Global overview: Foreign exchange - the times they have changed
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Abstract:

Trends in global foreign exchange markets during 1994 and the first half of 1995 are reviewed. Profits were low and the famed hedge fund managers did not make much money. Money has been lost on the dollar, US interest rates, and European interest rates over the past 18 months. In a cruel twist of fate, the one shining profit area of 1994 - emerging markets - was shattered by the collapsing Mexican peso in late December 1994. Other trends included: 1. Disappointing returns by macrohedge funds prompted many to reduce their activity. 2. Derivatives gained notoriety as their use and misuse hurt some institutions and exaggerated market moves. 3. Banks saw their foreign exchange trading profits decline dramatically, but pushed ahead with plans to globalize their major trading businesses. 4. Central banks had limited success, but seemed to end the period stronger.

Full Text:

Few traders regretted the passing of 1994 and the first half of 1995. Profits were low and the famed hedge fund managers did not make much money. Money has been lost on the dollar, US interest rates (both up and down), and European interest rates over the past 18 months. And in a cruel twist of fate, the one shining profit area of 1994--emerging markets--was shattered by the collapsing Mexican peso in late December 1994.

What happened? A dispassionate view would suggest that traders should have had a banner year in 1994 and 1995. The markets, ex-post at least, had large trends; $/yen went from Y113.1 on January S 1994 to Y99.6 on December 30 1994 and Y80 in April 1995. The same applies to $/Deutschmark--Dm1.76 to Dm1.55 by the end of 1994 and to Dm1.35 by March 1995--and long-term US interest rates--6.34% to 8.17% in November 1994 and 6.5% in June 199S. Similarly, long-term German rates followed US interest rates.

Only equities were trendless in 1994, yet money managers under-performed because they were looking for a large decline. In the first half of 1995, equity managers have also under-performed, missing the strength of the US market and the rebound in emerging markets.

Why were the markets continually surprised? This is a question with an elusive answer, but one meriting serious attention. Although the primary focus of this article is on global currency markets, it is also recognized that looking at currency markets in isolation is hazardous to profits. Further, understanding the linkages among markets, across instruments, and between politics and economics is necessary for profitable survival.

Currency markets

The break from the past in foreign exchange markets began in the summer of 1993, when in response to a two-year period of turmoil, European central banks widened the ERM bands to 15%. By defending narrow bands, European central banks had reduced, if not removed, the risk of holding high yielding currencies and provided 'free' profits for traders. In addition, when pressure began building for one of the inevitable devaluations, due to changing economic fundamentals, the market was allowed to profit--again.

The widening of the bands effectively ended this subsidy. Not fully comprehending how the world had changed, the market stuck to what had worked in the past. In the spring of 1995, pressures on the Belgian franc, the French franc, the Danish krone and the Irish punt forced authorities to raise interest rates.

However, even though Spain and Portugal capitulated to the pressure and accepted a devaluation, a systemic crisis did not materialize. The devaluations occurred before the 15% band limits were violated; in subsequent months, both currencies returned to pre-1995 devaluation levels.

To some extent, the increased volatility in the foreign exchange market reflected adjustment to the post-Cold War, post-Berlin Wall relationships. This adjustment to new political economic conditions helped mitigate the effect of cyclical economic fundamentals--a tenuous relationship even at the best of times. The Deutschmark and yen tended to benefit from regional safe haven flows in ways in which the US dollar clearly did not.

Comments by a number of US officials, including the Treasury Secretary Lloyd Bentsen, led market participants to believe the dollar was going to be used as a weapon to pry open Japanese markets. This act by policy makers provided perhaps the last of the 'free' lunches to traders, who correctly surmised that if the US Treasury Secretary was talking down the dollar, who were they to question it.

The failure of US-Japan bilateral talks in 1994 led to a Valentine's Day Massacre of dollar bulls, who ignored Bentsen's doctrine. Defying economic logic and experience, the dollar's decline from February 1994-March 1995, and especially January-March 199S, occurred despite seven tightenings by the US Federal Reserve.

Credit markets

Bond yields were expected to decline in Europe during 1994, as central banks explored the room for independent action now that the tether to the Bundesbank had been loosened. With the Federal Reserve thought to be on hold, US Treasuries were expected to be stable.

Long-term interest rates rose sharply in the US after the Federal Reserve began raising rates in February 1994, and yields in Europe followed. This increase in yield --from 5.8% (30-year US bond) in November 1993 to 8.2% in November 1994--came despite US inflation dropping to its lowest level in 30 years.

This unexpected increase in real yields meant large portfolio losses for fixed income investors and an attenuation in equity gains. The calendar year of 1994 marked the first year that the US bond market generated a negative return. In general, speculators (hedge funds), which can profit from moves in both directions, missed this 12-month trend.

Derivatives

Some treasurers also guessed, wrongly, that interest rates would remain low for the foreseeable future and their resulting losses generated a great deal of public interest in derivatives. Their use was linked to the increased volatility of the financial markets, as was the case with stock index futures in October 1987. Many corporates reassessed their use of derivatives, but for the most part derivatives remain an integral and growing part of heeding strategies.

The collapse of Barings highlighted the necessity of adequate risk controls, especially as product innovations bring about new generations of exotic derivatives. Despite the negative perception and the overall decline in the volume of options traded, the use of exotic options (eg, barrier, average-rate and digitals) increased last year. Their efficiency makes them more appealing to the end user and, as their comfort level grows, they will become an important tool in managing foreign exchange risk.

The number of banks actively making markets in currency options dropped significantly during the last year. The tough year experienced by many traders encouraged a more risk averse stance by commercial and investment banks, and fewer banks remain committed market makers.

In addition, the need for sophisticated risk management tools for trading exotic derivatives encourages economies of scale and has contributed to the consolidation of the foreign exchange options business. However, for those banks that can adequately manage the risk inherent in exotic derivatives, the exotic options business has proven to be very profitable and as with plain vanilla options, a good mechanism for cross-selling other foreign exchange products.

Emerging markets

The devaluation of the Mexican peso and the subsequent effects on international investments demonstrates how the market can be surprised by economic fundamentals and its sometimes lemming-like behaviour. Mexico was one of the primary recipients of hot capital flowing into developing countries during the 1990s. These flows contributed to the significant strengthening of the the peso's real exchange rate and sparked a sharp increase in private consumption of imports, resulting in an unsustainable current account deficit.

Several warnings about an impending devaluation were given to investors Chiapas, decline in international reserves, political assassinations, and an expansion in credit demand. Yet, much like the bond yield explosion, and the dollar's decline, the market was taken by surprise.

Nevertheless, the Mexican crisis helped crystallize a number of important issues for market participants and policy makers. First and foremost, global integration and deregulation make countries more vulnerable to the fickle judgment of managers of hot capital. Macro-economic policies that generate low inflation, and small current account and fiscal deficits are (generally) 'rewarded'; others are punished.

National policy objectives are increasingly subject to the discipline of market forces. The boycott of government bonds by Sweden's largest insurance company, to protest against lax fiscal policies, drives this point home. Governments are likely to encourage less volatile foreign direct investment and long-term portfolio investment in lieu of more volatile short-term capital flows.

Increased vigilance on the part of international monitoring agencies and greater openness on the part of governments is likely to be forthcoming. Paradoxically, the Mexican episode will help in reducing the risk of investing in emerging markets.

Financial markets in 1994 and 1995 have made even the most speculative financial market participants risk averse. Thus, many investors that missed the global bond market sell-off of 1994 also issued the bond market rally of the first half of 1995. After suffering losses in the emerging markets in 1994, many players were reluctant to get involved again in 1995.

Consequently, the recovery in the emerging markets in early 1995 was missed. The average international investor earned only 1% relative to the 6.4% gain in the Morgan Stanley International Index for the year ended March 31, 1995, and the average emerging markets investor lost 12.2% against a decline of 10.7% in the Emerging Markets Index.

New reality

The poor results registered by many macro hedge funds in 1994 were also repeated in the first half of 1995. According to the index compiled by Hennessee, hedge funds had an average return of only 8.3%--substantially lower than the 30%-plus returns in the halcyon days of 1992 and 1993. A common explanation for the lack of performance of large hedge funds is that they are too big. An alternative explanation is that the rules of the game have changed and market participants have not adapted to the new emerging reality.

The hedge funds have cut back, but despite these much publicized retrenchments, they will continue to play an important role in the global financial markets.

Commercial and investment banks continued their multi-year project of consolidation and cost cutting. The integration of global capital markets requires banks to build and operate their foreign exchange businesses globally. London and New York remain important centres for foreign exchange activities, whereas Singapore has grown in importance at Tokyo's expense as banks vie for business in the fast growing nations of south east Asia.

For their part, corporates continued to reduce the number of banks with which they transact foreign exchange business. Corporate treasurers are placing a premium on valued-added services and are less inclined to deal with banks on a transaction-only basis.

Central banks

Central banks experienced mixed success at influencing the foreign exchange market. Their efforts to support the dollar against the Deutschmark and yen failed initially; however, on a trade-weighted basis, the dollar has remained relatively stable. European central banks were more successful at restoring stability in the Exchange Rate Mechanism. Both Denmark and France were forced into a defensive posture when their currencies weakened to around 6% from their central rate against the Deutschmark.

Countries such as Italy, Spain, and Sweden were forced to counter rising price pressures, which threatened to undermine their currencies, by raising key interest rates. This time the market judged these policy responses appropriate, given the extreme relative values reached in the foreign exchange and interest rate markets.

Dollar reserves

Official reserves have been the subject of great debate over the past six months. Speculation that the dollar's decline to record lows against the mark and yen would jeopardize its reserve currency status. While some data suggests the dollar's share of world reserves is indeed in a long-term down trend, the decline has been gradual and, indeed, after bottoming in 1990, has been on an uptrend.

To add to the confusion, it was widely reported in mid-April 1995 that Asian central banks were actively diversifying their holdings out of $-denominated assets. Here too, the dollar's demise was more in the nature of panicky conjecture. Press reports notwithstanding, the data actually suggests that for some Asian countries, the apparent change in the composition of reserves was simply a function of the dollar's dramatic loss of value.

Other Asian countries took a more active role in managing their reserves. The frequent appearance of a few of these central banks has given rise to market perceptions that some may be undertaking more speculative transactions in both the spot and options market, in order to enhance returns on reserves rather than merge the composition of reserves.

New frontiers

The rapid growth in international capital flows to emerging markets experienced during the first half of this decade should continue at the same pace for the rest of the century. Such flows are now a major item influencing world credit and exchange rate markets. From a level of less than $50 billion in 1990, such flows had reached more than $160 billion in 1943 and 1994 and, the Mexican debacle notwithstanding, should be about $150 billion in 1995.

Increased global economic integration necessitates the greater mobility of capital. The economies of scale offered by multinational corporations help meet the demands of the a global consumer, whether in New York, London, Frankfurt and Tokyo, or Singapore, Hong Kong and Bombay.

The wave of financial and economic deregulation continues to sweep across the globe and creates investment opportunities where they previously did not exist The role of banks as intermediaries, deal-makers and market-makers is therefore enhanced.

Capital formation in the developing economies is assuming greater importance. Infrastructure expenditure alone is estimated at about $200 billion a year. Developing countries, for their part, are likely to rely on the more stable foreign direct investment to finance modernization, rather than portfolio flows. A few years hence, one can expect an increase in two-way capital flows between the developed and the emerging world.

Corporates will continue to invest outside their respective home markets, as they respond to competitive pressures to reduce production costs and penetrate new markets. Even if the commitment to free trade is not unwavering, the establishment of the World Trade Organization reflects a commitment to reducing barriers to trade.

The recent leadership shown by Europe in negotiating a financial market liberalization agreement after the US withdrew is indeed a promising development. The prospects of greater economic growth in emerging markets relative to the more developed economies should ensure that these markets remain attractive for corporate investment.

Banks have responded to the maturing capital markets by pursuing globally-integrated strategies that cross geopolitical and product lines. The foreign exchange business has not grown in isolation, but as an integral part of banks' presence in the global capital markets.

The arena of competition among banks is shifting from pricing and execution to providing a full range of investment and hedging products. When the consolidation and concentration that is occurring has run its course, fewer but larger global banks will remain, offering clients a full range of services.

The numerous niche institutions that survive are more likely to service the large global banks than customers directly. Meanwhile, the consolidation of industry relationships will continue as corporate treasury departments reduce the number of banks with which they do business.

In an effort to capture higher returns and diversify risk, portfolio managers are likely to increase their international asset allocations. For example, over the next few years US pension fund managers are expected to increase their international allocations from the current 8% to as much as 20%--and a large portion of this increase is expected to go towards emerging markets.

At the midpoint in the decade, the foreign exchange market remains an exciting and integral part of global capital markets. Future growth is assured as the bond and currency markets of emerging economies begin to look more like those of their more developed brethren. The competition for this business will be intense, and easy profits in this growth area are likely to be temporary and illusory.

Nevertheless, the next frontier pertains to the continued integration of global capital markets brought about by the growing importance of emerging markets. It is here that lies both the risk and opportunity of the forex market.