06 Feb 2016
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Weekly Thoughts : GBPAUD

Global financial markets continue to remain volatile, and for many justified reasons of which are reason for concern for market participants' sentiment: 1) Prolonged low-interest rate environment 2) Possible deterioration of risk appetite in regards of policy implementation vs communication, in which markets may find disconcerting versus prior periods of handheld forward guidance from central banks 3) Perception of slowing growth/inflation prospects 4) Worries of contagion from financial exposure from bad credit in commodity sector. The recent pressure seen in banks can be illustrated quite simply with the chart on the left below which overlays DB and the EUROSTOXX banks with the ECB rate.

Fig 1. DB EUROSTOXX Banks, and ECB Rate

Fig 2. iTraxx Europe Crossover Widening

If rates are where they are at currently (which they can be for quite a while), we can expect banks to remain under pressure from squeezed margins. The current selloff has also been accompanied with a broader concern in European credit as proxied by the iTraxx European crossover index, an equally weighted index of 75 credit default swaps on the most liquid sub-IG European corporates, which has been widening to new highs recently. Risk is persistent, and the return profile on risk-off styled trades should look to perform best. The VIX still trades above 20 and although the shock in vol was much higher in August, the current persistence for volatility to remain elevated is a clear sign that we are currently in a different volatility regime than we have seen for the past few years. What seems to be a good trade candidate would be the GBPAUD on the long-side in the FX.

Fig 3. VIX Index

Fig 4. GBPAUD with 2y Rates-Spread

The chart to the above on the right overlays the GBPAUD with the 2y rates spread. From a quick technical look at the price action on the daily chart, we see that we're consolidating across the overall uptrend in price and pending a possible breakout to the upside. In addition to this, we're seeing that the RSI is signalling a positive divergence which may add as a confirming signal of a coming rally. The 2y rates spread also quite simply show that the FX pair is respecting the notion that it's still following expectations on the future path of the relative interest rates. There's reason to believe that the pressure on the UK front-end has been quite rapid, currently testing 2015's January lows, and is likely to experience some short-term relief. Fig 5. on the following page looks at the 2y swap rates for the UK and Australia.

Fig 5. 2y Swap UK and Australia

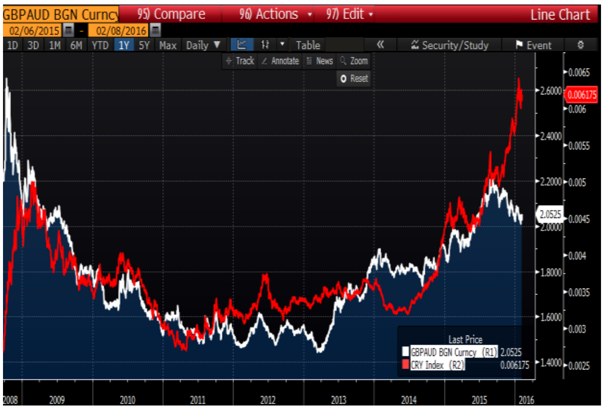

Fig 6: Reuters Commodity Index vs GBPAUD

In general, we can expect DM rates to track each other to an extent and we have seen this with the two swap rates since mid 2014. Currently however, we see that the UK rate has fallen quite markedly quicker than Australia's. The extent of the fall can be explained by the fact that a lot of market participants have expected the BoE to be right behind the Fed in the incoming rate hiking cycle. This expectation didn't materialize as we headed into year-end last-year with the BoE revising down growth/inflation forecasts lower, and not showing any dogged vocabulary to hike. Yes, we know Carney's communication is quite muddied, but he did highlight that the next possible move by the bank over the next couple of years would be a rate hike. This is not to say to bet on a hike, but that even if rates hold, there is a bias for a future hike (for now) and that should justify a stabilization in regards to the fall in UK yields in the short-term. In terms of the Australian yield, the downside bias should be present, given risks to the China outlook, which should halt the RBA from being too hawkish despite some domestic resilience in the Australian economy. A downside near-term bias for AUD yields, and a potential bounce in GBP yields would then help support the case for GBPAUD upside. When looking at the long-term picture for the GBPAUD, we see that the AUD has a higher 'beta' in the pair, as the pair generally tracks commodity price cycles. This is quite an understandable relationship as commodities can be argued to be a derivative (to an extent) of China / EM, which Australia is linked to. Fig. 6 illustrates this supposition with an overlay of the FX pair with the Reuters CRB index (inverted). A risk to consider when taking a long position in the GBP is Brexit for obvious reasons. However, there should be little concern in the political risk's impact on the GBPAUD, as a majority of the downside protection is done via the GBPUSD in the options market. To look at the demand for downside protection in event of Brexit, we can take a look at the skew in 6m risk reversals in the GBPUSD vs GBPAUD. We can see that riskies are moving lower on the GBPUSD but, largely flat for the GBPAUD, and can conceive from this that participants would prefer to use the GBPUSD (and perhaps other crosses) than the GBPAUD for protection in regards to the development of Brexit.

Fig 7. GBPAUD 6m Risk Reversal

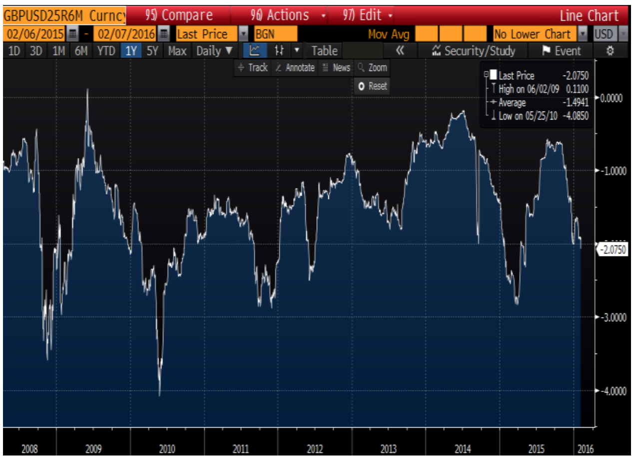

Fig 8. GBPUSD 6m Risk Reversal

The GBPAUD (given the high AUD 'beta') has tracked overall FX volatility since the August deterioration in FX appetite, although has since decoupled. Elevated volatility across the FX space and continued risk off sentiment should help to keep the pair bid.

Fig 7. GBPAUD overlayed with JPM's Global FX Vol Index

In terms of how to play this trade idea, a gradual positioning of longs in spot would be best in my opinion, as vols currently are expensive, despite a continued move upwards, vanilla calls don't seem too attractive. 5-month ATR for the pair currently stands at 837 pips, and if we do go for an upside breakout from here (spot at 2.0525 at time of writing), it doesn't seem too far off to see the move to test 2.2000 highs under 4 months, taking into account that not all monthly changes from here will be pure upside for the sake of conservative perspective.

Despite vanilla being too expensive in my opinion, there are some interesting possible plays with simple exotics. For example, Digicalls for 3 month expiry at 2.1500 strike, is priced at 27% of notional, while a 2.200 strike one-touch for a 4 month expiry is priced at 34% of notional which doesn't seem too bad either. Personally, I'd prefer to play it via spot tactically from and accumulate as we head higher, just for flexibility. The level to watch for the thesis to hold would be 2.000, which is a key psychological handle (if it has any impact whatsoever), and so far held as support into the year also having been resistance last year in February.

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