4X Global Research

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Low global FX vol: maturity or complacency?

Global FX volatility – as measured by the 5-day Standard Deviation (SD) in the daily percentage change in the spot (closing) price of a turnover-weighted basket of 32 major currency pairs against the US Dollar – remains depressed by historical standards.

While global FX volatility rose slightly on 11th August to about 0.32 SD following the release of US CPI-inflation data, it is still well below its level one month ago (0.43 SD) and 10-year average (0.47 SD). Notably global FX volatility is at a similar level (0.30 SD) as it was in the run-up to the 16th June Fed meeting and release of a more hawkish FOMC "dot-chart".

Volatility versus the US Dollar in most of these 32 developed and EM currencies has either fallen in the past month from already modest levels or been broadly stable. Volatility in the high-yielding Brazilian Real and low-yielding Canadian Dollar, Czech Crown, Norwegian Krone and Hungarian Forint has fallen the most in absolute terms.

However, there have been a few notable exceptions, including the Turkish Lira, Thai Baht and Chilean, Colombian and Philippines Pesos.

USD/THB volatility has risen further in past month and is now near top end of its admittedly narrow 12-month range. The Baht has been choppy against a strong US Dollar, resulting in the Baht NEER appreciating 1.4% since the multi-year low recorded on 6th August.

GBP/EUR volatility is currently at its lowest level since early June. Sterling's appreciation against the Euro has been slow and steady, in line with our expectations.

Volatility in global FX (and the S&P 500) also remains very modest compared to volatility in other asset classes, notably US Treasuries and Brent crude oil (see Figure 5).

Most of the price action has been in the US rates market in recent months, perhaps unsurprisingly given protracted debate about the timeline for Fed tapering and rate hikes.

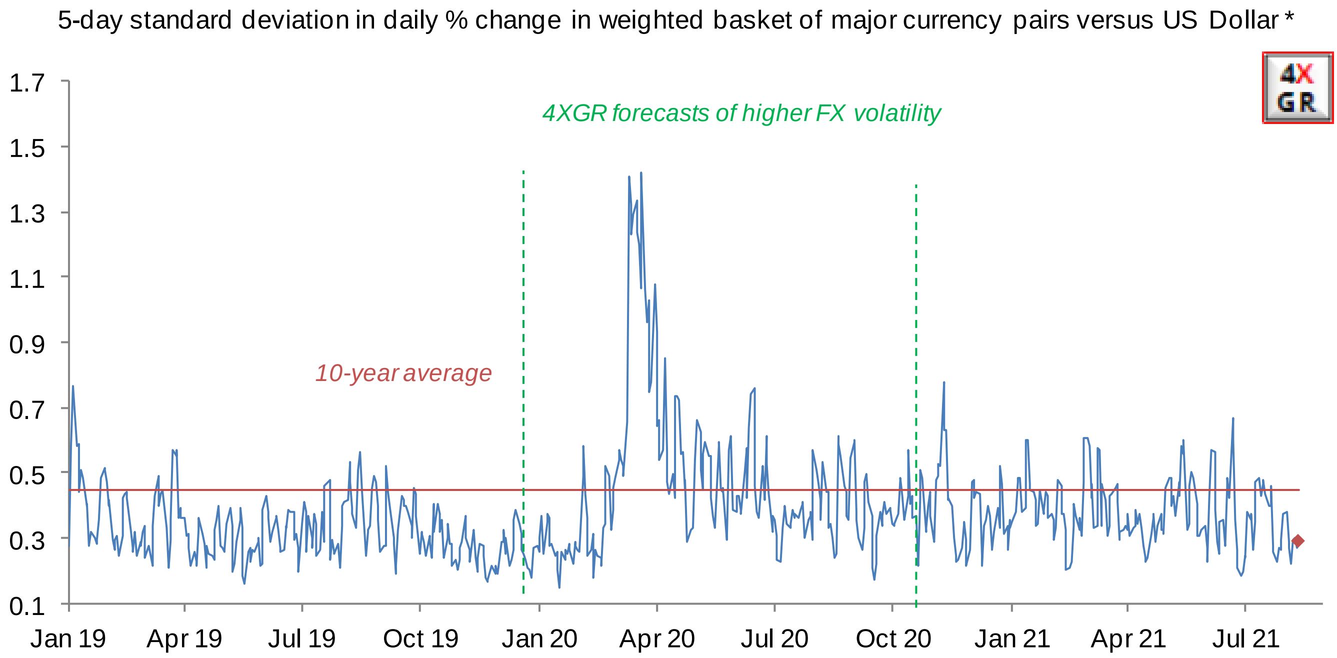
There are a number of factors behind this low transmission from US rates to Dollar crosses and equities but, as was the case in late-2019, FX markets are ultimately pricing in very little risk of policy, macro data or geopolitical surprises, in our view.

FX volatility low by historical standards, vol in most USD crosses down in past month

Global FX volatility remains depressed both by historical standards and relative to volatility in other asset classes, in particular US Treasuries and Brent crude oil. There are a number of factors behind this low transmission from US rates to US Dollar crosses but FX markets are ultimately pricing in very little risk of policy, macro data or geopolitical surprises, in our view.

We estimate that realised volatility in a turnover-weighted basket of 32 major currency pairs against the US Dollar – measured by the 5-day Standard Deviation (SD) in the daily percentage change in the spot (closing) price – was 0.32 on 11th August (see Figure 1). While global FX volatility rose slightly on 11th August following the release of US CPI-inflation data for July, it is still well below its level one month ago (0.43 SD) and below its 10-year average (0.47 SD). Notably global FX volatility is at a similar level (0.30 SD) as it was in the run-up to the 16th June Federal Reserve policy meeting and the release of a more hawkish FOMC "dot-chart" (see Fed: Same game, different rules, 22nd June 2021).

Figure 1: Global FX volatility has fallen in past month and is well below its historical average



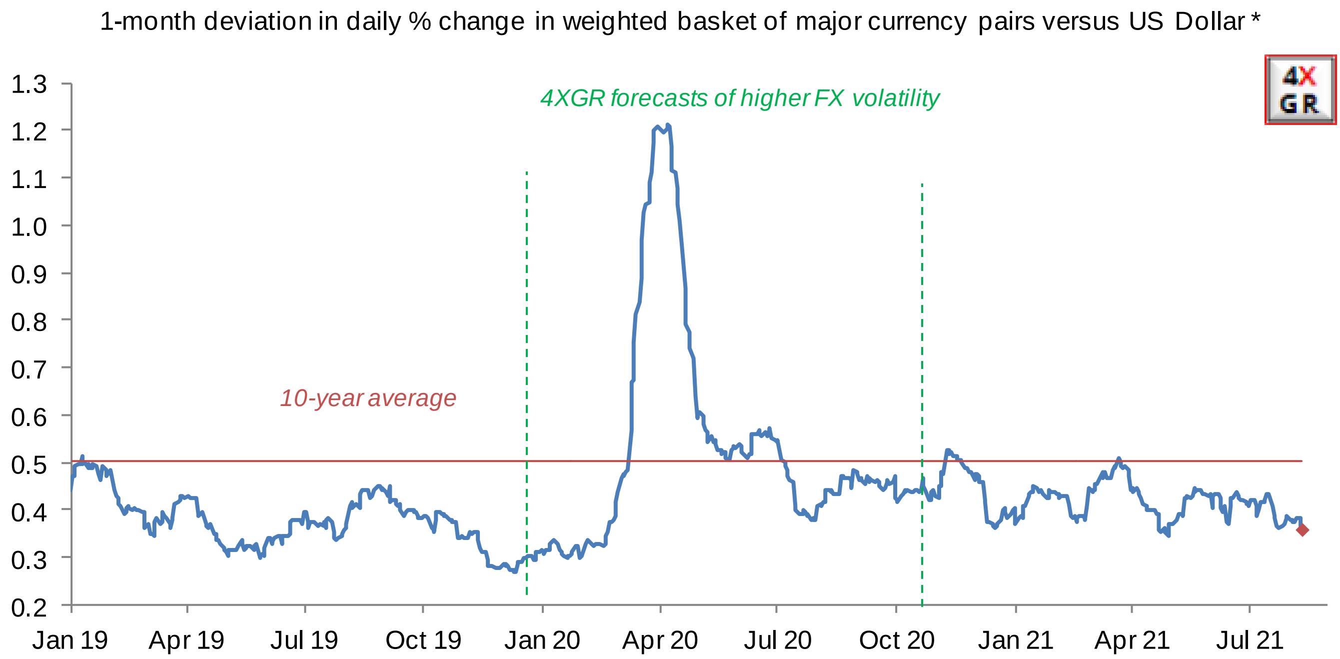
Source: 4X Global Research, BIS, investing.com

*Note: * Spot/closing price. Basket weighted by currency-pair turnover in 2019; currency pairs versus US Dollar are AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD, SEK, ARS, BRL, CLP, COP, MXN, CZK, HUF, PLN, RON, RUB, ZAR, TRY, ILS, CNY, IDR, INR, KRW, MYR, PHP, SGD, TWD and THB. Latest data point is for 11th August 2021.*

The picture is even more benign if we take a longer-term measure of global FX volatility. Specifically the one-month standard deviation in the daily percentage change in the spot (closing) price was about 0.36

on 11th August, its lowest level since late-April and again well below its 10-year average of about 0.5 SD (see Figure 2).

Figure 2: FX volatility even more benign when calculated using longer timeframe



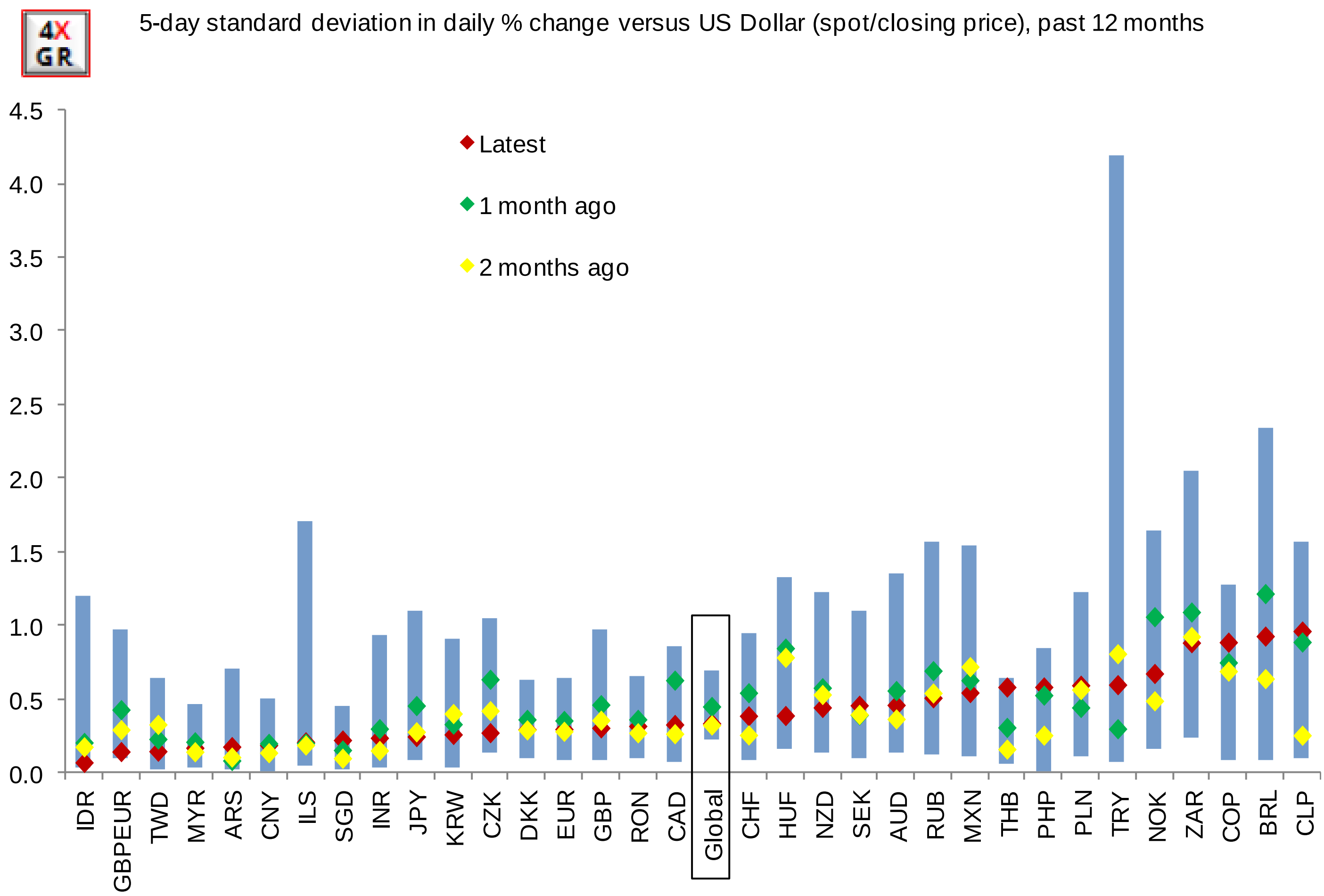
Source: 4X Global Research, BIS, investing.com

*Note: * Spot/closing price. Basket weighted by currency-pair turnover in 2019; currency pairs versus US Dollar are AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD, SEK, ARS, BRL, CLP, COP, MXN, CZK, HUF, PLN, RON, RUB, ZAR, TRY, ILS, CNY, IDR, INR, KRW, MYR, PHP, SGD, TWD and THB. Latest data point is for 11th August 2021.*

Volatility versus the US Dollar in most of the 32 major developed and emerging market currencies tracked has either fallen in the past month from already modest levels or been broadly stable (see Figure 3). Volatility in the high-yielding Brazilian Real and the low-yielding Canadian Dollar, Czech Crown Norwegian Krone and Hungarian Forint has fallen the most in absolute terms. Volatility in most currencies is also currently lower or comparable to the volatility recorded in the run-up to the Federal Reserve's policy meeting on 16th June (as highlighted by the yellow diamonds in Figure 3).

We note that GBP/EUR volatility has continued to fall and is currently at its lowest level since early June. Sterling's appreciation against the Euro has been slow and steady, in line with our expectations (see FX Focus: USD, GBP, NZD and THB, 6th August 2021, Sterling's coming home…albeit slowly, 16th July 2021, and Sterling leads Euro 1-0 at half-time in dull encounter but could extend advantage, 29th June 2021). In level terms only the USD/IDR cross, which Bank Indonesia arguably manages very closely, is currently exhibiting lower volatility than GBP/EUR according to our estimates.

Figure 3: Volatility vs Dollar in most currency pairs has either fallen or been broadly stable in past month



Source: 4X Global Research, BIS, investing.com

Note: Latest is 11th August 2021.

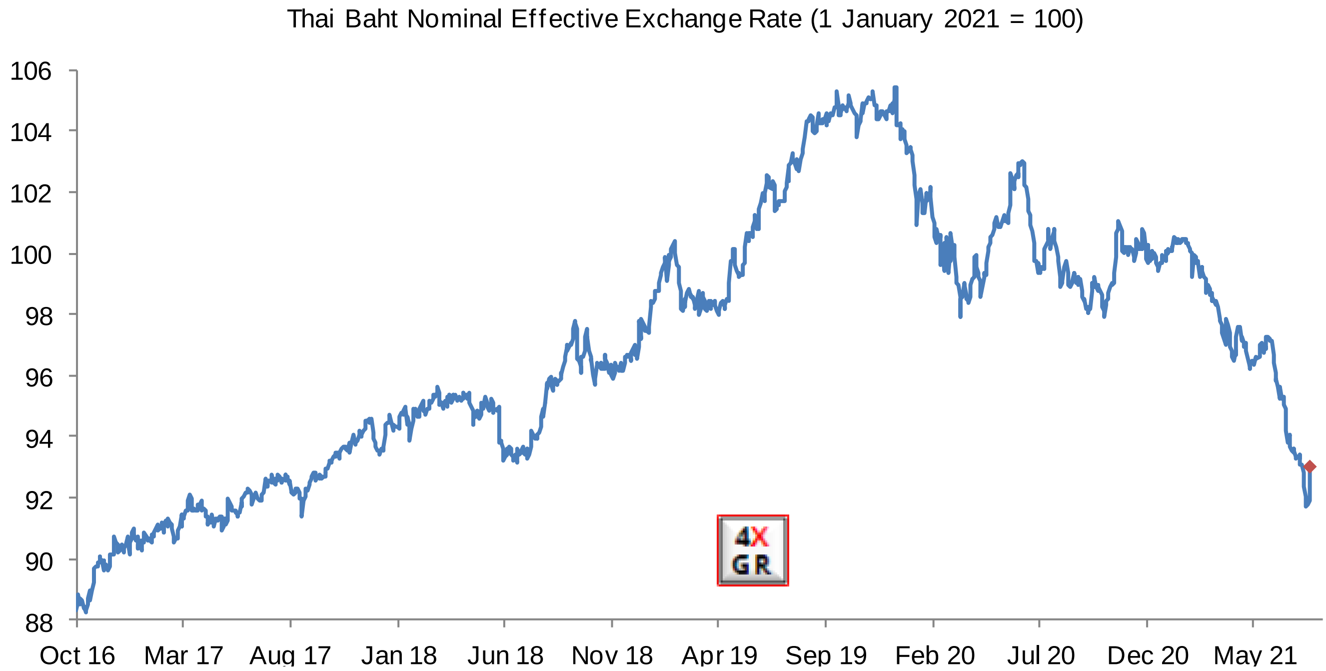
There have been a few notable exceptions.

- The high-yielding **Turkish Lira** has recorded a non-negligible increase in volatility in the past month but USD/TRY volatility remains low by its historical standards (see Figure 3).

- **Thai Baht** volatility has risen further in the past month and is now near the top end of its (admittedly narrow) 12-month range. The Baht has in the past eleven sessions traded in a wide range of nearly 2% against a reasonably strong US Dollar (around the 33.1 level). As a result, the Thai Baht Nominal Effective Exchange Rate, which had weakened to a 204-week low on 6th August, has since appreciated about 1.4% according to our estimates (see Figure 4).

- Volatility in the **Chilean, Colombian and Philippines Pesos** has not risen much in the past month but is materially higher than it was two months ago and in the upper half of their respective 12 month ranges.

Figure 4: Thai Baht, volatile against strong Dollar, has rebounded in NEER terms from multi-year low



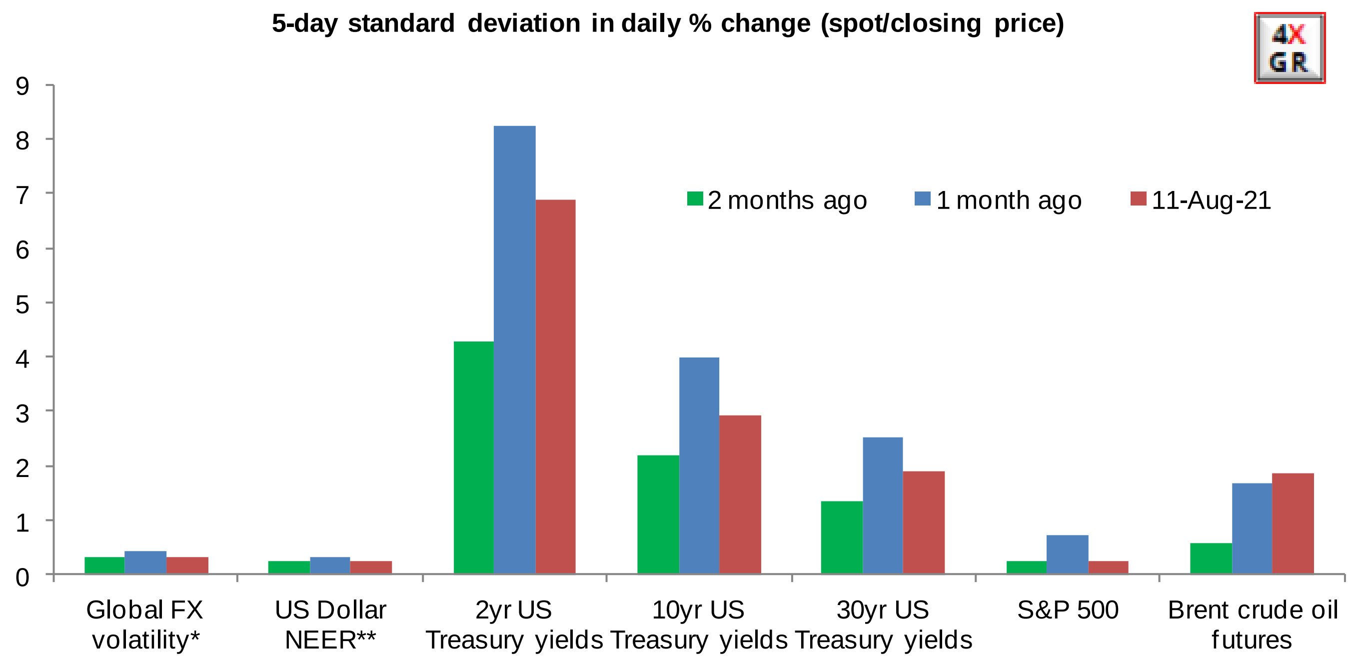
Source: 4X Global Research, BIS, investing.com

FX volatility also materially lower than volatility in US Treasuries and Brent crude oil

Global FX volatility also remains very modest compared to volatility in other asset classes, notably US Treasuries and Brent crude oil (see Figure 5). Even volatility in USD/CLP, currently the highest (at about 0.95 SD) among major currencies according to our estimates, is materially lower than volatility at even the very long-end of the US Treasury curve (volatility in 30-year Treasury yields is about twice as high at about 1.9 SD). Volatility in the S&P 500 has also been very subdued while the US Dollar's gains (and losses) have been "orderly".

The bottom line is that most of the price action has been in the US rates market in recent months. This is perhaps unsurprising given the protracted (and at times schizophrenic) debate about the short and medium-term outlook for US inflation and economic growth and by extension about the likely timeline for the Federal Reserve to start tapering its QE program and hiking its policy rate.

Figure 5: FX and equity volatility remains far weaker than in US rates market and Brent crude oil



Source: 4X Global Research, BIS, Federal Reserve, investing.com

*Note: * Turnover-weighted basket of 32 major currency pairs against the US Dollar; ** US Dollar Nominal Effective Exchange Rate (using Federal Reserve trade weights).*

The release on Friday of very strong US labour market data for July along with yesterday's release of broadly-in-line US CPI-inflation data have done little to quell volatility in US rates. Headline CPI-inflation remained unchanged at 5.4% yoy in July and arguably more relevant core CPI-inflation fell to 4.3% yoy from 4.5% yoy in June (see FX Focus: USD, GBP, NZD and THB, 6th August 2021) . Two 2-year US Treasury yields had yesterday morning risen to their strongest level since mid-July (just short of 0.25%) but fell sharply in the wake of the CPI-inflation release to close at around 0.22% or nearly 2bp down from the previous day's close. US 10-year yields fell by a similar magnitude (in basis point terms) while 30-year yields closed broadly unchanged, resulting in a dovish steepening (albeit modest) of the US yield curve.

The narrative will now conceivably shift to whether US CPI-inflation may have already peaked despite signs that the labour market and headline growth remain strong and to the implications for US monetary policy. However, price action in the past few months suggests to us that markets (and analysts) may still be a long way off from coming to a firm and uniform conclusion.

Importantly the transmission mechanism from the US rates market to the US equity and global FX markets has not been particularly strong, for a number of reasons in our view.

First, it is not always crystal clear whether a fall or rise in US interest rates (and the reasons behind these moves) are a net positive or negative for a specific currency or equity index. At the very least short-term interest differentials, both in terms of levels and changes, have operated with a low beta vis-à-vis other asset classes, in our view.

Second, many central banks – particularly in Asia – continue to actively manage their currencies (via Dollar swaps and intervention in the FX market) to both influence their underlying paths and to minimise volatility against the currencies of their main trading partners which in most cases includes the US Dollar.

A third, inter-related reason is that there has been limited currency contagion across emerging market (EM) currencies, a theme we have elaborated on in previous *FIRMS* reports (see Depressed FX volatility allows for few surprises, 22nd November 2019, FX Vol gone AWOL, directionality has not, 19th July 2019, and Three Themes: Low FX vol, EM contagion and global growth, 5th April 2019).

Finally, participants in US equity and global FX markets will have a varied number of reasons for maintaining their positions (whether long or short) which are largely unaffected by daily gyrations in US rates markets.

Nevertheless, as was the case in late-2019, FX markets are ultimately pricing in very little risk of policy, macro data or geopolitical surprises, in our view.

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