Trendiness In Currencies

Different markets react in different ways to trends. Self-described "momentum players" in equities are regarded with suspicion by value investors and those who pay attention to folderol such as balance sheets and income statements. Such disdain in the world of currency trading is rare, however, as traders learned the hard way and a long time ago just how right Isaac Newton was: Markets in motion tend to stay in motion and markets at rest tend to stay at rest.

This is so for a very good reason. Currencies reflect long-term national policies and tendencies slow if not impossible to change; these include monetary policies that tend to persist. For example, when the Federal Reserve acts to loosen or tighten credit, it does so over a lengthy period of time. If these cycles are out of phase with those of other central banks, and they have been between the U.S. and the Eurozone for some time now, the dollar will strengthen or weaken accordingly.

But two problems arise. The average annual excess return for ABN-AMRO's index trend-following currency traders since the end of 1986 has been 3.8% with a near-zero Sharpe ratio of 0.03. Such performance raises the question, "Why bother?" Second, are all currencies created equal in their trendiness?

The Trend Is Your Friend. Maybe
Wall Street always has a bit of doggerel for every situation. Here it is, "The trend is your friend except for the bend in the end." Once a trend gets moving and the trade gets crowded, all it takes to make everyone scramble for the exits is…anything. And I do mean anything; who has not seen weeks of profits evaporate in an execution vacuum on the slightest bit of questionable news? As this melodrama is part of human nature, we can consider it to be a permanent feature of the trading landscape.

Now let's address the question of trendiness while skipping over all of the intermediate mathematics involved. For those interested, the calculations and definitions are in Chapter 2 of my book. We will use a sample of six major currencies, the euro, Canadian and Australian dollars, Japanese yen, Swiss franc and British pound (EUR, CAD, AUD, JPY, CHF and GBP, respectively) and six minor currencies, the Mexican peso, Indian rupee, Indonesian rupiah, Brazilian real, Chilean peso and South African rand (MXN, INR, IDR, BRL, CLP and ZAR, respectively). The study sample extends from the January 1999 advent of the euro onwards.

The two sets are sorted in increasing order of how much time each currency spent in a trending state. Two other measures are provided, the average absolute trend oscillator, which gives an idea of how violent movements within a trend are, and the average excess volatility. Excess volatility is the ratio of the implied volatility of three-month non-deliverable forwards to the actual high-low-close volatility for those forwards, minus 1.00. The higher the excess volatility, the less confident a market is of its trend conditions.

First, let's look at the majors.

Major Currencies' Summary Trend Statistics

	Percent In Trending State	Average Absolute Trend Oscillator	Average Excess Volatility
EUR	60.5%	0.1672	0.0741
CHF	61.1%	0.1656	0.0303
JPY	63.6%	0.1646	0.0585
GBP	65.2%	0.1674	0.0879
CAD	68.2%	0.1508	0.0505
AUD	68.5%	0.1645	0.0195

The Australian dollar has been, by far and away, the trendiest major. We can attribute this to the Reserve Bank's propensity for really putting some mileage on its interest rate moves. The Canadian dollar, unsurprisingly, ranks a close second.

Why, you may ask, is the euro at the bottom of the list? The answer, ironically, is because everyone trades it and because all of the instruments involved in interest rate arbitrage are similarly deep and liquid. If a small number of very large players establish long-term trend positions and wind up with substantial unrealized profits, how much of a spark does it take to set off a reenactment of the *Hindenburg* disaster right there in your trading room?

Oh, the humanity!

The Minors

We should expect the minor currencies to behave differently for a number of reasons. The instruments involved in interest rate arbitrage are not as deep and liquid, and neither are the markets for their forwards. Second, while the Federal Reserve, Bank of England, European Central Bank, et al, have turned their public pronouncements into grandiose public art forms, smaller central banks do not command the public stage similarly. Perhaps they should don some costumes out of a Gilbert & Sullivan operetta – Jean-Claude Trichet as a *Pirate of Penzance*? - and start mocking their big bank brethren. I, for one, would find it amusing.

Third, while a great deal of international commerce is denominated in the majors, very little is denominated in the minors. It is limited mostly to direct payment for goods and services, to the remittances of expatriates and to whatever international portfolio investment is done in that currency.

Finally, smaller countries learned to manage their currencies better after the devastating speculative attacks of 1997-1998 during the Asian crisis. This is not to say, of course, they have accomplished any sort of mission permanently, but rather their currencies have been notably less raucous in the years since then.

Given these factors, the minor currencies are in fact structurally different in their trending nature. Only the Mexican peso has spent a major-like percentage of time in a trending state, and the Indonesian rupiah scarcely has spent any time at all trending.

Moreover, a glance at their average excess volatility levels is revealing. The Indian rupee appears trusted by no one in the currency option world, while both the Mexican peso and the South African rand have implied volatilities less than their realized high-low-close volatilities over time. In both cases markets trust the respective central banks to keep the currencies within a trading range.

Minor Currencies' Summary Trend Statistics

	Percent In Trending State	Average Absolute Trend Oscillator	Average Excess Volatility
IDR	11.3%	0.0841	0.9108
CLP	27.5%	0.2178	0.3453
INR	48.8%	0.1992	1.4238
BRL	55.1%	0.1978	0.0811
ZAR	55.1%	0.1240	(0.0181)
MXN	65.9%	0.1269	(0.0467)

What can we conclude about currencies and trend-following? First, each market is different, which means an attempt to trade them on a one-size-fits-all basis will fail. Second, everyone can recognize a trend when it is happening, and that means the market is likely to inflict the greatest pain upon the greatest number by reversing suddenly.

Finally, trend-following holds out the promise of getting rich quickly, like no one ever thought of such a scheme before. The one strategy studied by ABN-AMRO that works over a long period of time is the carry strategy of borrowing in a low-yielding currency and lending in a high-yielding currency. That depends on time and convergence to work, but since December 1986 it has produced an average annual excess return of 7.7%. For those of you keeping score at home, that is Tortoise 1, Hare 0.