Foreign Exchange

Tuesday October 16 2012

www.ft.com/reports | twitter.com/ftreports

Euro casts a long shadow

Uncertainty about the single currency and a lack of volatility keep business slow **Page 2**

Inside »

Central caution
How the SNB could change its mind on the euro-buying policy
Page 3

Renminbi moves abroad
Foreign banks able to clear transactions
Page 4

Mrs Watanabe diversifies
Japanese home investors look overseas
Page 6

Mexico tops Brazil
Peso gains advantage over real – for now
Page 7

Market stalls as rates fall
Investors wary of euro-funded carry trades
Page 7

Deutsche Bank. Leading the way in FX.
With the right partner it's easier to stay ahead in FX.

Passion to Perform

Deutsche Bank
db.com/fx

World's No.1 FX Bank
Euromoney FX Survey 2005 – 2012

This advertisement has been approved and/or communicated by Deutsche Bank AG. This advertisement does not constitute an offer or a recommendation to enter into any transaction. The services described in this advertisement are provided by Deutsche Bank AG or by its subsidiaries and/or affiliates in accordance with appropriate local legislation and regulation. Deutsche Bank AG is authorized under German Banking Law (competent authority: BaFin – Federal Financial Supervisory Authority) and authorized and subject to limited regulation by the Financial Services Authority. Details about the extent of Deutsche Bank AG's authorization and regulation by the Financial Services Authority are available on request. Deutsche Bank Securities Inc., a subsidiary of Deutsche Bank AG, conducts investment banking and securities activities in the United States. Deutsche Bank Securities Inc. is a member of NYSE, FINRA and SIPC and its broker-dealer affiliates. Lending and other commercial banking activities in the United States are performed by Deutsche Bank AG and its banking affiliates. Investments are subject to investment risk, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time. "Passion to Perform" is not a product guarantee. © Copyright Deutsche Bank 2012.

Foreign Exchange

Hopes for a return to fundamentals

Uncertainty about the single currency and a lack of volatility are keeping business slow, says *Alice Ross*

The foreign exchange market is having another difficult year. Volumes have fallen across the market, and volatility has hit its lowest level in five years. Many hedge funds have given up trying to profit from the euro and have moved into rates or equity markets instead.

Yet returns on currency investing are looking more positive this year, as investors wise up and work out how to make money in an environment of global central bank easing and dwindling interest rate differentials.

Investors and traders alike are hoping that the eurozone crisis will no longer dominate the foreign exchange market in the next few months, offering some respite to investors who have been foxed by the so-called "risk on, risk off" (ro-ro) effect that has made it hard to buy or sell currencies based on economic fundamentals.

"Forex has been a very difficult asset class this year because of the variables at play," says Peter Taylor, managing director in forex trading at Barclays. "We've moved away from a lot of the normal drivers of forex – such as interest rate differentials – and moved into the realm of politics. It's added to the uncertainty of the environment when you could have such big sentiment swings on comments from eurozone ministers."

Trade in the forex market was particularly subdued over the summer as investors waited for central bankers in both the US and Europe to give markets some direction. August was a particularly quiet month as currency markets waited for the European Central Bank to outline its plans to buy government bonds in September, and the US Federal Reserve to decide whether it would announce further monetary easing.

"It's a tiring market – a lot of people took the summer off, especially the buyside community," says Fred Boillereau, head of foreign exchange at HSBC.

Yet returns in the currency market are showing some signs of improvement. A Parker index of currency managers shows that currency funds lost more than 6 per cent last year on average. Many of these losses came from investors trying to short the euro in the belief the single currency was bound to fall further, a trade that frequently went wrong as the euro stayed stubbornly strong.

This year, investors have shied away from trying to trade the single currency. Currency funds have made nearly 1 per cent on average in the year to date, but the trading environment remains difficult.

"It's a mess out there in general in currency markets," says Stephen Jen, founder of macro hedge fund SLJ Macro Partners.

"I'm concerned that, with the global economy having decelerated so much and QE3, the tensions are higher than any time I remember this year."

In the end, the move by the US Federal Reserve to conduct more monetary easing in September did not spark a clear move in the forex market. Some had expected the dollar to weaken and risk appetite to soar. But that has not materialised because of concerns about limp global economic growth. That has left large currency pairs such as the euro-dollar yet again trapped in a range, which is frustrating investors.

"The last two years were about identifying volatility spikes. Now, volatility is lower and ranges are tighter, which a lot of investors have difficulty coping with.

Illustration: Øivind Hovland

They have to maintain much shorter time horizons," says John Normand, head of foreign exchange strategy at JPMorgan.

And investment banks are now in a race to stay competitive. While bigger banks including Deutsche Bank and HSBC say their volumes have increased this year, volumes across the industry have fallen. Daily forex volumes on the ICAP-owned EBS platform fell to their lowest-ever September levels this year, while August volumes were on a par with the traditionally quietest month of December.

Clive Ponsonby, a trader at JPMorgan, estimates that market-wide volumes have fallen 20 to 25 per cent in the past year. That is having implications for banks' pricing in forex.

"Spreads have compressed massively in the past six months. The market response to falling volumes is to compete even harder. People are trying to cut costs," says Mr Boillereau.

And Deutsche Bank, currently the largest trader of forex in the market, says that

> 'It's a tiring market – a lot of people took the summer off, especially the buyside'
>
> Fred Boillereau, head of foreign exchange at HSBC

its volume growth has come mainly from companies rather than investors this year.

"For investors, the lower volatility hasn't made it the most exciting year for the forex market," says Kevin Rodgers, head of forex trading at Deutsche Bank.

"What the speculative side needs is a story and a trend, and we haven't really seen that this year. Some of the major pairs have been pretty quiescent."

While investors believe they are facing fewer tail risks thanks to central bank interventions, that comes at a cost. Volatility has fallen as major currencies have been trading in a range against each other, offering fewer opportunities for investors to place so-called momentum trades.

Many argue that the ECB has helped to reduce the ultimate tail risk: the prospect of nations leaving the eurozone. By promising to do "whatever it takes" to save the euro and introducing a plan to buy government bonds when sovereign states request aid, Mario Draghi, the ECB president, has created what traders call the "Draghi put", reducing the likelihood of further steep falls for the euro.

"The Draghi plan has taken the extreme scenario risk off the table," says Mr Rodgers. "Central banks across the world have been intervening to stabilise the currency markets, so we're not seeing the massive swings we saw in 2011," he adds.

The Draghi put has also helped shift focus from the eurozone on to other areas.

"Currency markets are becoming more multipolar among the eurozone, China and the US, and European shocks will be less acute," says Mr Normand.

Traders are hoping that a shift in focus could lessen the ro-ro effect and enable them to focus on fundamental drivers in the forex market – such as interest rates and economic growth – once more.

"The biggest criticism you get from clients is that there's only one trade: ro-ro. They would like to see more diversity," says Steven Saywell, global head of forex strategy at BNP Paribas.

But some currency investors believe the ro-ro effect is starting to fade. Harmonic Capital, the London-based macro fund with nearly $1bn under management, has returned nearly 23 per cent to investors this year. The hedge fund has stuck mainly to trading emerging market currencies against each other, rather than trying to place bets among the major pairs, with central bank easing in the US, the UK, Japan and the eurozone reducing interest rate differentials and volatility.

Patrik Safvenblad, a partner in the firm, says that while major currencies have been stable or unpredictable, emerging market currencies have been responding more to fundamental drivers such as interest rates or economic growth prospects.

Many investors and traders see the US fiscal cliff, with a range of spending cuts and tax increases scheduled to come into effect in January, as the next big event risk. If that is satisfactorily resolved, the market is hoping that forex will finally be able to return to fundamentals.

Foreign Exchange

Sheltering from the storm no longer a necessity

Swiss franc

James Shotter looks at ways in which the SNB could drop its euro buying policy

As the eurozone's troubles boiled over last summer, the Swiss franc lurched towards parity with the euro, propelled by vast inflows from foreign investors desperately seeking a haven from the crisis.

With Switzerland's exporters threatened by uncompetitiveness and its economy facing the spectre of deflation, the Swiss National Bank jumped into action.

On September 6 2011 it stunned markets by promising to buy as many euros as necessary to stop the franc appreciating beyond SFr1.20 to the euro. With one fleeting exception, the floor has been maintained.

But whereas initially the SNB's rhetoric was enough to enforce it, this year the policy has become increasingly expensive.

> 'As long as inflation expectations stay low, there is no reason for the floor to be challenged'

By the end of September, the SNB's foreign exchange reserves had swelled to SFr429bn ($456bn) – or close to 75 per cent of national output – up from just SFr238bn in April.

Despite this precipitous ascent, the SNB's policy enjoys broad backing in Switzerland.

Since the ousting of Philipp Hildebrand as SNB chairman in January – widely seen in Switzerland as political over-reach – attacking the bank has not been a fruitful pastime for politicians.

The macroeconomic data are also supportive: exports shrank 0.7 per cent in the second quarter; consumer prices fell 0.5 per cent in August. Without the floor, both measures would probably be worse.

The other key benefit, argues Paul Robinson, global head of foreign exchange research at Barclays, is that the floor broke the correlation between negative developments in the eurozone and the appreciation of the franc.

"If your main trading partner has problems, you don't want your exchange rate to move one-for-one with those problems. If it does, it amplifies rather than mitigates their impact. The floor has reduced that effect, which is very important for the Swiss economy," he says.

How long the SNB will continue to maintain its policy, however, remains an open question.

"If you are in the happy position of buying rather than selling reserves then, in theory, there is no limit," says Oliver Adler, head of global economics at Credit Suisse. "But in practice there is . . . if, for example, the SNB concluded that the euros they would expect to be buying would lose value because of defaults in the eurozone, then they would probably stop their programme," he says.

The other risk is inflation, says Jeppe Ladekarl, director of research at First Quadrant. "If the SNB's balance sheet expansion starts to have an impact on inflation and inflation expectations, the SNB would probably start taking steps to bring down their balance sheet.

"But as long as inflation expectations remain low, there is no reason for the floor to be challenged, even in the face of uncertainty in the eurozone."

For the moment, neither of those risks looks pressing.

The European Central Bank's promise to buy unlimited quantities of eurozone sovereign bonds has – temporarily at least – stilled fears that Spain or Italy will be pushed towards insolvency. And Swiss prices have fallen for 11 of the past 12 months.

Indeed, the SNB's euro purchases have recently slowed, suggesting the flight to safety may be abating.

This – together with an admission from Thomas Jordan, SNB chairman, that the floor is "not for eternity" – has prompted speculation about what the SNB's plans for a voluntary termination of the floor might be.

One possibility, says Beat Siegenthaler, an economist at UBS, would be to move from an explicit floor against the euro to a benchmark against a basket of currencies. This, he argues, would "allow the SNB to make things less transparent: the market wouldn't know so clearly where the floor was. The disadvantage . . . is that other countries might look on it as currency manipulation, which they haven't so far."

Another possibility, says Mr Robinson, would be for the SNB to allow a stepwise appreciation of the franc. The advantage of this, he says, is that it would deter speculators from targeting the floor.

But such a move might also irritate other central banks, says Ugo Lancioni, head of currency management at Neuberger Berman, the asset manager.

Mr Berman says: "The macro data are not bad: GDP growth is expected to be around 1.1 per cent; unemployment is around 3 per cent.

"If the SNB raised the floor in those circumstances, it would probably face criticism."

Given these difficulties, the best outcome for the SNB, says Mr Ladekarl, would be if the market did its work for it. And, to a certain extent, that is happening.

The combination of the peg and the euro's decline have already helped weaken the franc against other major currencies.

And – just as significantly – in recent weeks the Swiss franc has started to weaken against the euro as well.

If the eurozone's politicians can get a grip on their problems, that trend could continue over the next few months, says Mr Ladekarl. "If normal stability sets in in the macro picture, rather than exogenous shocks, then some volatility from 1.20 upwards is probably a good bet," he says.

Corporates & Markets

Our expertise – your edge

Discover why our award-winning FX offering* is ready to provide exceptional insight, constant support and fully coordinated execution – from simple to complex, from voice to electronic – whenever you need it.

Contact us at **ficsales@commerzbank.com**

www.cbcm.commerzbank.com

* No.1 Best Global Liquidity Provider & No.1 Best Global Institutional FX Provider, World Finance 2012

Achieving more together

Offshore hubs to improve liquidity

Renminbi The internationalisation of the currency is moving faster than expected, writes *Jeremy Grant*

When Taiwan in August agreed with China that the island's banks would be allowed to clear transactions in the renminbi, the currency of mainland China, it marked a big step in closer economic ties between the two rivals.

It was also a sign that the internationalisation of the renminbi is moving arguably faster than many expected – at least in terms of growth in the use of the currency in offshore centres for trade finance.

In July Singapore edged ahead of London in the race to become the next location for offshore renminbi trading after Beijing said it would authorise one of its banks as a clearing bank for renminbi in the city-state.

That would enable Singapore-based banks, including branches of foreign banks such as Standard Chartered and Citigroup, to skirt the multiple custodial relationships with banks in Hong Kong to access the currency at Bank of China's branch, the sole designated offshore clearing bank.

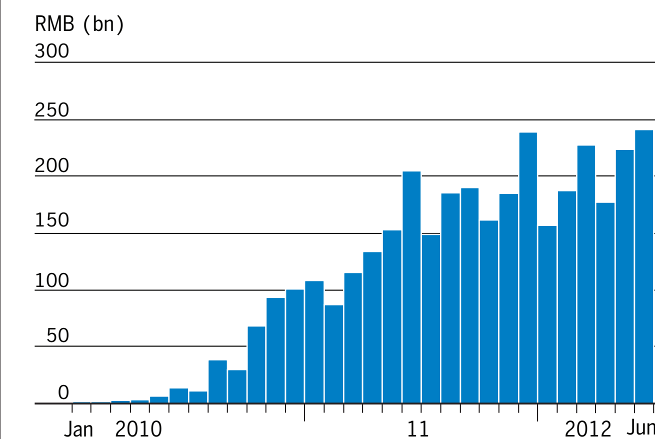
Both are seen by economists as key steps in a policy initiated by Beijing in 2009 to internationalise its currency and facilitate greater use of the renminbi for trade – much of it being done by Chinese companies that are globalising their businesses.

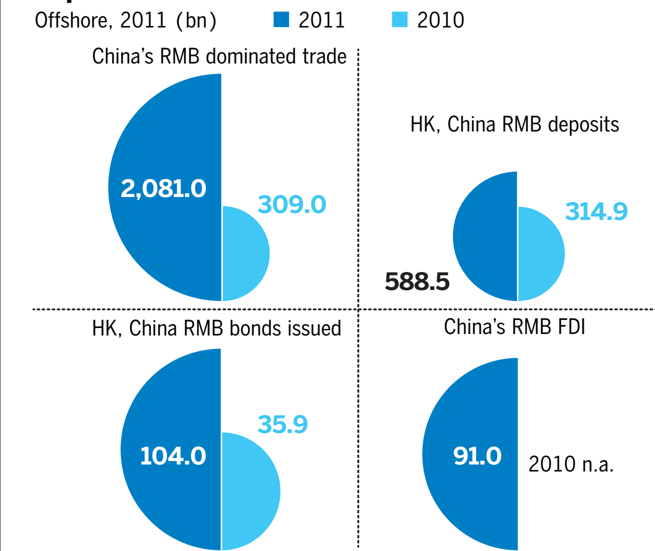
A two-track strategy has been under way ever since: the use of the renminbi in cross-border trade settlement and creation of an offshore market, starting with Hong Kong in 2009, as a paper out last month by Chatham House, the UK think-tank, points out.

That has been accompanied by greater use of the Chinese currency in capital markets, with Beijing in May allowing mainland non-financial companies to issue "dim sum" bonds, while the finance ministry issued renminbi-denominated bonds in June.

Hong Kong is set to remain the dominant offshore centre, not least because it handles more than 60 per cent of foreign investment in China. Chatham House says the volume of renminbi deposits accumulated in Hong Kong banks rose to Rmb588bn ($93bn) at the end of last year from Rmb56bn in July 2009.

Singapore's location means it is more likely to need to depend on trade links with China Getty





Sources: HKMA; Chatham House; MoC; Reuters

London has been promoting itself as the key centre outside Asia, not least because Europe is China's biggest trading partner but also with an eye to wealthy Europeans wanting to hold renminbi investments.

This process started a year ago at the UK-China economic and financial dialogue when George Osborne, UK chancellor, and Wang Qishan, China's vice-premier, ushered in a private sector-led development of a renminbi market in London. In April this year a City of London initiative emerged to make it a centre for renminbi business.

The aim is to develop London as a "western hub" for the international renminbi market as a complement to Hong Kong and other financial centres. Initiative members include Bank of China, Barclays, Deutsche Bank, HSBC and Standard Chartered.

But as Chatham House asks, how will London – and other international financial centres that plan to enter the offshore business – shape the development of the renminbi market. Specifically, the question is whether London's development depends on Hong Kong, which, in turn, depends on Beijing's provision of renminbi liquidity.

"Although the development of the eurodollar market in London provides some references, building the renminbi market is likely to progress in a different way," argue the paper's authors, Paola Subacchi and Helena Huang. "Unlike the eurodollar market, which expanded outside the jurisdiction and control of the US, the renminbi offshore market is constrained by the currency's limited convertibility."

The paper adds that until the currency is fully convertible and non-residents are comfortable holding it, "there is limited scope for pure offshore renminbi transactions".

Another question is: what is meant by a "renminbi hub" in the first place?

Greater use of the currency in trade finance does not necessarily mean spurring greater amounts of trade – merely that more trading is being settled in renminbi. The amount of trading remains the same.

Michael Vrontamitis, head of product management, east, transaction banking at Standard Chartered Bank in Hong Kong, says: "If you start using renminbi as an invoicing currency it doesn't create new trade flows. The question really is what happens on the back of this trade, ie: foreign exchange, capital raising and so on. That's where offshore centres live and breathe."

In the latest sign of that, FTSE, the index company owned by the London Stock Exchange, and Cürex Group, a New York-based technology company, this month launched seven currency pairs, enabling investors to trade offshore renminbi against seven currencies at an independently calculated benchmark rate.

London already has a 46 per cent share of the global offshore renminbi spot market excluding that of mainland China and Hong Kong, says Swift, the payments system. Its timezone advantage means it is likely to grow as an offshore trading centre, whereas Taiwan and Singapore are more likely to need to depend on trade linkages with China, Barclays suggests.

But that would not be at the expense of Hong Kong. "We think any new renminbi offshore hub will likely be a complement to Hong Kong," Barclays says. "Development of more offshore centres will increase renminbi trade settlement . . . and should have a positive impact on renminbi liquidity. This extra liquidity should have a positive impact on renminbi volumes in Hong Kong."

Left behind

Onboard

Sometimes the margin for opportunity is small.

No Dealing Desk avoids dealer intervention and trade restrictions, so you won't miss out.

Leveraged foreign exchange trading carries a high level of risk to your capital and you could lose more than your initial investment. Forex trading is not suitable for everyone; please ensure you understand the risks.

To find out more visit www.BarclaysMarginFX.com or call us on 0808 159 4947†

Margin FX

†0808 calls are free from a BT landline. The price on non-BT phone lines may be different. Please contact your supplier for further details. Calls may be recorded to monitor the quality of our service, to check instructions and for security purposes. Barclays Margin FX is a trading name of Barclays wealth and investment management products and services to its clients through Barclays Bank PLC and its subsidiary companies. Barclays Stockbrokers is the Group name for the businesses of: Barclays Stockbrokers Limited, a member of the London Stock Exchange and PLUS. Registered No. Churchill Place, London E14 5HP. All companies are authorised and regulated by the Financial Services Authority. Stockbrokers Limited. Please note that Barclays Margin FX may not be available in certain jurisdictions. The products offered by Barclays Stockbrokers under the Barclays Margin FX brand differ from products offered by the Corporate and Investment Banking division of Barclays. Barclays offers 986161. Registered VAT No. 243 5822 62; Barclays Sharedealing, Registered No. 2092410. Registered VAT No. 243 5822 62; Barclays Bank Trust Company Limited, Registered No. 920880. Registered VAT No. 243 8522 62. All companies are registered in England and the registered address is: 1

Shopping around: individual investors will still be keen to squeeze more yield from their assets Getty

Investors look abroad for returns

Japan 'Uridashi' bonds rise as Mrs Watanabe looks for foreign opportunities, reports *Ben McLannahan*

Dobro pozhalovat, Mrs Watanabe. In recent years the fabled keeper of Japan's household savings has been flitting around the world in search of precious income. Now she is checking into Russia. In the third quarter this year net flows into rouble-denominated "uridashi" – bonds sold in Japan, mostly to retail investors – ranked third by currency, behind the still-popular Brazilian real.

The mighty Turkish lira, which has accounted for more net inflows into uridashi this year than the next three currencies put together, was still out in front. "The rouble could be a new hot currency," says Masafumi Yamamoto, chief foreign exchange strategist at Barclays in Tokyo.

The Mexican peso could challenge it, say analysts, while other currencies such as the New Zealand dollar and the Indonesian rupiah have seen strong support. Even the renminbi has drawn solid flows into bank accounts, in spite of current diplomatic difficulties between China and Japan, says Takako Masai, FX strategist at Shinsei Bank.

One thing is certain, though. Whether in uridashi bonds, mutual funds or in FX margin trading, the fictional Japanese housewife – whose surname translates as "cross-border" – will continue to travel.

With domestic interest rates grinding ever closer to zero, signalling decades of weak growth ahead, individual investors will remain keen to squeeze more yield from their collective Y1,515tn ($19tn) in assets, while diversifying holdings away from a super-strong yen.

Appetites for taking on risk are limited, of course. Japan's retail investors are a fundamentally conservative bunch, many of them already in retirement and looking primarily for steady income to fund the daily costs of living.

And because of fears of slowing growth in emerging markets and a prolonged stagnation in Europe, caution has prevailed. Overall flows into mutual funds – which represent the bulk of investors' non-yen exposures – have turned to outflows over the past 12 months, as investors have liquidated holdings in euros and other beaten-up currencies. Quarterly data from the Bank of Japan showed that households increased yen deposits and cash to Y838tn in June, from Y830tn in March.

Still, these retail flows of money outside Japan have the power to move exchange rates. Take debt denominated in Turkish lira, which has been favoured for its high yields and reasonably high rating.

"Investors are playing strong domestic growth and the prospect of the re-emergence of demand in Europe," says Yunosuke Ikeda, head of FX strategy at Nomura.

Such support is welcome. Turkey's current-account deficit widened to a record of more than a 10th of GDP last year, most of it financed by short-term flows from banks.

"Money from Japanese savers can be a stable source of capital-account financing, which supports the exchange rate," says Mr Yamamoto of Barclays, noting that the lira has gained more than 6 per cent against the US dollar this year.

Always simmering, meanwhile, is the Australian dollar. In January 2010 Nomura started asking individual investors to name one currency as an "appealing" investment target over an approximately three-month period. The Aussie has topped the rankings in each of the 32 monthly surveys since then.

The Aussie gives investors what they're looking for: liquidity, a relatively high yield (despite recent rate cuts and the threat of more to come) and backing by one of the world's few remaining triple-A sovereigns, says Anna Hibino, FX strategist at JPMorgan in Sydney.

> These retail flows of money outside Japan have the power to move exchange rates

Further more, owing to the well-trodden tourist routes between the two nations, Japanese investors know the country and are comfortable with it, she says.

There is also enduring interest in the Brazilian real, although at much lower levels than the frenzy of 2010 and the first half of 2011. Since last autumn passions have cooled as the central bank has cut rates sharply and taxed foreign inflows, helping to push the real down about 12 per cent against the US dollar.

Regulators have also signalled concerns over sales of complicated, multilayered mutual funds, many of which focused on Brazil.

Holdings of real-denominated assets among Japanese mutual funds declined to Y1.82tn as of August, from a peak of Y2.87tn in March 2011, according to Japan's Investment Trust Association.

"Although the interest rate is more than double Australia's, investors are not forgetting the collapse in the currency last year," says Yoshihiro Hamada, head of the product development group at Diam, one of Japan's largest fund managers.

Instead, some investors are warming to the Mexican peso.

"If you have an optimistic view of the US, [the peso] is an ideal way to enjoy high yields and sustained appreciation," says Mr Ikeda of Nomura, the biggest mutual fund manager, which looks after more than a fifth of the Y59tn net assets across the industry.

There is also the Kiwi dollar, which pays a little more than the Aussie but with "a little more moderate exposure to China", says Mr Ikeda.

Across continents and hemispheres, the Watanabes' world tour goes on.

Foreign Exchange

Mexico gains favour over weaker Brazil currency

Latin America

Central bank action undermines real but US ties may hurt peso in the end, says *Vivianne Rodrigues*

After a period of broad gains in most Latin American currencies on the back of remarkable economic growth and fiscal discipline in the past couple of years, the region's foreign exchange market is showing signs of divergence.

While the Mexican peso has been getting stronger in the past year, the Brazilian real and the Argentine peso have stayed weak. In Chile, where the currency appreciated 12 per cent since January, investors are increasingly worried about possible central bank intervention.

The divergence is more visible through analysts and investors' outlook for two of the most heavily traded currencies in the region, the Mexican peso and the Brazilian real.

With foreign investors chasing higher yielding assets throughout the globe, bets in Mexico's local debt markets have increased as the pace of purchases of Brazilian assets has slowed.

The shift in investor preference is also being compounded as expectations for economic growth in Mexico surpass that of Brazil in 2013. Moreover, Mexico's central bank has traditionally avoided interference in the foreign exchange markets, unlike its Brazilian counterpart.

"It seems everybody loves to love Mexico these days, while Brazil has lost some of its 'darling' status to foreign investors," says Marjorie Hernandez, a foreign exchange strategist at HSBC.

"But focusing on fundamentals, what we have in Brazil now is a case of slower growth, lower rates, higher taxes and a very active central bank. Meanwhile, the economic background is stronger in Mexico and the central bank is being more market friendly."

Appreciated: Mexican peso is up 9 per cent this year Bloomberg

> 'Everybody loves to love Mexico, while Brazil has lost some of its "darling" status'

That combination, alongside Mexico's ties with the US economy – which has performed relatively better throughout 2012 than other developed nations – has contributed to an increase of foreign investment into Mexican bonds.

According to data from Banxico, the country's central bank, and compiled by HSBC, since the beginning of 2010 foreign holders of domestic Mexican bonds have nearly tripled to stand at $65bn in August.

Some of the demand, HSBC explains, came from Mexico being included in Citigroup's World Government Bond Index in 2010, which alerted a larger pool of investors to the country's positive dynamics.

But Ms Hernandez warns that the bulk of the move in favour of the Mexican peso versus the Brazilian real may have already been completed and at this stage, a straight sell-Brazil and buy-Mexico strategy would offer limited returns.

"It may be a bit too late for investors to try and catch that move as it is mostly behind us," she says.

Indeed, the Mexican peso has appreciated almost 9 per cent this year. In contrast, the Brazilian real has declined over 20 per cent since hitting a cyclical high in late July 2011, in part as a result of a series of benchmark rate cuts by the central bank to stimulate growth.

In addition to the cuts, Brazil's central bank has introduced several taxes on international financial transactions in recent years seeking to slow speculative inflows and damp rapid currency gains. Moves included a levy on foreign exchange derivatives to discourage long bets on the real.

One group that was hit by the tighter capital control measures was Japanese investors, who have traditionally supported the Brazilian real via so-called Toshin funds. As a result, Brazil-related investments now account for 60 per cent of Japanese holdings in emerging markets, down from 68 per cent at the end of 2009, JPMorgan data show.

Another challenge for the Brazilian real is the country's stronger ties with China. While China's voracious appetite for commodities and other goods in the past decade helped fuel an economic boom in Brazil, now that the world's second-largest economy is growing at a slower pace, pressure on the real is mounting.

The Chilean peso also faces a similar threat, given almost a third of its total exports are destined for the Asian nation, compared with a 22 per cent share in Brazil. In addition, the two currencies display a high correlation with copper prices, one of the most widely used indicators of future economic prospects in China, which render the currencies vulnerable to the metal's price fluctuations.

"Brazil is more linked to the China story," says Jose Wynne, head of North America foreign-exchange strategy at Barclays. "When you examine the performance of the Brazilian and Mexican stock markets in dollar terms, you notice the correlation between the moves in Brazil and markets like Shanghai and Taiwan, are stronger."

Mr Wynne says that investors should not completely disregard the Brazilian real as the country's economic fundamentals remain solid and Mexico's ties with the US also make it vulnerable to potential headwinds in the world's largest economy. The looming "fiscal cliff" in the US at the start of 2013, for example, may hurt the US economy and weigh on the Mexican peso story.

"There's no doubt Brazil is going through a soft patch and it's growing below potential," he says. "But while we are a bit more optimistic that the Mexican peso will appreciate in the near term, it is not a complete risk-free proposition."

Market stalls as interest rate differentials fall

Carry trades

Investors shy away from euro-funded transactions despite lower volatility, writes *Alice Ross*

When the European Central Bank cut eurozone interest rates to a record low in July, it was inevitable that some traders would spy an opportunity.

Some currency investors started using the euro in carry trades, borrowing in the single currency to fund more lucrative investments in higher-yielding emerging market currencies.

Selling the euro against the Mexican peso, the Australian dollar or the Swedish krona was a popular trade over the summer as investors bet on stable rates in higher-yielding currencies and even lower rates in the eurozone.

However, there are signs that these trades have stalled. For carry trades to be successful, investors normally require two things: low volatility and a decent interest rate differential.

Volatility in the currency markets hit a five-year low in September, according to an index by JPMorgan that tracks volatility among global currencies.

However, interest rate differentials are falling. Expectations that countries such as Australia and Sweden will cut rates have risen, as central banks around the world struggle to keep their exports competitive amid the slowdown in global growth.

The euro has been trading in a range as investors waited for signs of a bailout request from Spain, with many arguing the single currency could rise further.

Citigroup's foreign exchange desk reports reduced interest in euro-funded carry trades as a result, though Valentin Marinov, the bank's forex strategist, believes appetite for the trade will return.

Furthermore, lower volumes are also posing a threat to carry trades.

James Kwok, head of currency management at Amundi Asset Management, says that under normal conditions, lower volatility should be good for currency investors.

Carry trades work best when volatility is low because there is a reduced chance of a sharp spike in the funding currency. But with low volumes and investors taking smaller positions, it has become harder to get in and out of large trades, according to Mr Kwok – particularly in smaller, less liquid currency pairs.

Some believe the swings in currency pairs such as the euro-Aussie or the euro-Stokkie (Swedish krona) could also be simply because central bankers are reallocating resources. Many have been diversifying their stockpiles of reserve currencies into more unusual areas this year, with the Australian dollar, the Canadian dollar and the Swedish krona thought to be particular beneficiaries.

One point in the euro's favour is that it does not tend to get stronger when risk appetite falls, which has been the case with classic carry currencies such as the dollar and the yen. That should make it a more attractive carry currency, says Paul Robinson, global head of forex research at Barclays. However, he argues the drawback has been that when people are risk averse they shy away from the carry trade itself.

> The euro has been trading in a range as investors await signs of a bailout request from Spain

Daragh Maher, forex strategist at HSBC, agrees. "I don't think carry is the prime consideration for investors at the moment," he says.

"At the end of the day, it's event risks, politics, tensions over Iran: bigger things than whether I'll get a 70 basis point pick up each year."

Real struggles to keep afloat

Brazil

The idea of free convertibility for the currency may be just a pipe dream, says *Joe Leahy*

In Basel in 1999, the then president of Brazil's central bank, Arminio Fraga, spoke of making the country's currency, the real, freely convertible into dollars.

This would merely formalise what was already happening in the economy, he was quoted by the BBC as saying at the time, with Brazilians finding ways to convert their money into foreign currency.

But in the intervening 13 years, while the question of a freely convertible real has continually re-emerged, today the reality seems to be further away than ever.

After a strong run against the dollar following the 2009 crisis, which sparked panic in a government already worried about Brazil's export competitiveness, the real has since been boxed into a tight band of around R$2 to the dollar. Like a hapless prize fighter who got out of control and had to be subdued by the referees, the currency does not seem to be able to budge without some form of official intervention to keep it in its place.

"We had a dirty float and now we've got a dirty band," said Tony Volpon, economist with Nomura, of Brazil's new foreign exchange regime.

Officially, of course, the real remains a floating currency. But its story of the past few years shows how difficult it can be for policy makers in Brazil to let markets run their course.

After Brazil emerged in good shape from the 2009 financial crisis, with economic growth soaring 7.5 per cent in 2010, the real began to grow in value, reaching nearly R$1.50 against the US dollar – an increase in value of 40 per cent from 2008.

This sparked panic in the government, which feared that the strong currency was undermining an industrial sector that was already weakening on the back of rising labour costs. A strong real meant Brazil's exports lost competitiveness abroad and domestically against cheap imports, particularly from China.

The government responded by stepping up its rhetoric against so-called "currency wars", or competitive devaluations by trading partners. The chief culprit was the US, which was engaging in monetary easing without accompanying fiscal stimulus programmes to make use of the increase in liquidity in the system.

This liquidity was finding its way into Brazil to take advantage of the country's steroidal combination of high interest rates, a strengthening currency and

> 'We had a dirty float and now we've got a dirty band'
>
> **Tony Volpon, Nomura economist**

rapid economic growth. For a time it seemed that the real was a one-way bet as China's demand for Brazil's iron ore and soyabeans looked insatiable.

The government implemented a series of currency controls, such as taxes on short-term inflows in bonds and stocks, deterring some would-be investors. Then the eurozone began to deteriorate and China to slow down. Gradually, the real, known in markets as the "BRL", came off the boil as an investment. Investors either switched to Mexico or began betting on Brazilian interest rates, which started a long, one-way slide to a record low, set this month, of 7.25 per cent – 525 basis points below their last peak of 12.5 per cent in August 2011.

The authorities also used the moment to weaken the real to around R$2, with the central bank intervening when it threatened to go beyond that level. A sharply weaker real is also considered undesirable because it would wreak havoc with corporate hedging contracts and raise the local currency cost of companies' foreign debt.

Marcelo Salomon, economist with Barclays, identifies keeping the real at this level as a key platform of the government as it seeks to remove high costs and other distortions that have hampered industry.

"We identify the attempt to keep USD/BRL above 2.0, mimicking a crawling peg regime between 2.0-2.10 as one of the 'horizontal' measures the government is pursuing to improve competitiveness and encourage investment," Mr Salomon said in a report.

However, the government cannot have its cake and eat it. Some economists believe that with interest rates low and the currency weak, inflation will return next year. Rather than increase rates, the government may have to let the currency appreciate again.

So it seems the dream of free convertibility of the currency remains just that – a pipe dream, at least for the next year or two.

Face value: a weaker real is thought to be undesirable Reuters

EBS

What's behind the leading platform in spot FX?

You and EBS. Working together.

The greatest partnerships are based on mutual understanding. Our partners understand we're committed to their interests. We understand what works for the market, today and for the long term. It's what makes us the natural choice in FX. It's what makes us EBS.

www.ebs.com

The heart of the FX market

ICAP