MONTHLY MARKET UPDATE: THE CURRENCY ROLLERCOASTER

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Operator: Thank you all for joining, and welcome to the Monthly Market Update from Simon Derrick. The statements and opinions expressed by Mr. Derrick during the call are those of Mr. Derrick's as of today, March 26, 2015, and do not necessarily represent the views of BNY Mellon and any of its affiliates. Much of the information referenced by Mr. Derrick during this call comes from publicly available sources that have not been independently verified. This call is being recorded for distribution at BNY Mellon's discretion. Neither BNY Mellon nor its affiliates are acting in an advisory capacity with respect to this material. I would now like to turn the call over to Mr. Simon Derrick. Please go ahead, sir.

Simon Derrick: Thank you very much indeed, and hello to everybody on the call. I know we've had a few other calls over the course of the year so far in slightly different venues, but welcome to the first of the proper monthly calls, I guess, for the year.

As you'll have seen from the title, we're really addressing the remarkable changes we've seen in the foreign exchange markets over the past few months and the rise in volatility. We'll also be talking a little bit about one of my favorite topics, of course, the Eurozone.

But let's start with that topic of volatility, because I think this is one that many people will have recognized that there's been an enormous change in the way the foreign exchange markets have behaved.

And certainly over the course of the last six months, we've seen a number of extraordinary moves develop in the currency markets. Last December, we saw the largest daily move for the ruble against the dollar since the Russian crisis in 1998. January, we saw one of the largest, if not the largest, move for a mainstream currency pair when the Swiss National Bank removed its minimum exchange rate for euro Swiss, while last week saw the euro gain then lose close to 4% against the dollar in one 24 hour period.

Even on Friday of last week, we saw sterling gain something in the order of $0.02 against the dollar in otherwise fairly unremarkable trading conditions. So the question we need to ask: are these just random instances of heightened volatility, or are they indicating an as yet unclear structural shift in the market?

While it's certainly true that perfectly rational causal factors can be found for many of the moves: the collapse in the oil price, for example, the cancellation of the minimum exchange rate policy by the SNB, it's the scale of moves that have emerged that really stands out.

Moreover, while it's certainly possible to identify structural changes taking place in the market, such as retreats in the reserve management community, which is a topic we've discussed in the past or regulatory shifts, none satisfactorily explain these sudden bursts of extreme volatility.

Instead, I suspect that the real answer as to what might be going on can be gleaned from noting that all of these moves have emerged since September of last year, which of course is when the ECB properly broke the zero band for its deposit facility, shifting from minus 10 basis points to minus 20 basis points.

And the market behavior we've seen is highly reminiscent of what happens when investors collectively get caught short of volatility, or another way of saying that is of longer risk.

To date, when I've been thinking about this over the course of the last month or so, I've looked at it as being nothing more than a supercharged carry trade environment. However, the more I think about it, the more I feel it is something more than this.

While it's certainly true that the current monetary climate in Western Europe presents truly remarkable funding opportunities with in fact investors effectively being paid to borrow money, it also puts anyone with a significant cash balance in a difficult position.

Because their choices boil down to either accept in being actively penalized for remaining in cash, or at best take an enormous nonexistent yield for the privilege of lending money to a northern European sovereign, or putting money into far riskier assets, including FX on the hedged investments overseas.

But more simply, I think the collective efforts of the European Central Bank, the Swiss National Bank, the Danish National Bank, and beyond have put a significant group of investors into a situation where they're effectively forced to take on far greater risks than perhaps they would have otherwise preferred.

Now, what's interesting to note is that this change in the FX environment, the currency environment, has coincided with growing talk that a fixed income bubble may be forming.

Now, perhaps the clearest example of this discussion emerged in the Financial Times over the past weekend in a story that quoted a survey of 300 global managers by CFA UK. And that survey showed that four out of five fund managers believe bonds were over-valued.

Collectively, the group believed that corporate bonds were more over-valued than ever before, while government bonds were the most over-valued asset class.

Now, while it's perfectly reasonable to argue that this is a natural consequence of six years of QE programs in various parts of the developed world, it's also possible to imagine that the search for assets with even a moderate yield over the past nine months has exacerbated the situation. And sometimes in some ways I wonder whether I should even be worrying about working out the cause and effect here.

Whatever the answer, what is certainly true is that our iFlow data that we extract from our custodial system showing the flows through that system, show accelerating inflows into a wide range of bond markets since the start of the year stretching from Australia to the United States.

What's also interesting about this is it stands in pretty marked contrast to our equity flow data despite the highs that so many indices have been making of late. Indeed, the only really major search is a net buy that we registered coming to the Eurozone, which is unsurprising really, Malaysia, Poland, South Korea, and Sweden, again, perhaps though not surprising given the recent policy shifts.

It's also worth highlighting that the inflows in emerging market currencies, and they're usually the litmus test with investor sentiment. Those inflows into EM currencies have been patchy at best this year.

That I think is in turn arguably consistent with the view that this is not an environment where investors are willingly embracing risk, but rather one where they're being forced into taking it.

Now, I think the implications for that are simple enough to see. With a market that's being forced to be structurally long of risk, even relatively minor shifts in expectations can lead to substantial moves, while genuinely major events, i.e. the Swiss National Bank move, can lead to unprecedented moves emerging.

And again, just to kind of put things in context, I think it's worth comparing the Swiss franc move to those that emerged in the early 1990s when differing or different European currencies broke their bounds within the old European exchange rate mechanism.

This then means something rather different then to the carry trades of old, which were normally characterized by extended periods of declining volatility and in many cases, those periods lasting for years, as investors slowly and steadily added to their risk, and equally often ended with a collapse as everybody headed to the exit at the same time. Instead I think we have a situation where intermittent bursts of ultra-high volatility are becoming the norm as investors have been forced into holding risky positions start to react to events.

So, I think the worrying question we therefore need to ask is: what might happen if a serious event, let's say Grexit or an escalation of hostilities in Yemen, emerges? I clearly don't have an easy answer to that, but I do think it's one of those issues that we need to start thinking about fairly seriously over the course of the next few weeks.

Obviously, we're talking about Grexit. That brings me to one of the other great taboos to be broken in the last few years beyond simply moving to negative interest rates. And that's the idea that membership of the Eurozone is irrevocable.

The first real sign that an exit from the Eurozone was possible I see mostly a few years ago. It came in September, 2011 in an article published in Spiegel online. And according to the paper at the time, the German Finance Ministry officials had concluded there were two possibilities for agreed bankruptcy.

Either the country remained in the monetary union or it withdrew. It said either option would involve a haircut and 50% was the number mentioned specifically in the article. However, the paper also argued, I'll quote, it here in moderate length. It said, "In reality, Athens would have no choice. The government could only hope to boost its languishing economy if Greece reintroduced its own currency and sharply devalued the new currency against the euro."

The article actually also provided the first evidence of capital controls being considered. And of course, subsequently they were introduced in Cyprus in March of 2013. And we heard the words "capital controls" mentioned several times over the last few weeks by eurozone officials, most recently, Mr. Dijsselbloem.

Details of what might have been discussed with regards to Greece, the possibility of a Greek exit in 2012, appeared in an article that was actually published by the Financial Times on May 14 of last year. The paper reports that pre the summer of 2012 IMF officials had already prepared a 20-page matrix of actions drawing on their experience on bank runs and currency crises. And the paper said that the detailed blueprint reportedly including turning off all the cash machines and reinstating border controls to prevent capital flight.

And they also reported the ECB officials had studied Argentina's experience of issuing IOUs during their 2001 currency crisis. And among the options considered reportedly was issuing Greek IOUs worth about half the value of those euros since getting Greek bank notes to Greece, and again, I'll quote directly, "would be a logistical nightmare."

Reports say consideration was also given to what would happen once Greece was disconnected from TARGET2 given that it would, at that point, have no way to clear transactions. The crisis developed sort of similar to 2012, however. The FT noted that a hard default, failing to pay an outstanding bond, was increasingly seen as being the most likely route to Grexit since there was no one left to lend to Athens, it would not just be the government that would run out of money.

And they argued that the only way to restart the banking system would be for Athens to set up its own central bank and begin printing its own currency. The paper also noted that inside the ECB, there was a broad consensus that the call would lead to Grexit should not be made by central bankers. And again, I'm quoting exactly what was said, and carried on and said, “instead, they would pass the decision to eurozone politicians."

Now, I think it's also clear that since the Cypriot crisis of March 2013, thinking on the topic of a potential exit has continued to evolve. Der Spiegel published an article on January 5 of this year that reported, and again, I'll quote exactly, "several changes to the currency unit have been made since the peak of the crisis in 2012. First and foremost, the risk of other countries being negatively affected has largely disappeared. And furthermore, the European stability mechanism, the currency's own permanent backstop fund, remains ready to bailout member states that run into turbulence. And the stability of large European credit institutes, Berlin officials were confident, apparently, is guaranteed by the European Banking Union."

The paper went on to say, “taxpayers, officials say, would only have to become involved at absolute worst case scenario. And they also noted that large privately owned banks had largely divested themselves to involvement in Greece.”

Again, I quote at length, but the article concluded that “technically, such an exit will become a reality were, for example, the ECB to refuse to supply more money to Greek banks due to insufficient reserves, or were Athens to no longer receive sufficient money from the bailout funds, or from capital markets to cover expenses.”

And it said that “in such a situation, the government would be forced to print its own currency, the new drachma. But of course Greece's euro debt would remain.” And they noted that “some 80% of those debts are held by the ESM, the ECB, the IMF and individual partners in Europe. So, if Greece were to introduce a new and devalued currency, it seems unlikely that Athens would be able to service and pay down those debts. And the result would be the creditors, Germany first and foremost, would be forced to write down their claims.”

So, that's the backdrop of how the discussion with regard to the possibility of an exit has been socialized, if you like, through the media over the course of the last three years.

So, the question is, where do we stand at the end of the first quarter?

Well, while the European Union's executive commission may still be arguing that membership of the euro is irrevocable, it has become apparent that it's anything but. And I think that was made all too clear on January 16th of this year by Chancellor Angela Merkel when she told Frankfurter Allgemeine Zeitung that she preferred that Greece remain in the eurozone, but noted that the basis of all European efforts build a principle of solidarity before individual effort and responsibility.

Now, by highlighting that she would prefer Greece to remain a member of the single currency, Ms. Merkel also implicitly was saying that it was possible for Athens, and indeed anyone else, to leave.

Now, it's true that the risk of an imminent exit by Greece might be slightly less than it was in the run-up to February 24th of this year, which was the day the Eurogroup accepted Greece's initial list of reforms of the basis for negotiations over extending out the support program by four months. But nevertheless, that risk remains a real one. And, I think the first signs that something might be wrong actually began to emerge as far back as just two days after that list was sent through.

On February 26th, when Greek finance minister Yanis Varoufakis told the magazine Charlie Hebdo, "This is what I tell my counterparts, if you think it is in your interest to shoot down progressive governments like ours, just a few days after our election, then you should fear the worst."

However, since the receipt by the Eurogroup of the initial list of reform measures proposed by the Greek government, events have been moving at a fairly rapid pace. And again, the response from the Eurogroup itself to the proposed reforms that came through just a week or so ago was straightforward enough with Bloomberg quoting Chairman Dijsselbloem as saying that the list of measures was far from complete, and that Athens probably wouldn't receive any aid disbursement this month, which given how close we are to the end, that looks almost certainly that's going to be the case.

And the Newswire also quoted two officials representing creditor institutions who said that the plans were amateurish and didn't signal substantial progress to meeting the commitments that the Greek government had made just in February.

The response from the Greek government, you'll be less than surprised to hear, was straightforward, with Mr. Varoufakis telling Il Corriere della Sera that the government would call new elections or hold a referendum if the Eurogroup rejected the government's reform proposals.

That was backed up by Prime Minister Alexis Tsipras, again, speaking to Der Spiegel, said this. He said, "If we were to hold the referendum tomorrow with a question, do you want your dignity or a continuation of this unworthy policy, then everyone would choose dignity regardless of difficulties that would accompany that decision."

So, I guess there's little wonder then that ECB governing council member Luc Coene told Le Soir, "When I hear certain declarations of the Greek government, I ask myself, what are they still doing in the mechanism?" And it was equally unsurprising to hear Mr. Schauble insisting after a recent Eurogroup meeting that the payments of the next tranche of funds depended on the current agreement being implemented in full.

Now, while it's certainly true that technical discussions over the proposed reforms have at least started now, and that Mr. Dijsselbloem has said that Greece could be awarded smaller chunks of emergency funding if it vows to complete the reforms demanded, the relationship between Athens and Germany remains fragile. Although it's fair to say that the visit by Mr. Tsipras earlier this week to Berlin might have mended a few fences.

The “so-what” of all this is simple enough. With the relationship between Greece and the rest of the Eurozone remaining fragile, it's by no means clear that the Eurogroup will accept Greece's more detailed proposals when they're presented at the start of next week. If so, then the prospects of a referendum in Greece could become a very real one. And given this and the report that Athens will run out of money by April 20, it's certainly not possible to rule out the possibility of an accidental exit of Greece from the Eurozone.

And indeed this was exactly the point that was made by Mr. Schauble to Austrian broadcaster ORF. When he was asked about the topic of Grexit, he said, “As the responsibility, the possibility to decide what happens only lies with Greece. And because we don't exactly know what those in charge in Greece are doing, we can't rule it out."

And that point was also made by Austria's finance minister Hans-Joerg Schelling, who very simply said, "The danger exists."

So, I think that the period of volatility that we've been talking about over the course of the last half hour and the quite remarkable series of events we've seen so far, it certainly looks to me as though the potential for that to continue is there in the foreign exchange markets in the months ahead.

I hope that was of value to everybody. As always, we welcome your emails and comments. I'm concerned everybody knows my email address. But if not, it's simon.derrick@bnymellon.com. If you'd like to ask any questions, please let me know. Alternatively, if you're looking for access to our morning briefing that we send out, which covers this and other topics, again, please email me or your contact, and we'd be more than happy to put you on that.

That only leaves me to say, thank you very much for listening, and have a good rest of the week.

Thank you.

Operator: And that will conclude today's call. We thank you for your participation.

BNY MELLON