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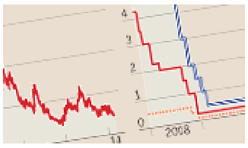
Currency traders mourn loss of volatility

By Delphine Strauss

Political crises and central bank action have played havoc with emerging markets currencies since the start of the year. But for many investors in the foreign exchange market, the bigger problem has been the unnatural calm prevailing in major currency pairs.

Uncertainty over the pace of the US recovery, combined with the steady policy stance of the biggest central banks, has confounded fund managers and driven volatility in developed market currencies to lows barely seen since the "great moderation" that preceded the financial crisis.

Currency volatility



At the start of the year, many were betting that the dollar would gain against both the euro and yen as the Federal Reserve scaled back stimulus while its counterparts were expected to ease policy further. Instead, they have seen weak US data and inaction by both the European Central Bank and Bank of Japan – leading many to cut positions and step aside from the market.

Deutsche Bank's currency volatility index, based on three-month implied volatility in nine major currency pairs, fell this week to its lowest level since December 2012, as did JPMorgan's index of G7 currency volatility.

The lack of direction is proving painful both for speculative investors, for whom volatility creates opportunities to trade, and for institutional investors who tend to look for longer-running trends. Returns at currency funds tracked by the Barclays BTOP FX index are down about 1.7 per cent in the year to date.

"You have days that certainly feel like things are happening and things are moving. Unfortunately it's become quite difficult to put two of those days together and form a trend," says Matthew Cobon, a fund manager at Threadneedle Investments. "The market has had a lot of difficulty this year forming and holding on to positions."

"There have been so many reasons not to get involved," says Neil Staines, head of trading at the ECU Group, a currency manager. "We've seen extended periods of very narrow trading bands in major currencies . . . The question now is what is required for speculative and investment sectors of the FX market to re-engage."

Funds that have failed in recent months have blamed poor returns on the distortions of quantitative easing, and most analysts say that volatility is bound to increase as soon as central banks begin raising interest rates. Investors are "waiting for major divergence in monetary policy cycles", says Chris Turner, strategist at ING.

But some are starting to question whether central bank inaction is sufficient to explain the lack of movement in currencies – and to ask whether a market mired in scandals might be undergoing a more fundamental change in structure.

"It seems clear to us that the currency market is in something of a crisis at the moment," says Steve Barrow, strategist at Standard Bank. He argues that currency turnover and volatility have in the past been fuelled by traders with access to crucial information on order flows, which they used to position their portfolio.

Now regulatory probes into alleged collusion among traders at the biggest dealing banks have led banks to limit instant messaging and traders to clam up. "If currency traders shy away from such 'information trades', for fear of reprisals . . . it seems reasonable to think that currency volatility might fall as well," Mr Barrow says.

If true, this could reinforce a longer-term decline in the trading activity previously generated by spot traders at the dealing banks, whose influence has been waning as clients switch to electronic platforms and as bans on proprietary trading bite.

"The fast money that created some of the short-term volatility as well as probably some of the liquidity, some of that has exited the market," says Paul Lambert, head of currency at Insight Investment.

"There's certainly been a reduction in trading driven by bank dealing desks," Mr Staines says, although he holds that hedge funds have largely filled the gap.

While this could explain a decline in intraday volatility, it would be unlikely to prevent more sustained trends in exchange rates developing as central banks return to business as usual.

For now, currency investors are adapting their strategies to a more difficult market, with some turning to emerging markets as the best source of returns.

But Jane Foley, strategist at Rabobank, notes speculation that by next year, the Bank of England, Federal Reserve and even the Reserve Bank of Australia could be on their way to raising interest rates. “Fast forward to 2015 . . . and it will become a different kettle of fish.”

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