

Foreign Exchange Markets

“Nowhere is more nonsense talked than by currency experts about foreign exchange.”ⁱ

Sir Winston Churchill

For this issue of the Tapestry SPOTLIGHT we examine the history of global currency markets, the tools of trade used by market participants, and some of the key considerations surrounding this asset class.

Read any business trade journal or newspaper and you will invariably find an article about currency markets. Throughout history, global central banks have used currency reserves as one of their tools to inflate, deflate, improve economic standing or protect domestic interests. The intended effectiveness of currency intervention has been mixed as other macro factors exacerbate policy decisions. Today, currency news is at our doorsteps; with unprecedented economic stimulus through the printing of money in the US, China's much criticized depreciation of the yuan in an effort to increase global competitiveness, and just last month the coordinated effort by G-7 central banks to intervene given a surging yen amidst a national crisis in Japan.

1156 dates the earliest record of a foreign exchange (forex) contract where two brothers borrowed 115 Genoese pounds and agreed to reimburse the bank's agents in Constantinople 460 bezants one month after their arrival. It was thought that this potentially profitable transaction resulting from a time difference didn't violate Canon laws against usury.ⁱⁱ As reflected in this verbal agreement, a forex transaction is a contract to exchange one currency for another currency at an agreed rate on an agreed date.ⁱⁱⁱ

The recent growth in the global forex market has been staggering with an average \$4.0 trillion in global FX exchange market turnover in 2010 compared with \$1.2 trillion in 2001. FX swaps have consistently represented the largest component of market turnover with \$1.8 trillion in 2010. Of the total global currency market turnover (37 total currencies, with each single currency representing half a trade), the US dollar (85%), Euro (39%), and Japanese yen (19%) represent the largest percentage of total currencies traded. US/EUR represents the largest pair trade at 28% which has been consistent since 2001. In the over-the-counter (OTC) interest rate derivatives market, growth has been dramatic with market turnover growing from \$489 million in 2001 to \$2.1 trillion in 2010.^{iv} Since 2005, Currency Exchange Traded Funds (ETFs) have added to the volume of trading with total fund assets in 2010 reaching over \$6.0 billion and represented by more than 30 funds trading across global currencies.^v The largest of these currency ETFs is the PowerShares DB US Dollar Index Bullish (UUP) with \$873 million in assets.^{vi}

The global forex market is different from the stock, bond and commodity markets in that it essentially trades 24 hours a day, is fairly decentralized with a large volume of transactions taking place through an Interbank, OTC market system, and contracts are structured as relative value trades being long and short different currencies. Within the Interbank system, banks can deal with each other directly or through electronic trading platforms. The largest banks that trade this asset class per the most recent *Euromoney Annual Benchmark Global Foreign Exchange Survey* are (in order of market share) Deutsche Bank, UBS, Barclays and Citigroup. Electronic trading platforms offer algorithmic trading programs which per ICAP now accounts for 45% of their total customer trading with the balance through manual trading. This is a large jump from 2007 when algorithmic trading represented 28%.

Since the collapse of the Bretton Woods system and the floating of major currencies during the 1971-73 time period, nation members have been free to choose any form of exchange arrangements they wish except pegging their currency to gold. This has resulted in a mix of free float (US dollar), pegged (Bahrain dinar),

adopting another currency (Grenada's use of the East Caribbean Dollar), participating in a currency bloc (Eastern Bloc), or forming part of a monetary union (Euro).

In the US, much more public debate has been held during the last year on moving away essentially from a Fiat system and bringing back the gold standard to support the US dollar's value given the prevailing trend of a global depreciation in currencies. Recently, the state of Utah passed a bill to make federal gold and silver coins legal currency with similar measures being discussed in 13 other states. Supporters believe an inflation anchor is needed whereas critics believe linking the US dollar to gold opens more risk exposure to financial shocks.^{vii}

During the 1980's, market participants started to take notice of the ability to trade and invest in currency markets which evolved from trading primary US dollar pairs to the expansion into non-dollar cross rates. Today, the asset class has been refined even further to invest in dollar majors (most actively traded), dollar minors (less actively traded), crosses (non US dollar pairs), Asian exotics (less liquid), and commodity currencies (export driven). During the last two decades, investment analysis of currency markets has grown from anticipation of changes in trade balance to the incorporation of interest rate and inflation forecasts, interest rate differentials, capital flows, economic indicators, and volatility trends.

Market participants can invest in currencies through exchange traded derivatives including forwards, futures and options, or through OTC contracts including cash (spot) market, swaps, options and other (sometimes multi-legged and complex) structured products. Additionally, investors can select from a myriad of ETF/ETN products that provide exposure to a particular currency or group of currencies and investible indexes which attempt to replicate some of the commonly used, actively managed currency strategies including trend, value, volatility and carry.

Trend followers as a group did well during the early 80's when the US dollar was in an extended bull market and in the late 80's when the US dollar was in an extended bear market. In its basic form, a trend following approach waits for a specified price move and then initiates a position in the same direction based on the assumption that the trend will continue. The timing (short to long term), sensitivity and complexity of each strategy vary by the inputs utilized. Systematic Commodity Trading Advisers (CTAs) that trade currencies may offer a dedicated currency fund, provide exposure as part of a diversified program, or offer as an overlay strategy to hedge or gain exposure to an identified risk. The Barclays CTA Currency Index for the period Jan-01 to Feb-11, has generated an annualized return of 3.0% with annualized risk of 4.8%. Much stronger returns were generated during the late 80's and early 90's during periods of heightened fluctuation and a less crowded marketplace. Banks such as Barclays Capital and Deutsche Bank offer currency trend index products that attempt to capture trend and trend reversals in global forex markets. For example, the Barclays Capital Adaptive FX Trend Index has generated an annualized return of 5.9% with annualized risk of 5.6% for the period Jan-01 to Feb-11.^{viii}

The carry trade is another currency strategy that became popular in the late 80's when investors borrowed in Japanese yen to finance European securities. The carry trade is structured to benefit from the positive interest rate differential between long investments in higher yielding currencies financed through lower yielding currencies. Loose monetary policy and a stable forex market support this type of strategy. This phase ended in 1993 when assets were repatriated and the Japanese yen sharply strengthened. In 2008, the markets witnessed the unwinding of high yielding and riskier investments financed through Japanese yen and US dollar as investors became concerned about credit issues and the broader markets. The risk with this type of relative value strategy is the potential for a market unwind brought on by sudden and uncontrollable events. Carry trades can be employed utilizing systematic or discretionary inputs and tend to have a longer time horizon than some of the trend following strategies. When comparing 2010 cumulative returns for this strategy, the most profitable G10 carry traders were AUD/USD (19%), JPY/USD (14%), and NZD/USD (11%).^{ix}

Fundamentally based or what is termed a value approach to forex investing takes into account the underlying economic health of a currency's country or region. This approach factors views on inflation, growth, money supply and Purchasing Power Parity (as exemplified by The Economist's Big Mac Index). Historically, this approach has had difficulty generating consistent profits in comparison to other approaches given the reliance on longer term forecasts. Discretionary strategies often look at fundamental factors and may rotate between this strategy and the carry trade depending on the prevailing market dynamics.

Another way to participate in the currency markets is by trading volatility through the currency option and swap markets. Currency options were initially developed to offset currency risk held by banks, corporations and international investors. Currency put and call options that are exchanged traded are listed in Philadelphia (PHLX) and Chicago (CME) whereas OTC currency options are traded through the Interbank market. Settlement and structure of currency options vary (exotic versus vanilla, European versus American). The attractiveness to investors is the ability to limit downside risk without severely capping profit potential. The interesting phenomenon earlier this year was the prevailing low level of volatility despite unrest in the MENA region and price action in the energy complex. HSBC's Global Hazard Indicator, which measures three month implied volatility of the dollar, euro, and yen fell to its August, 2008 lows of 12% early in March, 2011. Some market participants speculate that the level of central bank intervention has impacted volatility levels.

As we saw during the financial and liquidity crisis of 2008, currency managers held up comparatively well in terms of performance, business continuity and liquidity. The incorporation of this asset class into a broader portfolio does provide another tool for diversification and hence a more robust and independent return (except in periods where all asset classes are highly correlated and trade on sentiment in what has been coined as the "risk on"/ "risk off" trade). Currency strategies also provide another tool to invest in the growth story of less developed markets with less liquidity risk that investors have been subject to in the equity and credit markets. The key is to make sure the currency strategies added to a portfolio provide an attractive blend of strategy types which should serve as an "all weather" solution to currency market exposure.

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ⁱ The Way of the Dollar, John Percival, 1991

ⁱⁱ A History of Money from Ancient Times to the Present Day, Glyn Davies, 1996

ⁱⁱⁱ A Currency Options Primer, Shani Shamah, 2006

^{iv} Triennial Central Bank Survey of Foreign Exchange and Derivatives, December 2010

^v Barron's, January 6, 2011, Currency ETFs Seen Becoming More Mainstream, Murray Coleman

^{vi} Barron's, March 14, 2011, The Money Whirl, Sandra Ward

^{vii} My Fox NY, Utah House Passes Gold Standard Bill, March 4, 2011

^{viii} www.barcap.com

^{ix} Bloomberg