A world of opportunity

The foreign exchange market offers exciting opportunities for traders, but how will the complex global economic picture impact on currencies? Shares asked three experts to offer their views

Alex Poole

What market is global, open around the clock and worth more than $3 trillion daily? The answer is foreign exchange (FX), an exciting but visceral market that moves lightning fast and offers traders muscular leverage with unrivalled liquidity.

The FX market is likely to be on investors' radars for a variety of reasons. Many global companies listed in London operate in markets throughout the world, with currency fluctuations having a significant impact on their earnings. More directly the rise of easy-access trading platforms has opened up the FX market to private traders, who are attracted by the volatility, liquidity and sheer scope of this market. Whether the stock market is falling, rising or trading flat – or even when liquidity is ebbing out of the credit markets – the world's currencies will always trade at different rates to each other, creating a natural market that is brimming with trading opportunities.

Another key characteristic of FX for anyone who follows the financial markets is that it is inextricably linked with macroeconomic developments, and we are certainly not short of those at the moment. Quantitative easing (QE) is a prime example of how events in national economies can shape the FX landscape, as Jonathan Assia, chief executive officer (CEO) of FX trading platform eToro, explains. 'Although the US and the UK have executed large-scale QE they are not alone in the process,' says Assia. 'Japan has also executed a large-scale QE programme and in the Eurozone the distressed credit could mean the European Central Bank (ECB) might just be forced to act in the form of QE to revive the economy. This means the relative disadvantage of the dollar and the pound could narrow.'

As for what QE means for the UK and US currencies, Assia believes it is a case of business as usual for now. 'At least in the mid-term, both the dollar and sterling will maintain their classic rule in the FX arena,' he predicts. 'This means the dollar will continue its rule as a haven and gain whenever fears for growth loom and sterling will be a pro-growth currency, gaining when optimism is spurred.

'However as the crisis draws close to its resolution and credit markets recover, the countries which have used QE to pull themselves out of the crisis might find themselves with stable growth but softer currencies.'

Richard Wiltshire, chief dealer of foreign exchange at ETX Capital, urges caution in terms of predictions until the QE process has run its course and the impact on the real economy can be assessed. 'We are a long way into the QE programme aimed at pumping money into the UK economy, but I doubt we yet can draw any conclusions about where it will ultimately take us. The governor of the Bank Of England (BoE), Mervyn King, has noted the fall in gilt yields prompted by QE purchases to date, but said it was far too early to judge the impact of the QE program itself – suggesting it would take six to nine months before the impact on the real economy could be properly assessed.

'I would suggest sterling will struggle on any rallies as QE operations in the UK continue or are extended in time and scale. The slightly more bullish sentiment towards risk witnessed in the last few days is and will remain extremely vulnerable and price action suggests investors will jump back in to the dollar at the first signs of risk aversion.

'Those who have been largely unconcerned about the QE process have been to some degree vindicated by the fact the dollar has been fairly stable since this process began in October. The same cannot be said of sterling, however, which weakened rapidly once it became clear the BoE would pursue a strategy similar to that of US Federal Reserve Bank (Fed). I also believe the euro will come under pressure as the ECB is compelled to act more forcibly.'

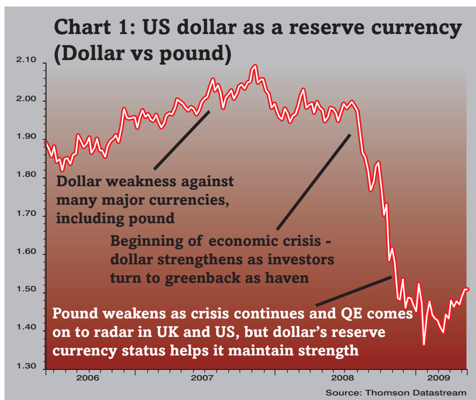

Chart 1: US dollar as a reserve currency (Dollar vs pound)

The impact of low rates

Of course, QE as a tool has been used by economies in a very low or zero-bound interest rate environment, so what are the implications if rates are held at their current levels in the UK and US? Marilyn McDonald, vice president, customer experience at IBFX, feels low rates will help prevent ailing economies becoming any worse. 'Policy makers need to be watchful and continue to support the struggling economies,' argues McDonald. 'Pulling back at this stage may lead to deflation and weak growth rates for the foreseeable future. Holding interest rates low is widely seen as necessary to ensure against a deep economic depression.'

Assia agrees rates look likely to remain low for the time being, but warns of inflationary pressures in the US and UK once demand recovers. 'The consensus for a prolonged period of ultra-low interest rates in the US and England is well presented and is strongly based on the latest comments from both the Fed and the BoE, outlining their willingness to keep rates low for as long as necessary,' says Assia. 'With the latest deflation pressures, credit distress and expanding unemployment a long period of low interest rates seems very probable.

'The possible implications will emerge when demand stabilises. Then the US and UK economies – which have kept their interest rates close to zero for a long period and executed massive QE – will be greatly exposed to inflationary pressures. In such a scenario the Fed and BoE will be forced to hike rates aggressively, which will be a burden on both economies.'

A changing of the guard?

One news announcement that made waves in the FX markets recently was China's suggestion for the creation of a new currency to replace the dollar as the world's standard (see Chart 1). The call, made in March by China's central bank governor Zhou Xiaochuan, might have got tongues wagging but Assia is cool on its prospects – especially when weighed against the reality of China's recent actions. 'The latest statement from Chinese officials on 11 May that China will continue to purchase US treasuries puts its suggestion for an alternative reserve currency to the dollar into perspective,' says Assia. 'The statement outlines China still intends to keep dollar-linked assets in its portfolio and leaves no question on its intention to hold the dollar currency and US debt. The Chinese suggestion therefore seems more an intellectual teaser to the world financial system rather than a serious move out of the dollar.

'As long as China has a regulated exchange rate, its trade surplus in dollars will continue to be large and the Chinese government will have large dollar reserves which forces China to hold US government bonds. China's real move out of the dollar will occur when the Chinese yuan will be a free-traded currency. This will greatly appreciate the yuan and will reduce its trade surplus, and the result will be a substantial reduction of Chinese holdings in the US debt.'

McDonald agrees it is unlikely China will make any serious moves out the dollar, and backs Assia's view developments with the Yuan itself are key moving forward. 'In the short term I think China won't be replacing the US dollar with the Yuan, says McDonald. 'They simply hold too much of their reserves in US dollars to risk destabilising the currency. However they are taking some action to strengthen their currency's standing with the International Monetary Fund (IMF)'.

Dollar negatives

Whatever China's economic strategy, a major factor affecting the dollar's ability to maintain its status as the world's reserve currency is of course the performance of the greenback itself. 'There have been some "dollar negative" developments beginning to come back in to play and combat the safe haven status rally,' says Wiltshire. 'A changing capital flow situation is likely to put pressure on the greenback and as Fed policy becomes consistent with a weaker currency the dollar could lose more of its shine and weaken as market confidence creeps back in.

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'Some commentators have even suggested US fiscal irresponsibility is jeopardizing the country's AAA ratings, while a Japanese opposition finance spokesperson was recently reported as saying that the opposition would refuse to buy US dollar denominated US bonds in the event his party would form the next government.

'If taken seriously, such sentiment could be seen as a tangible threat to the dollar, and have a knock-on effect on its place as the reserve currency of choice.'

Lets get physical

A debate has also emerged surrounding the impact on the dollar of China's supposed buying of physical commodities rather than US treasuries and disaffection with dollar-denominated assets. Assia paints an interesting potential scenario here, which includes a significant impact on commodity currencies popular with FX traders: 'Supposing the Chinese start to hedge their reserves against dollar weakness we must presume the risk aversion trade in the market will be depressed, since only then will the dollar be at strong risk of depreciating.

'In such a scenario the strong Chinese demand for commodities when risk aversion is depressed will weaken the dollar sharply. The dollar will then be expected to depreciate in the most intensive way against China's main commodity partners such as Australia and New Zealand, which will enjoy strong growth and relative strength in comparison with other economies. However in a case risk aversion returns to the arena the Chinese demand for commodities will just be a side dish in the currency trade, with the dollar potentially regaining strength.'

Staying in the eastern hemisphere, one potential strategy for FX traders is to view Japan's weak economy as an opportunity to be short of the yen, though whether this is truly a one-way bet is open to debate, with Assia urging FX traders to consider their time horizon on any yen play. 'For the long-term investor a downward position on the yen could be rewarding,' says Assia. 'However since yen depreciation will largely depend on market stability it could take a while before this downward course can produce substantial gains. We might anticipate the most rewarding downtrend of the yen would be against the commodity currencies of the Asia-pacific – the Australian dollar and the New Zealand dollar.'

McDonald also warns a short yen play may not be as straightforward as it first appears: 'If you look at the chart of USD/JPY (see Chart 2) you can see that the yen has been slowly strengthening since mid-2007.

'Yes, there have been some retracements but the overall trend has been the weakening of the dollar against the yen. In fact, in the week of 11 May the yen strengthened strongly against the dollar.'

Late to the party

Moving the focus back to Europe, some commentators have suggested the euro would be stronger now if the ECB had cut rates more decisively in the last year: 'Hindsight is a wonderful thing, but I believe the euro might be stronger now if the ECB had cut earlier in the game,' says McDonald.

Assia lays the blame for the Eurozone's economic woes squarely with the restricted credit markets. 'A more aggressive ECB rate cut would not be likely to affect the current status of the Eurozone economy,' he argues. 'The affect of low interest rates alone could not rescue the distressed credit markets, which are the real reason for the fast economic deterioration in the Eurozone, which is expected to emerge from the crisis slower than other advanced economies.

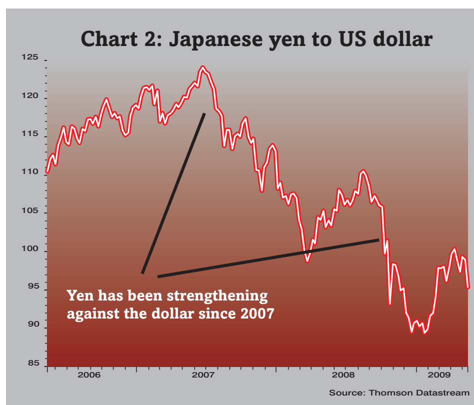
'Until the problems in the European banking system are properly addressed, the euro will be more of a risk currency than a haven. Strength or weakness in the euro is affected by market appetite for risk rather than interest rate differentials, which have been played out already.'

Wiltshire agrees interest rates have already played their part, and points to the scope of QE as a crucial factor for the euro moving forward. 'Axel Weber [ECB council member and head of Germany's central bank] has provided interesting details on the ECB's recently-announced plan to buy covered bonds,' says Wiltshire. 'He said it was not the ECB's goal to simply print money and that the measures were designed to improve market liquidity and financing for firms and banks.

'Most importantly, Weber expressed the view that there is currently no need to expand the asset purchase program into other forms of debt. This seems to contradict the comments from his boss, ECB president Jean-Claude Trichet, who had not ruled out a future expansion of the program to other instruments last week.

'The fact that the ECB has been last joining the QE party may weigh on it in the short term as the actions of the Fed and the BoE, while reactive, were viewed as timely, while those of the ECB may prove to be a little to slow.

'The fact the ECB held rates artificially high – in spite of evidence pointing to the contrary – actually helped put a base under it, even contributing to the euro rally just before the turn of the year. I expect the euro's fortunes to depend on how the Eurozone economies manage QE, but ultimately I expect the euro to strengthen against the dollar – particularly later in the year.'



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Negative equity

If the debate surrounding QE and developments in the Eurozone are familiar to any *Shares* readers who follow the big macroeconomic stories, then an FX topic even closer to home is the impact of rising equity markets on the dollar. 'The decline in the US dollar that we have seen over the past few weeks allied to rising stock markets seems to suggest people are shifting assets out of cash into equities,' says Wiltshire. 'Surveys of asset manager weightings have shown record cash holdings by fund managers in the period since the global financial crisis began.

'This perceived shift of asset allocation could gain momentum if investors start diversifying out of bonds as well. It is also worth considering the recent White House budget predictions for the next ten years, as many would argue that they are unrealistic projections for revenue going forward. While there are some legitimate reasons to be dollar negative creeping in, in the short to medium-term at least, our old friend "risk aversion" is still lurking out there somewhere and you ignore him at your peril – he may be on the back foot but he is certainly not down and out yet.'

While Assia agrees rising equity markets will have an impact on the dollar, he counsels against taking a simple inverse relationship for granted, as other factors such as hedging could come into play. 'The dollar is considered to be a haven investment and whenever market fears emerge investors flee to the dollar,' he explains. 'When investors look for high returns they buy equities, riskier currencies and sell the dollar.

'Stock prices could continue to rally for some time without substantial evidence of economic recovery. However, in such an environment investors who are still willing to participate in the equity rally might be propelled to hedge themselves from a downturn with dollar positions. Therefore dollar weakness alongside rising equity prices should not be taken for granted as a re-emergence of dollar strength while stocks continue to rally can not be entirely ruled out.'

Cash and carry

Another strategy that may coming back on to the FX trading radar is the carry trade, driven by an increasing appetite for risk. McDonald feels stability is key for the return of the carry trade to be a realistic prospect: 'The carry trade really depends on price stability in the markets,' she explains. 'The volatility in late 2008 really stood the carry trade on its ear. If we see return to some sort of stability we may see the resurgence of the carry trade, however the dollar's role as a yielding currency will not be reprised unless we see a significant interest change.'

Wiltshire also picks up on the current level of interest rates. 'The carry trade is not currently an issue. For example, interest rate differentials for New Zealand dollar against Japanese yen (NZD/JPY) and Australian dollar against Japanese yen (AUD/JPY) are small at 2.4% and 2.9%

respectively – this compares with more than 7% for the same pairs not so long ago. When kiwi rates were over 8% then "carry" was the game that lots of people wanted to play, but since August 2008 it has taken a place at the back of the queue.'

Assia concurs the low interest rate environment makes the return of carry trade unlikely. 'Carry trades are driven by large interest rate differentials,' he says. 'Since the latest appetite for risk is purely speculative and there are no evident signs of real recovery, interest rates in all advanced economies are expected to remain at record lows for some time to come.'

Commodity currencies

If the carry trade is unlikely to materialise in the near future, one FX story that will be in play is the view traders take on the commodity currencies. In particular, traders will be looking to see whether the two biggest commodity-backed currencies – the Canadian dollar and Australian dollar – will continue to rally.

Assia is keen to make a distinction between the prospects of these two currencies. 'Australia's biggest export and trading partner is China,' he says. 'China's robust demand for commodities alongside Australia's relatively-stable banking system and low sovereign debt will place the Australian economy well on the path of growth. This will further strengthen the Australian dollar and as upward pressure on commodity prices will be more present it would be able to push closer towards the one [US] dollar zone.'

According to Assia, however, Canada is a different story. 'Canada's major export market is the US, making up more than 50% of Canada's total export market,' he points out. 'While demand from China is expected to be robust the demand from the US is not likely to return quickly to high levels. Weak US fundamentals alongside the fragile banking system will make the recovery in demands from the US quite sluggish. Canada will also enjoy the elevated commodity prices but unlike Australia the recovery in the Canadian economy and the appreciation of the Canadian dollar could be a much bumpier ride.'

Wiltshire also highlights the Australian dollar as the best-placed of the commodity currencies. 'The Aussie in particular has a healthy fiscal position and should be flexible for adjustments should the economy weaken further,' he says.

'While many countries are switching on the printing presses to boost activity Australia seems one of the least likely to adopt QE, given the relatively high levels of interest rates at 3% and the ability to ease fiscal policy further if required.'

Keeping up the volume

With the global banking crisis not yet over, FX market watchers have been pleased to see the extent to which volumes have been maintained in the professional FX trading market. Our experts are not surprised by this though: 'Volumes have held up rather well,' says Assia. 'With high risk in equities professional traders have moved increasingly to the FX market to fish for profit opportunities. As long as uncertainty looms FX trading volumes are expected to remain high. When economic stability finally comes, then we might certainly expect a fall in the FX trade volume.'

McDonald's analysis identifies the same pattern: 'When price volatility increases we see a correlating increase in trading volume,' she explains. 'Prices became uncharacteristically volatile in late 2008 and continued through early 2009, and this was reflected in high trading volume. We are however seeing something of a return to normality at this stage.'

Wiltshire completes a consensus on this issue among our experts, pointing to the FX market's resilience in the face of 'anomalies' that affect most other financial markets. 'Volumes in the FX markets are holding up extremely well and FX as an asset class has benefitted from the recent woes in equity and other markets, as it is not susceptible to the anomalies that can affect these markets.

'The FX market is open 24 hours a day for the best part of six days a week and has enough market participants and liquidity providers to ensure markets, which remain relatively stable and efficient.'

North and south

Suitably reassured volumes are holding up well and the FX market remains as liquid as ever, which currencies should FX traders be considering over the medium term, and are any of our experts venturing off the beaten track? Wiltshire looks north and south to some smaller currencies which could make for interesting trading strategies: 'The currencies I feel offer good value for the next few years are the "Scandies" [Scandinavian currencies],' says Wiltshire. 'Expect Norwegian kroner (NOK) and Swedish kronor (SEK) to both perform well and to see increased trading appetite and volumes for these currencies.

'I would also expect to see retail customers increasingly trade the South African rand (ZAR). The risk of QE in the "Scandies" appears to be low, while the sell off of these currencies in the recent crisis seems massively overdone. Fundamentally they seem to be in strong positions, with NOK in particular likely to benefit from any releasing of its significant oil-related wealth.'

McDonald believes the traditional major currency crosses will be very much in play in the coming years, with traders continuing to be attracted by same things they are now – liquidity and favourable spreads. 'The bulk of our trading volume is done on the EUR/USD, with the GBP/USD in second place,' says McDonald. 'These currencies have the most liquidity and some of the tightest spreads, which make them ever-popular with currency traders.'

Away from the erstwhile majors, McDonald points to specific currency pairs offering volatility for traders with an appetite for risk. 'We see a certain segment of our traders gravitate towards highly volatile pairs such as the GBP/JPY or the GBP/CHF,' reveals McDonald. 'In the last six months, the daily average movement of the GBP/CHF was approximately 270 pips and the GBP/JPY was over 300. That sort of volatility is appealing to traders who are extreme risk takers.'

Looking up down under

Assia looks east for his big FX story of the future: 'China is expected to grow strongly in the next decade, with ever-growing demand for commodities. The Australian economy enjoys proximity to China and will be one of the biggest gainers from this growth.

'The substantial exposure of the Australian economy to China is expected to strongly magnify the importance of the Aussie dollar in the FX arena. As demand from China becomes stronger and more consistent we could see the Aussie dollar slowly transforming into a haven currency.'

Such a development would be a major shift in the balance of power among the world's currencies, and Assia's prediction is definitely one to watch. Whatever happens, one thing that is for certain is FX will continue to be a fascinating market offering multiple opportunities for traders and investors. ■