on pegged or fixed exchange rate regimes. A different set of considerations may be required when looking at freely floating exchange rates:
 - a. **Freely floating exchange rates imply high capital mobility.** The two tend to go together. The combination should mean in theory that capital flow reversals are transmitted through the exchange rate more efficiently and with less volatility.
 - b. **Freely floating exchange rates can however still see major bouts of volatility.** While they tend to be rarer these days, particularly if there are no major economic imbalances involved, freely floating exchange rates can also see significant bouts of volatility. This is not just the case within the emerging but also within the developed markets. A case in point is the collapse in the dollar–yen exchange rate in the autumn of 1998 from around 135 to 114 in the space of 36 hours. Speculative trends always reverse and when they reverse they tend to do so violently.
 - c. **As pegged exchange rates may be temporary, so freely floating rates are no panacea.** Freely floating exchange rates also exact costs and involve risks on the part of the currency market practitioner in seeking to manage currency risk.

Stay tuned for part 4!