Global FX: Shaken out of their low volatility torpor

With the rout in the global equity market and risk assets extending further, FX markets are under broad-based pressure. Given the fragility of markets and as they monitor the increasing number of worldwide Covid-19 cases, markets are likely to remain under pressure. Emerging market FX is likely to continue to struggle and safe havens should remain bid

Volatility awakens

The worldwide spread on Covid-19 has understandably taken its toll on risk assets as investors are forced to lower growth forecasts and even consider recession in some countries.

Financial assets, which had enjoyed the benign conditions of central bank money printing – have had a rude awakening. The S&P 500 is now 12% off its highs and the VIX fear index has surged back to levels not seen since the global financial crisis. Even EUR/USD volatility – written off this year – has quickly bounced back to levels last seen in 2018.

It has hard to make a call on when this equity correction will turn, especially after such a long period of low-volatility gains. However central banks will be carefully monitoring financial conditions and step in if they fear self-enforcing trends and market dislocation emerging. While credit spreads have certainly widened, we are yet to see major problems in the interbank space – e.g. a sharp widening in the TED spread (USD 3-month Libor over US T-Bills).

We would monitor that amongst other stress variables for signs that central banks could step in with a co-ordinated rate cut, as they did in October 2008. For the time being, however, we expect financial asset prices to stay under pressure.

FX markets react

As we outlined in Coronavirus: Gauging the market fall-out, we see the risk – commodity exposure framework as the best way to assess the current vulnerabilities in the FX markets and the reaction of currencies to Covid-19 related risks. The slowdown in global growth is hitting pro-cyclical currencies and Chinese slowdown in particular further weighs on commodity FX. Mixing these two factors together, a credible vulnerability scorecard exposes those currencies that are at risk and those that can outperform.

In addition, and given the extent of the moves, the current situation has triggered a positioning squeeze and carry trade unwind (which is also evident in the emerging market bond market, where high yielding sovereign debt is underperforming low yielders - the large sell-off in the overbought RUB is a case in point)

Coronavirus: Gauging the market fall out

AUD, NZD and NOK to remain G10 underperformers

As Fig 1 shows, the AUD, NZD and NOK (as well as the CAD) are the most at risk given their high beta and commodity exposures (they are in the undesirable top right quadrant).

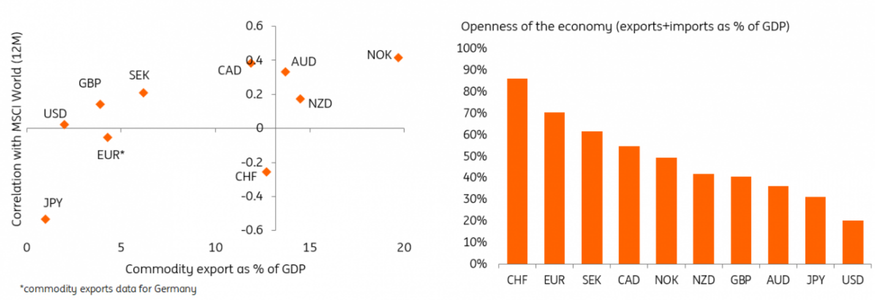
While SEK tends to weaken in the risk-off environment too, currently is an outperformer among the cyclical currencies given its lack of commodity exposure. This is in line with price action this week, whereby SEK outperformed its G10 cyclical peers.

AUD and CAD appear particularly at risk of facing additional selling pressure as the RBA and the BoC meet next week. As we have highlighted: "Australia's central bank to stand pat, with a possible dovish tilt", it will be hard for the RBA to deliver another hawkish surprise as Covid-19 risks to the Australian outlook have likely increased since the previous meeting.

Elsewhere, speculation that Canada's central bank may deliver a cut sooner than later has risen dramatically along with expectations of more Fed stimulus and we highlight a relatively high risk of a move in one of the next two meetings.

Australia's central bank to stand pat, with a possible dovish tilt

Fig. 1 & 2: Gauging the G10 exposure



Source: Bloomberg, ING

JPY: Regaining the attractiveness

In contrast, JPY does well and should continue doing well (within Fig 1, it screens as the most desirable currency to hold in a risk-off scenario) given its safe-haven properties.

While two weeks ago USD/JPY was testing 112 level, this has now changed as Covid- 19 enters second-phase with the focus of market concerns no longer tied to just Asian economies but now becoming a global story (and thus being negative for economies outside of Asia). In this environment, JPY is set to flourish.

Generally the sharper the dislocation in equity markets, the higher the USD/JPY correlation with equities. A short, very sharp equity correction, therefore, leaves USD/JPY vulnerable. There is some extreme outside risk to 105 here should equity losses run un-checked – but we'd see that as the base for 2020.

JPY: Three drivers behind the fall

EUR benefiting from a short-squeeze, but only for now

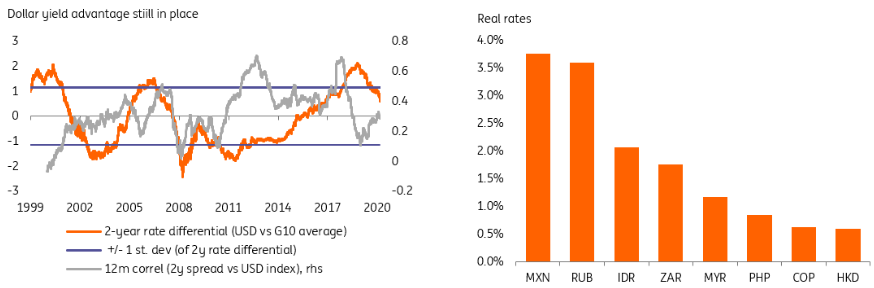
The EUR/USD spike this week is more about a euro short-squeeze (given that EUR functioned as a funding currency of choice for risk on long position in G10 cyclical currencies and EM high yielders) rather than a re-rating of the euro outlook (which in our view remains poor). The downside risk to the eurozone economy remains in place (given the very open nature of the eurozone economy and its linkage to the global supply chains which are now at risk - Fig 2).

On the dollar side, although the market's dovish repricing of the Fed rates outlook contributed to the reversal in EUR/USD higher, plenty of easing is already priced in, particularly in the context of the Federal Reserve cautious approach (which last year proved reactive rather than proactive). With the market already pricing three full Fed rates cuts this year, the dollar interest rate differential was eroded further vs the euro and its G10 peers (Fig 3), yet it still remains meaningful. This, in turn, keeps the dollar's appeal for now and EUR/USD upside should be limited.

Yet, as the dollar advantage has been eroded and the interest rate spread dropped further below the one standard deviation mark (blue line in Fig 3) this is likely to reduce dollar's appeal once the market stabilises and will increase the call for the turn in the dollar bull trend. Yet this is likely to be the case for dollar crosses against cyclical higher-yielding currencies rather than euro (as the former shows more appealing valuation than the latter), with the euro still remaining unattractive vs the dollar (both from economic and interest rate perspective) even after the dip in US rates.

But for now, we expect EUR/USD upside to be limited. EUR/USD 1.11-1.12 may be the best levels here before the markets get to assess the fresh damage done to the eurozone economy.

Fig. 3 & 4: USD and EM rates overview



Source: Bloomberg, ING

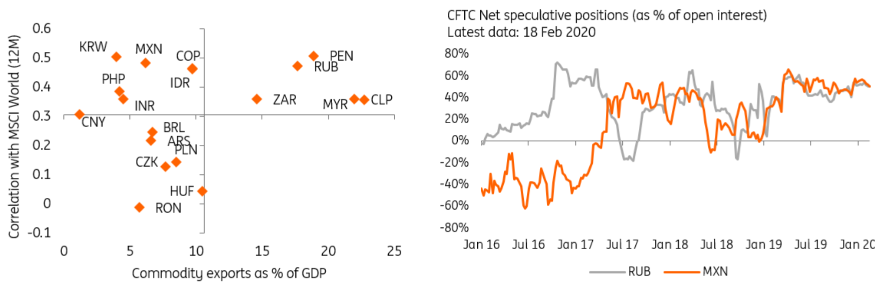
EM FX: Running way from high yielders

The latest emerging market FX price action clearly resembles a positing unwind. Today, the four weakest emerging market currencies are RUB, IDR, MXN and ZAR. It does not come as a surprise that these are the currencies with the largest real rates in the emerging market region (Fig 4), which in calm times made them attractive.

RUB and ZAR also seem particularly exposed from the risk-commodity exposure perspective, as evident in Fig 5 (with both currencies being in the undesirable top right quadrant).

Near term, as the risk sentiment is likely to remain fragile, the high yielding currencies should remain under pressure. With MXN and RUB having been up till now seen as the darling of EM FX (as evident in meaningful speculative longs – Fig 6), these currencies are at risk of a further positioning squeeze.

Fig. 5 & 6: EM exposure, MXN and RUB positioning in deep long territory



Source: CFTC, Bloomberg, ING

CEE FX: Vulnerable CZK vs no longer underperforming HUF

In the low yielding CEE space, CZK should continue underperforming. As it has been the case for RUB and MXN, the koruna has also been a regional darling (in the CEE space) with long CZK positions being meaningful.

Given the indiscriminative flight to quality and liquidation of EM FX positions, the koruna is now at risk. In contrast, we reiterate our constructive view on HUF. Positioning-wise, the forint is the opposite to CZK – the Hungarian currency has been one of the most oversold in the EM FX space and with its fortunes changing (after the NBH delivered close to two 25bp implicit hikes), it should now start outperforming CZK and PLN in the region.

The latest price action provides the case in point.

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com