Market Stress Points

- Moves in USD/CNY and USD/HKD forward outrights becoming more closely correlated
- Shift from a low to a high volatility environment for USD/JPY is usually rapid
- September, October and November look like key months both for eurozone and UK

With markets under increasing pressure it's worth keeping an eye on a number of key stress points:

1: Watch out for USD/JPY...

The pair has a history of staging dramatic moves, with 25 days since 1971 having seen a net drop for the USD of 3% or more (with three of these coming in 2016 alone). Over the past 21 years these moves have typically been in reaction to broader market stresses (1998 & the fallout from LTCM, 2008 and the fallout from Lehman Brothers, 2016 and the aftermath of Brexit). The shift from a low- to a high-volatility environment has usually been very rapid with little in the either the CFTC positioning data or options pricing to provide any early warnings of the push towards the exit door.

It's therefore worth noting that, at present, CFTC data continue to show speculative players running short of JPY (albeit not at particularly unusual levels for the period since Abenomics started at the end of 2012) while options pricing indicates an relatively unstressed market.

2: ... Along with the CHF and gold, as well as the USD

On a similar note it's worth highlighting that both the CHF and gold have begun to make
gains in recent days as well. Gold is up 2.4% against the USD since the close of business on Wednesday while the JPY has gained 1.1% and the CHF 0.8%. Overall the USD index is down 1.1% over the period. For the moment at least it therefore appears that the USD is not fulfilling its usual safe haven role.

3: Keep an eye on the HKD market

Most of the action in the USD/HKD forward outrights has been focused in recent days on the one-year rate, which had been rapidly accelerating up to join the shorter dates and spot in trading just under the edge of the band at HKD 7.85. However, today has seen a sharp reversal in this trend as the USD weakness that has been building elsewhere began to emerge in the HKD market as well.

Interestingly, this wasn't particularly reflected in the options market with one-year at the money forward USD/HKD implied volatility remaining at elevated levels (albeit still standing well below the levels reached during the CNY devaluation scare in January 2016) while the 25 delta risk reversal (which on Friday staged its largest one-day swing in favor of HKD puts since December 2016) continues to show the premium in favor of HKD puts.

This also comes at a time when iFlow has been showing accelerating outflows from the HKD (see chart below).

4: Events in the HKD market help bring into focus the significance of CNY 7.00
The norm is for a moderate degree of correlation between movements in USD/HKD one-year forward outrights and USD/CNY one-year NDF outrights (the average for the past decade is about a 40% correlation on a rolling three-month basis). However, there are points when the correlation can spike sharply higher.

The last time it happened was late last year as the CNY came under pressure before rebounding from CNY 7.00. It’s therefore noticeable that the correlation is on the rise again (around 70% on a rolling three-month basis).

It’s arguable that this, in turn, provides the PBOC with a further reason to attempt to draw a line in the sand at this level, at least for the moment. The problem, of course, is that this type of defense can itself lead to mounting pressures in markets.

5: September, October and November are shaping up to be a key months in Europe...

With Austria’s Social Democrat and Freedom parties reportedly favoring a September 29 election date (according to the Kurier newspaper) and La Stampa suggesting Italy could go to the polls around then as well, that month could prove particularly interesting. Headlines in the Italian press over the weekend only add to the evidence that a fresh political battle is building.

So far this has yet to show up in EUR/USD options pricing. However, it is noticeable that the Bund/BTP spread has finally started to widen out (as discussed in the Aerial View on Friday).

With this in mind it’s also worth highlighting that the 1992 and 2018 Italian crises saw the spread reach its widest in October of those years, while the 2011 blowout peaked in November (see chart below).
6: … And in the UK

With October 31 set as the date for Brexit, the months running up to it are likely to be filled with political uncertainty in the UK.
Given that GBP has a history of reacting poorly to this kind of risk, it was therefore understandable that the spread between six-month and three-month at-the-money-forward implied volatility for GBP/USD has been widening out for a week or so.

This process has accelerated in recent days, taking the spread to levels only seen previously in 2002, 2010 (in the run up that year's general election) and 2016 (ahead of the referendum). That seems a fair indicator of the level of stress now building.

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