Tracking funding stress in currency markets

April 2020

IN BRIEF

- Currency markets have experienced some of the volatility and unusual pricing dislocations seen in broader asset markets in recent weeks.
- Volatility has risen from the multi-decade lows seen at the start of this year to levels that exceed long-term averages, though generally foreign exchange (FX) volatility has remained well below the extremes seen during the financial crisis.
- While trading costs have increased significantly it has generally remained possible to transact in good size. The most notable area of stress in currency markets has been the divergence of the cost to borrow US dollars via FX forwards compared to short-term secured dollar funding rates, with this difference known as currency basis.
- We look at the reasons why currency basis has widened and the response from central banks to alleviate these funding stresses, while also analysing the impact on currency hedges and potential outlook for the valuation of the dollar through the current coronavirus volatility.

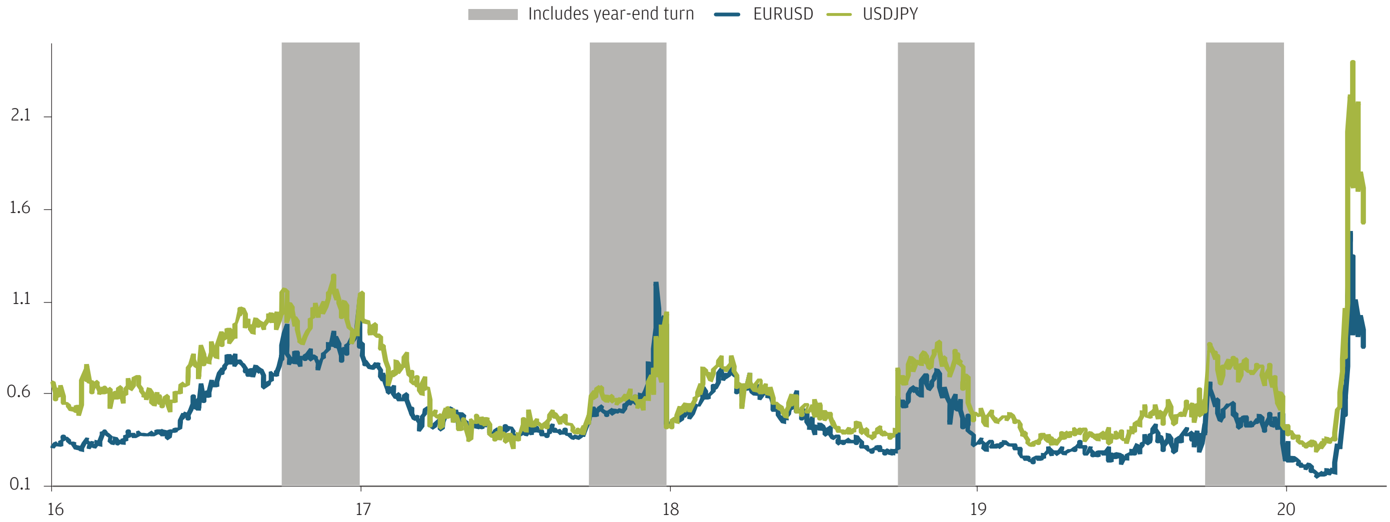
What has happened to currency basis?

Wide and volatile levels of currency basis are an area of poor market function that required and has received a targeted policy response. The sharp move wider in currency basis over the past month has been a function of the economic stresses resulting from the coronavirus outbreak. Demand for US dollars has risen sharply as corporations have drawn down on revolving credit facilities, while other US dollar borrowers have been forced to de-lever. The resulting shortage of US dollars, and balance sheet pressures more broadly, have resulted in severe funding stresses, threatening the efficient functioning of financial markets.

The US Federal Reserve, in conjunction with other central banks, announced an expansion of US dollar swap lines that provide lender-of-last-resort access to US dollar funding for non-US entities. Central banks have also reduced the cost of these dollar swap lines facilities, expanded them to cover the smaller developed markets and some emerging markets, and made the facility available daily rather than weekly.

While these facilities still require local banking systems to act as intermediaries in the provision of US dollar credit to local companies, the USD 206 billion of funding that has been made available to non-US borrowers in the last week of March has helped stabilise the pricing of FX forwards.

EXHIBIT 1: CURRENCY BASIS – THREE-MONTH RATE VS. OVERNIGHT INDEXED SWAP (OIS)



Source: Bloomberg, Goldman Sachs; data as of March 2020.

Managing currency hedges

Managing currency hedges in this volatile environment presents a range of challenges, particularly for clients looking to hedge US assets. However, there are also opportunities for those able to take advantage of market volatility. For example, in portfolios that seek to actively manage the tenors of currency hedges, we aim to balance interest rate risk with basis risk when selecting the tenor of our hedges. We do this by looking to extend the tenor of our short dollar hedges when rate cuts appear underpriced in the US, or overpriced in non-US markets, and when basis is wide. Conversely, we look to shorten tenors under the opposite conditions.

This investment view is balanced against the cost incurred from transacting in less liquid market conditions, and also against our ability to provide clients with a smoother cashflow profile from their hedging programme by laddering the tenors of our hedges, which can reduce the transaction costs associated with rebalancing the underlying asset portfolio.

The current elevated levels of currency basis suggest that maintaining a relatively reduced tenor on short dollar hedges is appropriate. This positioning will avoid locking in still elevated levels of funding stress in longer tenor hedges, while allowing the significant recent provision of US dollars to work their way through the financial system with the ultimate result of narrowing the currency basis.

Impact on the US dollar

While the relationship between currency basis and exchange rates is complex, we believe the dollar has been supported by the move wider in basis. The yield advantage of the dollar over other developed markets should have fallen significantly, which would typically see the dollar underperform, yet this fall has been cushioned by the move wider in basis in a way we do not believe will be sustained in coming months.

The loss of the yield advantage that US assets have enjoyed since 2014 feels particularly important for the dollar in the context of current valuations and with such a large stock of US fixed income assets having been accumulated by foreign investors. There are some parallels to the financial crisis, where the dollar initially strengthened as credit risk premia rose, yet ultimately fell once the central bank policy response allowed investors to refocus on the longer-term factors that drive exchange rate movements.

Currency Management

Since our first segregated currency overlay mandate funded in 1989, J.P Morgan Currency Group has grown to manage a total of USD342 billion (as of 31 March 2020) in bespoke currency strategies. Our clients include governments, pension funds, insurance clients and fund providers. Based in London, the team consists of 18 people dedicated exclusively to currency management with an average of over 15 years of investment experience.

We offer a range of hedging solutions for managing currency risk as well as a tailored optimal hedge ratio analysis:

- Passive currency hedging serves to reduce the currency volatility from underlying international assets. It is a simple, low cost solution designed to achieve the correct balance between minimising tracking error, effectively controlling transaction costs and efficiently managing cash flows.
- Dynamic "intelligent" currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
- Active "alpha" currency overlay offers passive currency hedging, if required, combined with an active investment process to deliver excess returns relative to the currency benchmark. Our approach is to build a global currency portfolio combining the output of fundamental models and incorporating the qualitative views of our strategy team.

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