Global forex flows surge as big investors return

After several lackluster years, the $5-trillion foreign exchange market has bolted back to life with institutional investors leading the charge and banks standing to gain from the activity.

Currency volumes spiked in January and have stayed robust so far, thanks to unexpectedly strong and persistent rallies in the euro and weakness in the yen, demand from institutional clients, and increased flows in world equity markets.

A strong mergers and acquisitions sector has also boosted turnover in the world's largest financial market, as often large volumes of currencies need to be traded for cross-border transactions.

Global M&A volume hit more than $158 billion so far this year, more than double the activity in the same period in 2012, according to Thomson Reuters Deals Intelligence.

"It's not just leveraged customers betting on where FX is going, it's more real money business, more hedging, bringing longer-term players back into the market," said Peter Taylor, managing director of FX trading at Barclays in London.

Barclays saw its second- and third-busiest trading days ever in January, with the yen as the primary driver. Citibank had four of the five best volume days in the bank's history last month. Its volumes were up 50 per cent in January year-over-year, also boosted by yen flows.

In recent years, it hasn't been like this. The euro zone debt crisis scared investors and confined them to the sidelines, while low volatility has curbed currency moves.

But that trend may have changed. Most banks saw record volumes last month, while large forex trading venues such as EBS and Thomson Reuters saw sharp increases as well. That fed optimism about healthier revenues for most market participants.

Breakout moves in heavily traded currencies such as the euro and yen spurred clients to enter and exit the market to hedge or cover rapidly changing positions, which should boost bank forex trading revenues after weak numbers the past five years.

Forex contribution to total fixed-income revenue from the top global investment banks has fallen since 2008 due to competition from other currency trading platforms and low volatility, said London-based financial analysis firm Coalition.

In 2012, forex revenues at major banks fell 22 per cent to $22 billion from the previous year, according to Coalition's survey, which tracks financials of the 10 largest investment banks led by Deutsche Bank, Goldman Sachs, JP Morgan Chase, and Barclays.

Investors this year seized on the weak yen theme, a trend that emerged in November 2012 when it became apparent Shinzo Abe would become Japan's prime minister. Abe favors aggressive easing to end Japan's tenacious deflation, which has spurred a wave of yen selling that has persisted to this day.

Market participants have shorted the yen as a way to play the carry trade, which involves borrowing or selling a currency with a low interest rate and then using the proceeds to buy another with a higher yield.

On the other hand, short bets on the euro were unwound sharply on the view that euro zone crisis fears have eased. As a result, central bank reserve managers brought their euro weightings back to more normal levels from underweight.

BANKS AND TRADE PLATFORMS

Deutsche Bank, the world's largest forex bank, saw "some of the best days in terms of volume and requests for quotes in January," said Kevin Rodgers, the bank's global head of FX sales and trading in London.

At UBS, forex volume was still at robust levels as of last week, although they have moderated from January's peak. Yen flows were still 36 per cent higher than the average weekly flow of the last 52 weeks, UBS data shows.

At EBS, the largest interbank FX platform for the spot market, the daily volume was $141.3 billion in January, up 54 per cent from December, after several months of declines, according to data from parent ICAP Plc.

Volume on Thomson Reuters FX dealing platform was at $126 billion per day last month, up 24 per cent from December, data from the company shows.

Jeff Feig, global head of G10 forex at Citigroup, said there are a number of potential catalysts for increased volatility as 2013 progresses.

For instance, intrigue over who will replace Federal Reserve Chairman Ben Bernanke, whose second term expires in January of 2014, could spur more activity as early as the third quarter, Feig said.

A Fed chairman viewed as an inflation hawk would tend to be supportive of the U.S. currency, as rising interest rates would boost the appeal of dollar-denominated assets such as US Treasuries.

Last year's focus on the global risk environment, which made it tougher to profit in currencies as volume declined and currencies reacted predictably to macroeconomic events, may be ending, analysts said. Investors will likely focus more on fundamentals specific to individual currencies and economies this year, which should spur more volatility.

INSTITUTIONAL INVESTOR DEMAND

The rotation out of cash into equities by institutional investors early this year, as risk appetite improved, has also helped drive momentum in the currency market. Investments in stocks in foreign markets entails a lot of currency conversions.

"Greater equity participation from institutions is a key source of currency flows," said Samarjit Shankar, BNY Mellon's director of market strategy in Boston. He added that

BNY has seen large institutions pour money into equities especially in Asia and the United States.

In most cases, foreign equity holdings' currency exposure needs to be hedged and that further boosts forex activity.

London-based asset manager Seven Investment Management, for instance, is bullish on Japanese equities, senior portfolio manager Alex Scott said. But the firm, which manages assets of about $7 billion, has fully hedged its yen exposure because of the Bank of the Japan's easing stance, he added.

US investors have also been big buyers of foreign equities this month, UBS data show. In the first week of February alone, US investors' weekly purchases of foreign stocks were the largest since October 2008. They bought mostly euro zone, UK, and Japanese shares.

That same week also saw the euro zone attract more than $1 billion in inflows, the strongest since April 2009, supporting the euro and backing assertions by European Central Bank President Mario Draghi that capital inflows were gradually returning.

The rise in institutional FX trading was evident in the spike in volumes at Knight Capital-owned Hotspot FX, a forex venue known for attracting asset managers and big-money investors. In January, Hotspot said its daily turnover was $27.1 billion, up 38.3 per cent from December.

Hedge funds such as Soros Fund Management have already scored huge profits in the forex market betting against the yen. Soros made close to $1 billion on a bearish yen trade since November last year, the Wall Street Journal reported.

Soros is often remembered for making a fortune shorting the British pound in the early 1990s.

Overall, most market participants agree that signs of optimism are evident after two years of what Barclays' Taylor described as a "difficult trading time."

"I think there will be massive change (in the FX market) this year. I'm happy to see a resurgence," Taylor said.

(Economic Times)