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IN THE CURRENC ERIVATIVE MARKETS

SEPTEMBER 2014: VOL.16 / ISSUE 154

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How Important is Market Colour?

Automating Market Surveillance

FX Turnover Rebounds, e-Ratios Sink

Rule Change Headache for CTAs

Deutsche Bank's Jason Vitale: A New Age for FXPB

Jason Vitale, managing director, global head of foreign exchange prime brokerage and EMEA head of fixed income prime brokerage at Deutsche Bank talks about the changing face of the industry.

Buy Side Broadly Welcomes FSB Benchmark Proposals

Is New Zealand Part of Australia?

Jesse Pinkman: Is New Zealand part of Australia?
Jane Margolis: New Zealand is New Zealand.
Jesse Pinkman: Right on. New Zealand. That's where they made "Lord of the Rings". I say we just move there, yo.

Recent developments and what makes NZD interesting

In the end, Jesse didn't move to New Zealand (Spoiler alert!). Had he done so, it would have made no difference in the NZD currency market, given its size: over NZD 100 billion is traded per day, according to the BIS Triennial Central Bank Survey of April 2013. The most volatile among G10 currencies, the New Zealand dollar is also one of the 10 most traded currencies. By contrast, New Zealand imports and exports only reach NZD 5 billion per month at their highest.

Speculative trading in NZD was slow to grow in volume. The NZD was allowed to float freely against all currencies on March 4, 1985 and its market share grew rather sluggishly. In 1998 it was only the 17th most actively traded currency. Its volume doubled from 2005 to 2007. As risk aversion surged and then fell during the financial crisis, its bigger sister AUD substituted for it during the unstable markets from 2007 to 2010.

NZD gained popularity among traders as more of them became aware of the forward rate bias, whereby forward exchange rates predict larger subsequent changes in the spot rates than those theorised by interest rate parity, whereas forward exchange rates are unbiased predictors of future spot exchange rates. Exploiting the forward rate bias defines the carry strategy, which consists of going long high yielding currencies and short low yielding (funding) currencies. Before the start of the financial crisis, carry returns made profits as investments flowed from low return to high return economies.

The financial crisis brought with it repeated reversals in the carry trade that adversely affected traders' portfolios. The subsequent fall in interest rates across the developed world further reduced the attractiveness of the carry strategy. NZD became more and more a reflection of the degree of risk aversion in markets. Since the end of 2008 (more precisely since the Lehman Brothers' bankruptcy), NZD weakness and implied equity risk have become synonymous.

We believe however that NZD is passing through a medium term window when country fundamentals and monetary policy developments make the currency interesting once more. In the first half of 2014, NZD was the strongest currency in the G10 space. It appreciated by 7.4% against EUR, by 6.9% against USD and by 6.3% against CHF. The gain relative to AUD was small (only 69bp), and the correlation between the two has remained very high. However, fundamental factors are now set for NZD to step out of the shadow of AUD.

Three-year rolling correlations of monthly returns, depicted in the chart opposite, have been above 70% over the last 15 years and are currently around 90%. The two currencies are correlated due to the trade flows between the two countries, labour immigration from New Zealand to Australia and essentially similar monetary policies - up to now. However, going forward, monetary policy itself may herald divergence.

As the Reserve Bank of New Zealand was more prudent in raising interest rates after the crisis, New Zealand is one step ahead of Australia on the road to recovery. In fact, New Zealand's economy is in expansion with considerable momentum and high employment, unlike Australia, where high unemployment remains a problem (there was a even a surprise jump in unemployment rate to 6.4% in July). New Zealand terms of trade are at a 40-year high, increasing purchasing power. High confidence and booming investment has, and will continue to put upward pressure on prices.

This spring, the RBNZ hiked the policy rate four times by 25bp, from 2.5% to 3.5%, in order to keep inflation near a "neutral" level of 2%. According to RBNZ and analyst consensus estimates, the prospects are of a rise in the Official Cash Rate to 4.5%-5.0% by spring 2016.

Politicians in many countries must be green with envy, as New Zealand seems to be the only economy in the developed world where conventional monetary policy still applies.

In spite of RBNZ efforts to prevent NZD from appreciating too much, we expect that a strong economy and rising interest rate differentials will cause further appreciation of NZD over the next few years. In fact, we see any RBNZ intervention in the FX market as a futile exercise that is likely to be overwhelmed by the size of international NZD trade. Past RBNZ interventions were not successful other than for a very short term, so we wouldn't have much confidence in the next RBNZ attempt(s) to lower NZD.

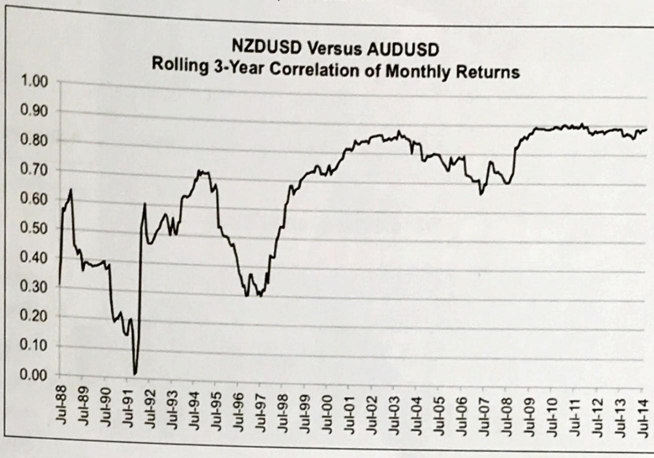
One important fundamental note: Australia is no longer the main trading partner for New Zealand. As of November 2013, the share of New Zealand's monthly exports to China climbed above 27.5% making China its new largest trading partner. China had already been the top imports partner since December 2011.

The composition of international trade also differentiates NZD and AUD. Australia trades commodities such as iron ore, petroleum and gold, while New Zealand's main exports are dairy, meat and wood (dairy products made up 29% of New Zealand's exports in 2013.)

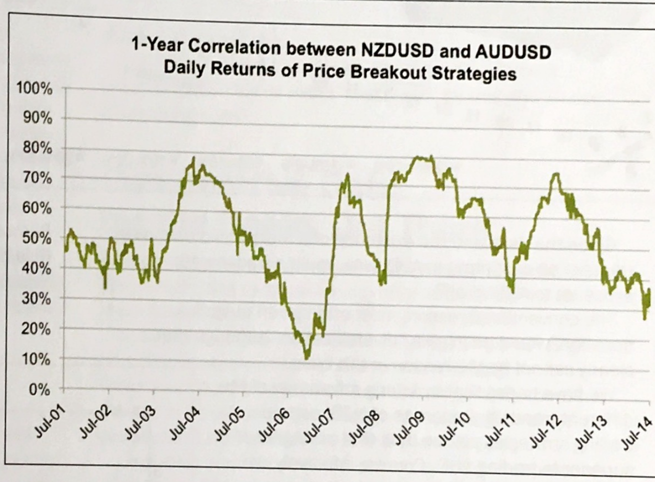
Fundamentals aside, the value of NZD appears to mean-revert to a long-term rising trend against AUD. The statistical similarities between the exchange rates for AUD and NZD versus the USD are profound, as can be seen from the Kernel frequency distribution of monthly returns.

Unsurprisingly, holding a NZD/USD long position has not historically provided a hedge in the worst of times for the AUD/USD pair. At times of stress, in the worst months for AUD (except for February 1989), the NZD was under pressure as well: the Lehman bankruptcy, 9/11, the equity collapse of January 2009.

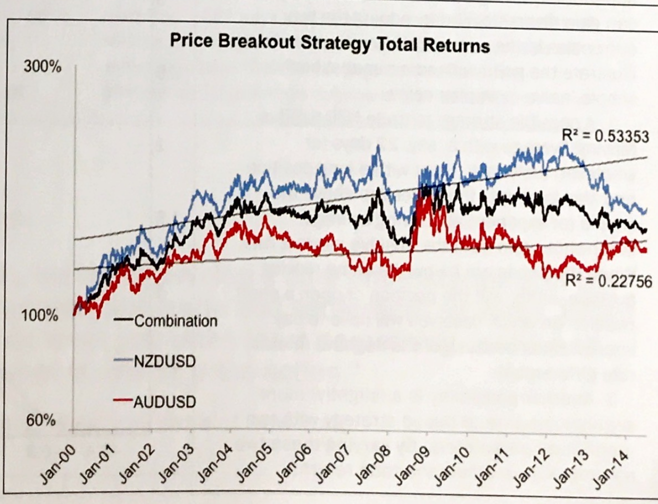
The NZD/USD pair yields slightly more than the AUD/USD pair in the long term but it is also more volatile. Volatility may be one reason to trade NZD in the recent low volatility environment but it also speaks against NZD trading. With less than USD 5 billion monthly exports and backed by an economy of less than USD 200 billion, the currency could be at the mercy of worldwide speculators.



NZDUSD Versus AUDUSD
Rolling 3-Year Correlation of Monthly Returns



1-Year Correlation between NZDUSD and AUDUSD
Daily Returns of Price Breakout Strategies



Price Breakout Strategy Total Returns

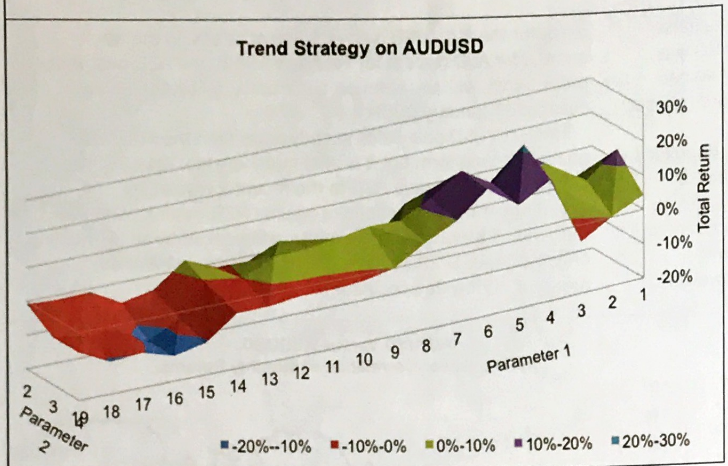
Given the risks and the existence of a more liquid and lower transaction cost proxy in AUD, why would a trader want exposure to NZD at all?

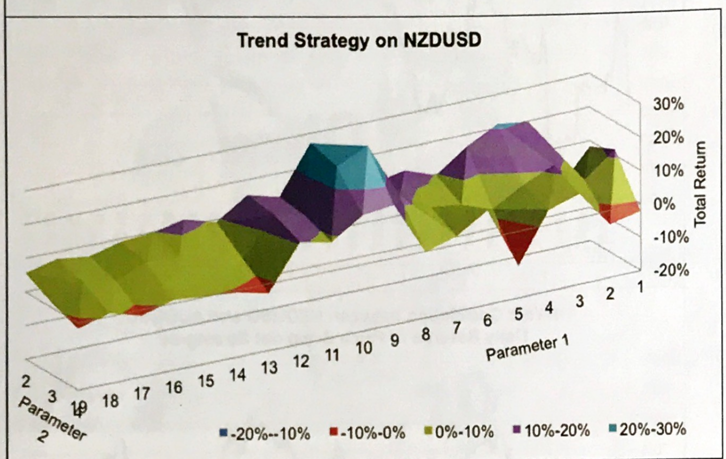
The conventional reason, most often given to such a question, would be to gain "diversification" although that clearly cannot be the reason in this case.

We have hopes that by taking advantage of the different trending properties of NZD, certain trading strategies can be built that are equal or superior to trading AUD. Counter-intuitively, we can gain diversification by adding the two currencies in the same portfolio. We attempt to illustrate the point with some unabashedly simple/naive examples below:

1. A possible strategy to trade NZD/USD is Moving Average with a, say, 22 days (or whatever) look back. Start with a long position and stay long until the prices are above the simple (or exponential) moving average. Meanwhile, gain from the positive interest rate. When the prices are below the same moving average, either exit the position or open a short position (in which case you will have to pay interest rates because of the negative interest rate differential).

2. Another possibility is a (slightly) more sophisticated trend-based strategy with two proprietary parameters. By varying these two parameters we obtain the total returns





depicted in the three-dimensional graphs.

In the next graph we represent the total returns of such a trading strategy for the two currency pairs on a logarithmic scale. We find that not only does the return track for NZD/USD dominate the return track for AUD/USD, but also there is low correlation between the returns of the two strategies. Therefore, trading these two strategies in a portfolio may prove useful.

To sum up, the next two years will be interesting for the NZD trader. There will be volatility, rising interest rate differentials, and a lot of news-related choppiness, as RBNZ will make repeated attempts toward weakening the currency. Simultaneously, a strong economic outlook may push NZD away from on/off risk-aversion trading.

NZD and AUD remain highly correlated and statistically similar. However, the two currency pairs are fundamentally different and are becoming even more so.

Combining the returns from the two currency pairs in a portfolio may generate quite an attractive risk and return profile for a trading program. This will be necessary to avoid the problem of not increasing diversification but just adding risk (and reducing liquidity) to a portfolio through correlation.

Notwithstanding the high current correlation between AUD/USD and NZD/USD, it can be seen that even a very simple trading strategy can create different total return profiles that can be improved by a more sophisticated strategy.

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