Minor Currencies Less Affected By Great LIBOR Kerfuffle

Does last month's conclusion ("see "Major Currencies And The Great LIBOR Kerfuffle") apply to a set of minor currencies? That conclusion was:

> *No one knows when the era of zero interest rates will end, how it will end and what the eventual market structure will look like when it does. What will remain constant, though, is the inability of generalized and simplified rules about what drives currencies over time. Perhaps we should be grateful: Just as a messy election is the sign of a functioning democracy, a messy market is one people want to trade.*

The approach taken for the majors was simple and straightforward, or at least what passes for straightforward in these precincts. As purchasing power parity and trade flows have proven well-nigh useless in assessing currency movements over time, only two market-derived variables hold out any hope for position traders, relative asset returns and expected interest rate differentials. The total return for a country's stock market relative to the U.S. market, all expressed in USD terms, serves as a proxy for relative asset returns. The difference in money-market yield curves as measured by the difference in forward rate ratios between six and nine months ($FRR_{6,9}$) between the non-USD currency and the USD is the difference in expected interest rates.

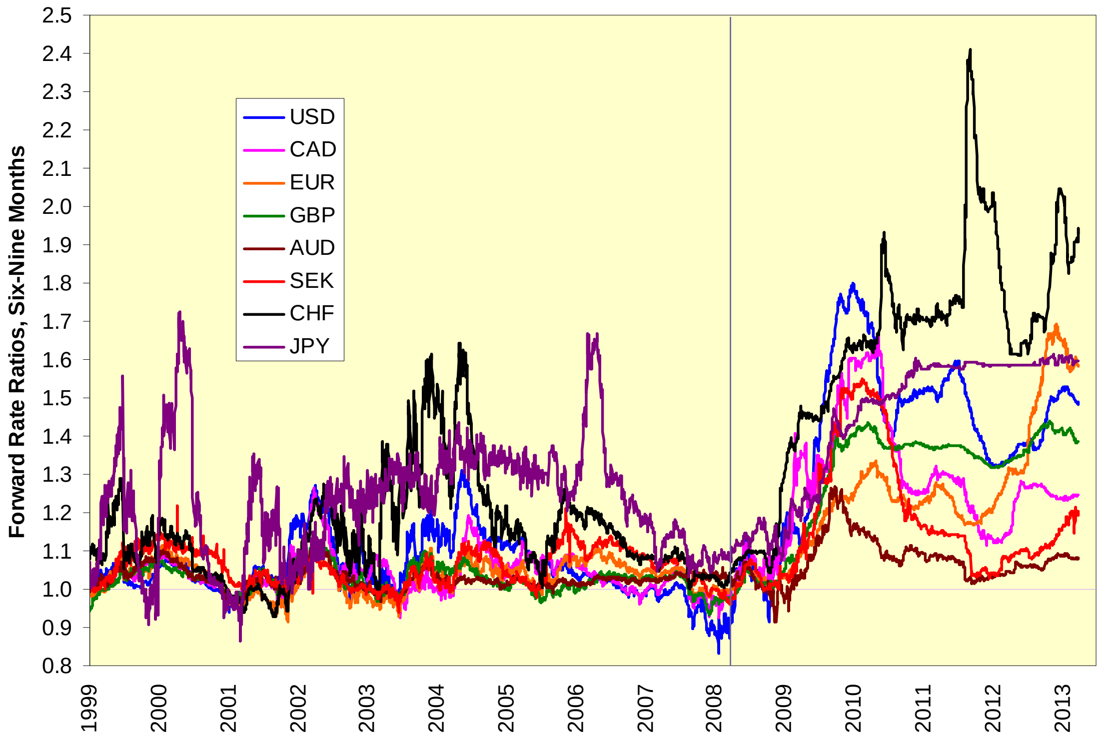
As before, the comparison will be split in time into the periods before and after the Federal Reserve-orchestrated rescue of Bear Stearns by J.P. Morgan Chase in March 2008. That preceded a story in The Wall Street Journal one month later about reporting irregularities in LIBOR. A cynic might note those irregularities were conducted with the direct approval not only of the reporting banks in the British Bankers' Association but of the regulatory bodies involved: After all, no one wanted to report the truth about the banks' parlous state of finances and their unwillingness to lend to each other.

Churchill said, "In wartime, truth is so precious that she should always be attended by a bodyguard of lies." Of course, he was talking about matters of life, death and national survival, not of anything as crushingly important as the basis for mortgage derivatives.

Messy Markets

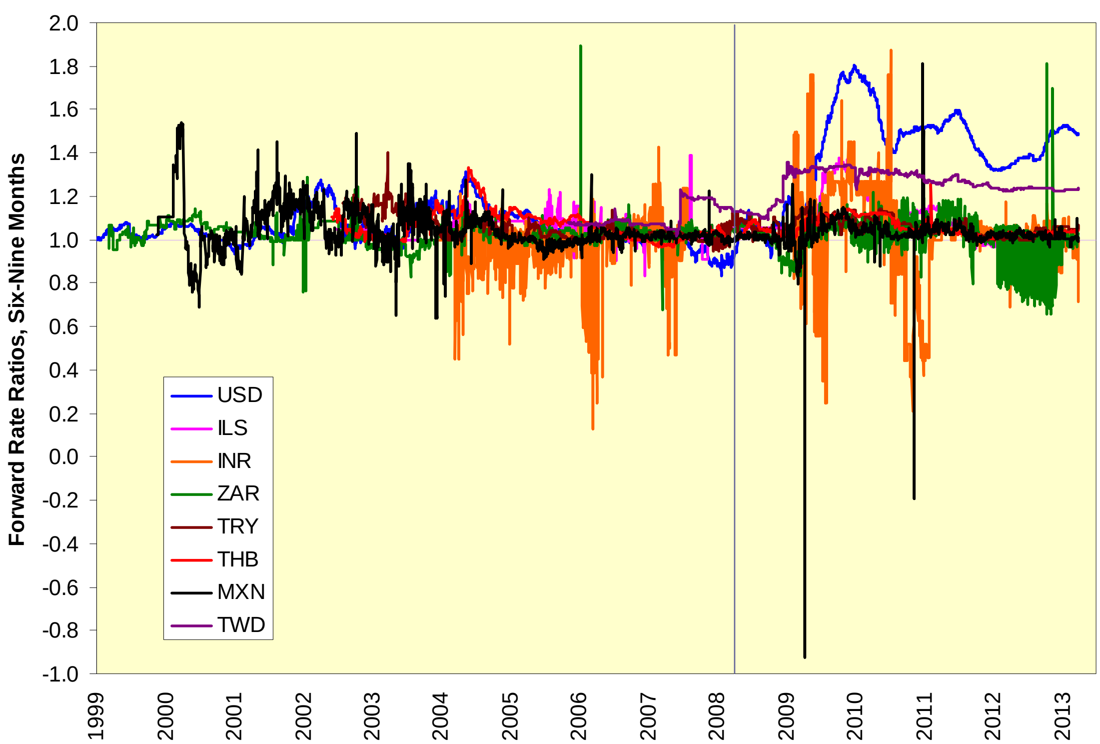
The messy markets referred to above and last month have the advantage of producing neat charts, something more valued by the nation's financial writers than is admitted commonly. Let's take for comparison the map of $FRR_{6,9}$ differentials for the major currencies:

Money-Market Yield Curves Before And After Bear Stearns



The post-March 2008 period has some fairly distinct lines and they look as if they are conveying signal and not noise. Now let's take the same construct for the set of minor currencies to be examined below:

Money-Market Yield Curves Before And After Bear Stearns



These are, with the possible exception of the TWD, a random mess. It was difficult to select a set of currencies as so many of the minor currencies either lack sufficient length in their histories or do not have nine-month interest markets. The very shape and noisiness of the $FRR_{6,9}$ lines in the chart above tell us we should lower our expectations for expected interest rate differentials driving these markets.

As a reminder, we should expect a country whose $FRR_{6,9}$ starts steepening relative to the USD $FRR_{6,9}$ should to see its currency rise relative to the USD unless the non-USD $FRR_{6,9}$ is steepening bearishly and the prospect of higher short-term interest rates is leading a capital outflow out of the country. Oftentimes an already relatively steep $FRR_{6,9}$'s associated currency starts to weaken as the short-term interest rates begin to "roll down the curve" as nine-month rates become six-month rates, etc.

Another important point to consider is most investors are trend-followers and chase performance, higher stock market returns relative to U.S. stock market returns tend to lead capital inflows and push the currency higher unless those inflows are forestalled by runaway money-printing. As we saw in the Swiss case last month, money-printing is a way of life in the modern world.

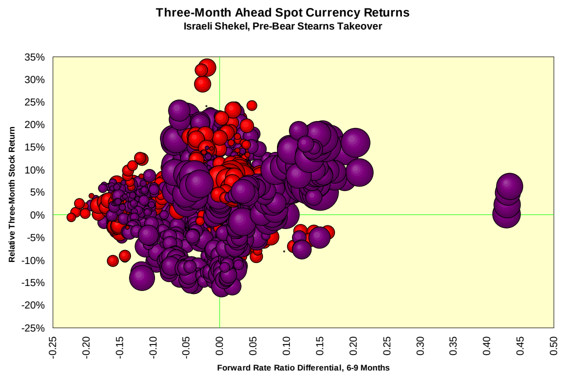
With these two preambles in mind, let's map three month-ahead spot currency returns for a set of minor currencies as a function of $[FRR_{6,9}^{Foreign} – FRR_{6,9}^{USD}]$ and of the trailing relative stock market returns as measured by the MSCI index return in USD terms between the non-U.S. and U.S. markets. The maps for the January 1999 – March 2008 and post-March 2008 periods will be displayed side-by-side. In all cases a positive three month-ahead spot currency return will be depicted with a red bubble and a negative return with a purple bubble; the diameter of the bubbles corresponds to the absolute magnitude of the currency's return.

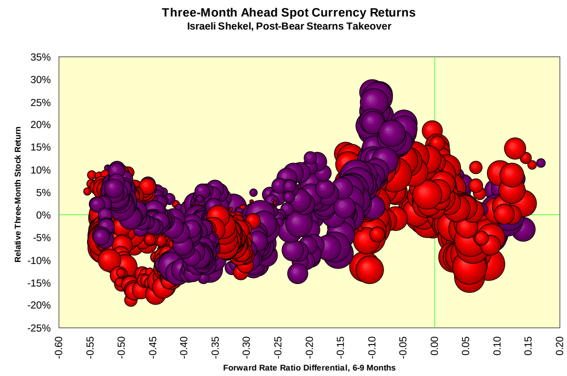
Results

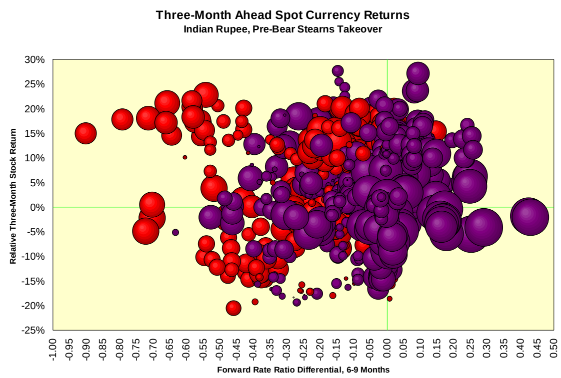
The results over a seven-currency set were somewhat unexpected as none of the seven demonstrated a dependence on either of the two independent variables either pre- or post-Bearn Stearns. The suppression of short-term interest rates and the outright fabrication meant nothing after March 2008; that was to be expected. What was startling is how little either variable meant prior to March 2008. If the Japanese yen tends to trade absent normal market variables, all of the minor currencies displayed below do.

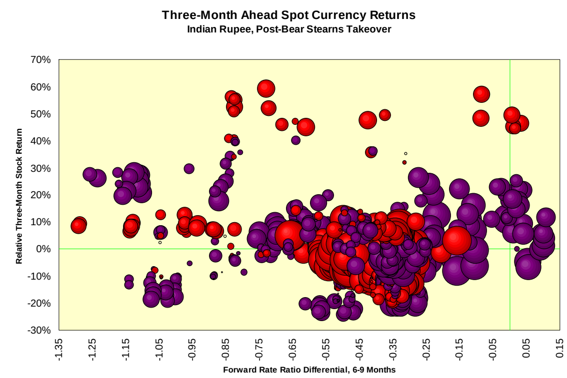
Let's remind ourselves what we are dealing with here: Currency trading is and has been the largest business in the world in terms of average daily transaction volume.

Given this conclusion, the before-and-after charts are displayed below almost as graphic appendices, without comment as no further comment is necessary.

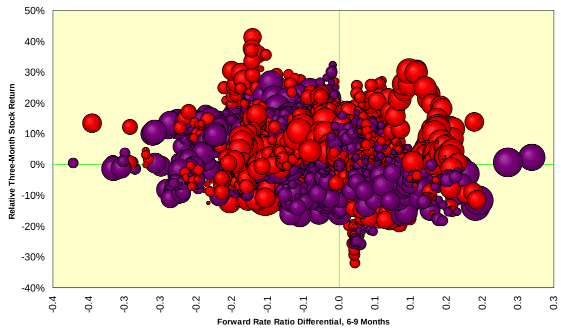








Three-Month Ahead Spot Currency Returns
South African Rand, Pre-Bear Stearns Takeover



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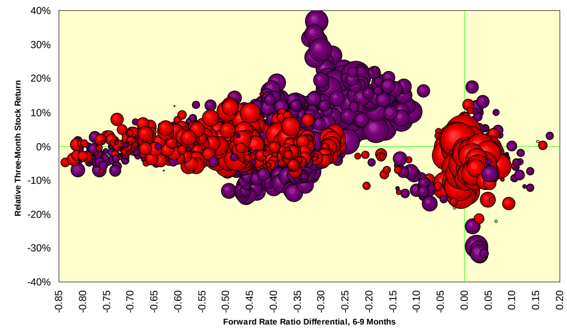
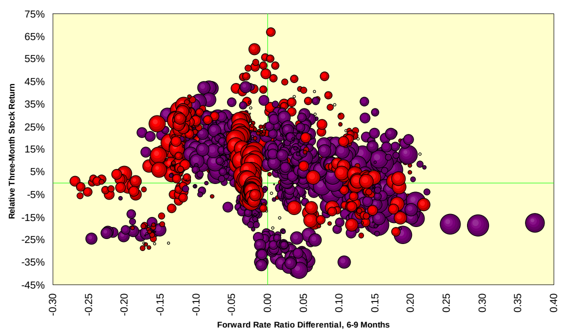


Three-Month Ahead Spot Currency Returns
Turkish Lira, Pre-Bear Stearns Takeover



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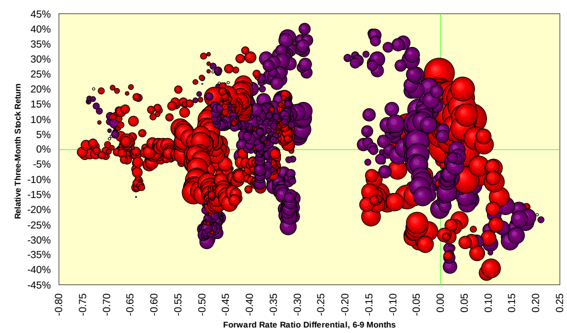
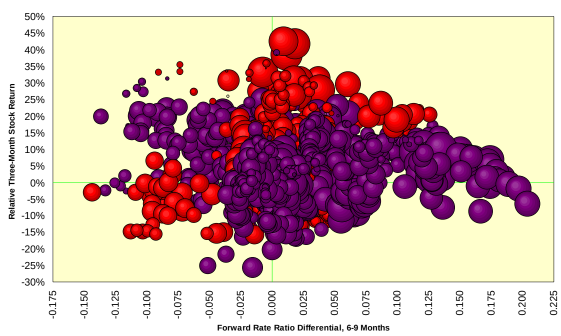


Three-Month Ahead Spot Currency Returns
Thai Baht, Pre-Bear Stearns Takeover



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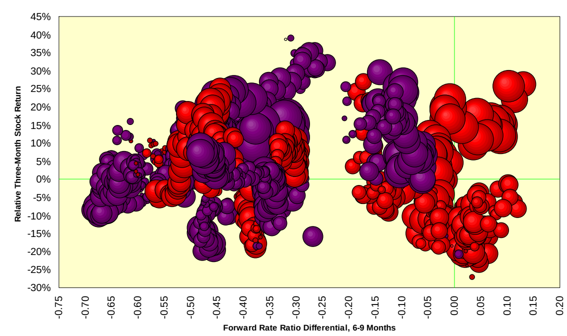
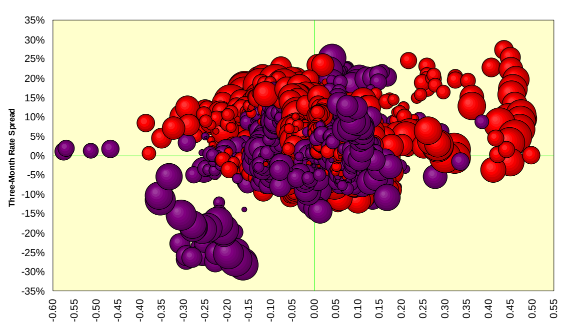


Three-Month Ahead Spot Currency Returns
Mexican Peso, Pre-Bear Stearns Takeover



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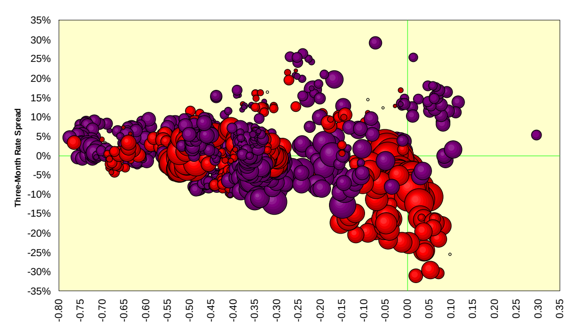

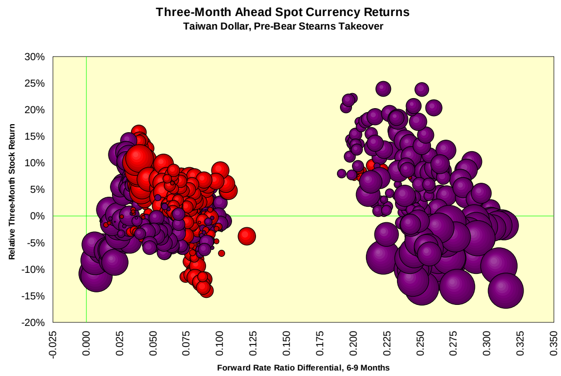

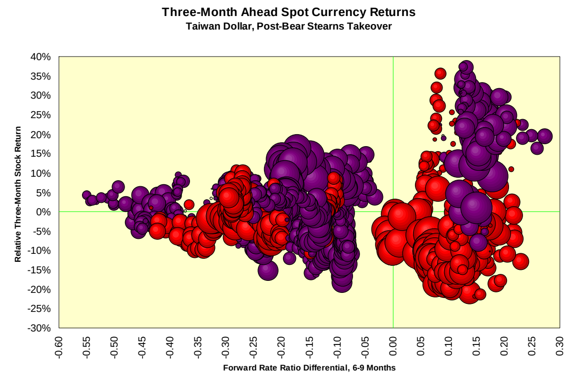

Conclusion

We used to be able to say the one constant in markets was human behavior; this was before the rise of the machines and the growth of high-frequency and algorithmic trading. As people were slower and trading costs were higher, the turnover rate was lower and the risk levels were higher. Now markets have devolved into a mishmash of Brownian Motion-capture where the characteristics of the underlying asset are unimportant.

In a strange way, the world of minor currencies always had a tenuous link to what is referred to quaintly as "value." Their patterns were never a set of rules and relationships craved by human traders making slow decisions so much as a set of ad hoc decisions and special cases. They were just ahead of their time and did not know it.