

Surge in Concerns Over China Triggers Large Panic in Currency Markets - Highlighting Misalignments in Currencies Across the Globe

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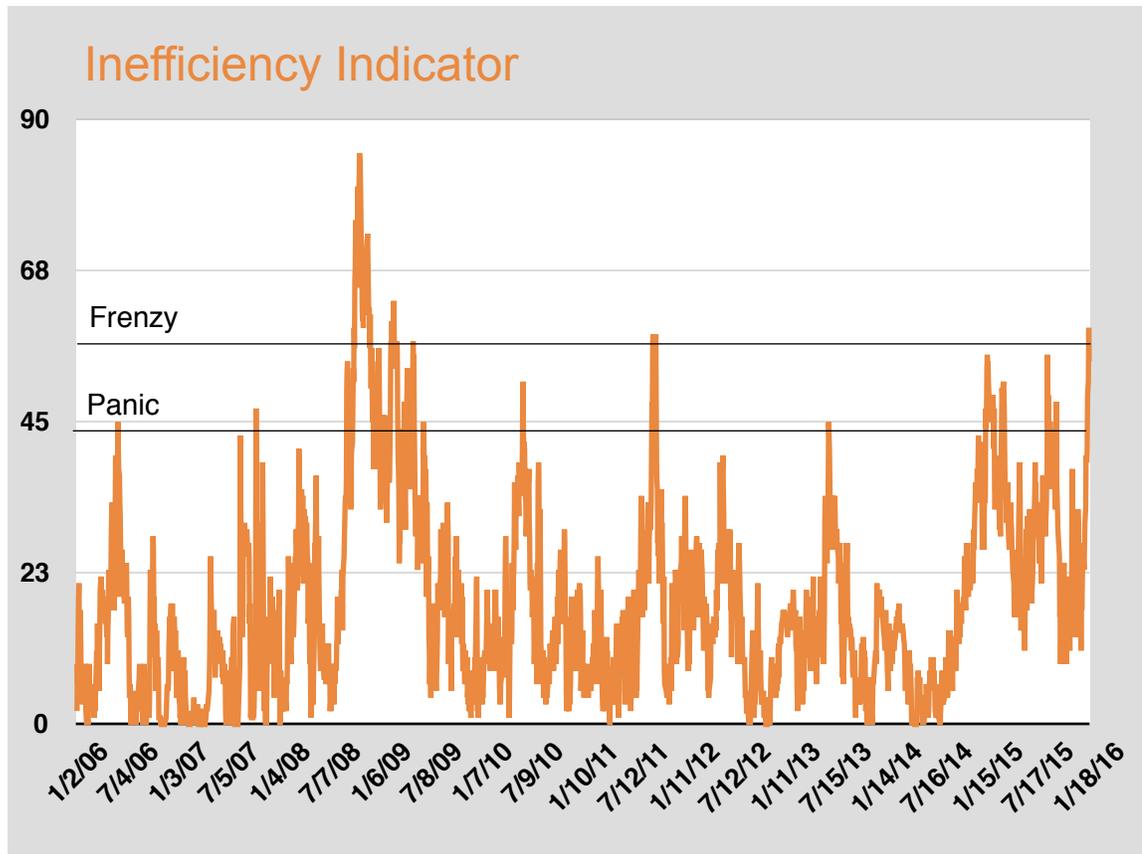


Executive Summary

- On January 20th the StatArb Algorithm identified what we define as a ‘frenzy’ across global currency markets. This ‘frenzy’ has resulted in a large inefficiency across global currency markets.
- The recent frenzy stems from developments in China. Specifically China’s poorly timed decision to further devalue the yuan and introduce a circuit breaker system in early January that resulted in another flare up in concerns over the health of China’s economy and more broadly the global economy.
- Coinciding with the flare up in concerns over China and the broader global economy, commodity prices (especially oil prices) plunged further.
- A further plunge in commodity prices has proven overwhelming for investors in a number of developing countries already facing a number of difficulties. As a result of the frenzy a large market inefficiency has developed.
- In the following report we highlight misalignments across global currency markets caused by the recent frenzy.

Shock from China/Oil Overwhelms Markets, Triggers Frenzy - Highlighting Misalignments in Currencies Across the Globe

On January 20th the StatArb Algorithm identified what we define as a 'frenzy' across global currency markets. This 'frenzy' has resulted in a large inefficiency across currency markets. Recall that a 'frenzy' is associated with a widespread loss of confidence among investors (with entire asset classes (such as EM equities) being effected. Panic's are much smaller and generally occur due to country specific developments.



In the above chart it can be seen that market frenzies are very rare. Since 2006 it can be seen that just two other market frenzies have occurred, one during the global financial crisis and one during the eurozone crisis.

The recent frenzy stems from developments in China. Specifically China's poorly timed decision to further devalue the yuan and introduce a circuit breaker system in early January that resulted in another flare up in concerns over the health of China's economy and more broadly the global economy, causing a surge in volatility across global financial markets.

Coinciding with the flare up in concerns over China, commodity prices (especially oil prices) plunged further. China is a key consumer of commodities including oil.

A further plunge in commodity prices has proven overwhelming for investors in a number of developing countries already facing a number of difficulties. As a result of the frenzy a large

market inefficiency has developed. Currencies across many developing countries dependent on both China and commodities have become deeply undervalued relative to currencies considered to be safe havens.

In the below table is the trade recommended by the StatArb Algorithm. As the panic surrounding recent events begins to dissipate the long basket of currencies is expected to appreciate relative to the short basket.

Long vs. GBP	Weight in Long Basket	Short vs. GBP	Weight in Short Basket
Australian Dollar	14%	Euro	12%
Brazilian Real	14%	Indian Rupee	12%
Canadian Dollar	14%	Japanese Yen	12%
Mexican Peso	14%	New Zealand Dollar	12%
Polish Zloty	14%	Norwegian Krone	12%
Russian Ruble	14%	Swedish Krona	12%
South African Rand	14%	Swiss Franc	12%
		US Dollar	12%

During market frenzies investors become overly focused on the event driving the frenzy (in this case concerns over the health of China's economy) and rush to sell-off assets seen as most impacted by the event.

As a result assets or currencies seen as being most vulnerable to the event become deeply undervalued. Although recent developments in China do not bode well for currencies in the current long basket, these currencies have become the center of focus among panicking investors and have bore the brunt of the recent market frenzy. As a result they have become deeply undervalued relative to currencies in the current short basket which are widely seen as being relatively insulated from the recent turmoil out of China.

Currencies At The Center of the Recent Panic Include:

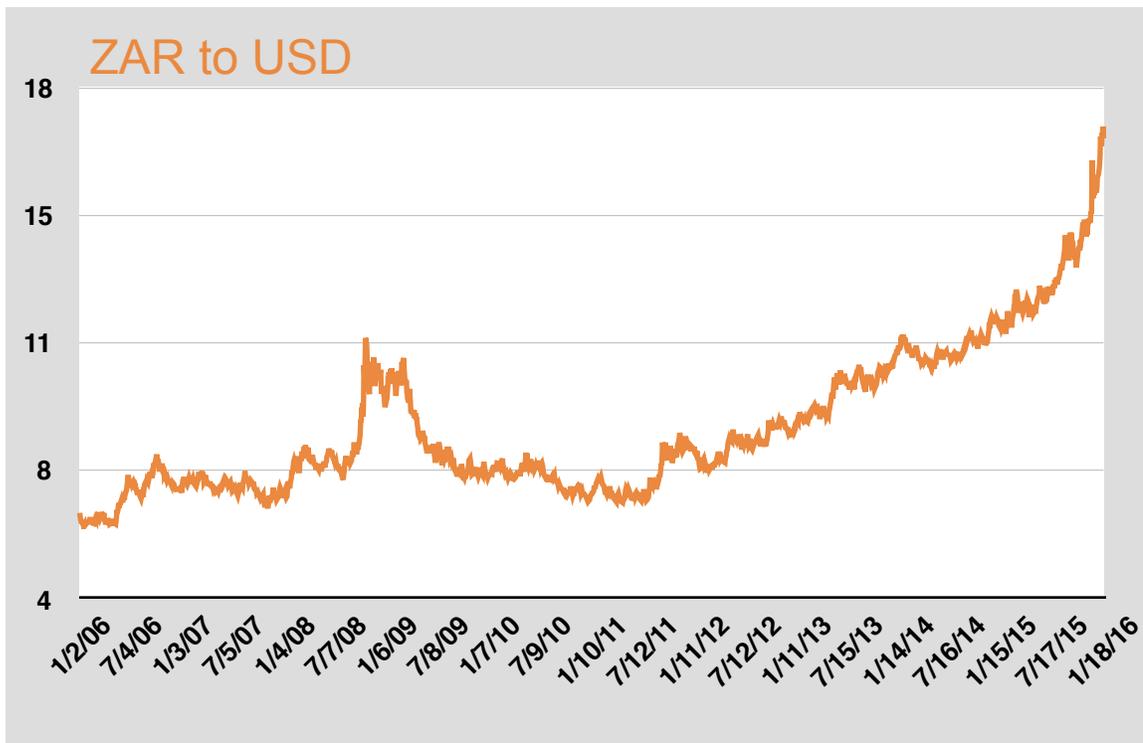
South African Rand

Negative developments revolving around South Africa have played a key role in driving the current 'frenzy'.

South Africa is facing the worst drought it has seen since 1904. Due to a lack of maize production the price of white maize on the South Africa Futures Exchange has more than doubled in the past 12 months. Due to a production shortfall it is estimated the country will need to import 5 million tonnes of maize in 2016, approximately 50% of its requirements.

The plunge in the South African rand has further complicated matters as it will make food more costly to import. The National Agricultural Marketing Council expects general food prices to rise by 15-20% in 2016.

The drought has overwhelmed investors as the commodity dependent country is already struggling due to the steady decline in commodity prices and the recent loss of confidence in the government following a reshuffling of finance ministers in December.



While South Africa's economy has become very fragile due to these developments the recent plunge in the rand is unjustified and has been driven by panic.

Russian Ruble

Russia is another prime example of a country facing so many issues that investors have become overwhelmed and panicked. Due to the panic the Russian Ruble has dropped to a record low against the USD, reaching more than 84 per USD last Thursday.

Due to the continued plunge in oil prices (with Brent crude plunging another 26% so far in 2016) Russia's government has begun to consider austerity measures.

Further complicating the situation in Russia are the continued sanctions from the West.

While Russia is extremely sensitive to oil prices (earnings from oil exports account for roughly half of government revenues) the recent weakness in the Russian Ruble is unjustified and is the result of panic. The toxic mix of recent developments has proven to overwhelm investors.

Mexican Peso

The Peso has been especially hard hit during the recent frenzy. The Peso, being the most traded EM currency, is very sensitive to risk appetite as it is often used as a proxy for risk. Mexico is also very vulnerable to weakness in oil prices as its government is highly reliant on oil revenues. Pemex generally provides about a third of the government budget.

Polish Zloty

The zloty was hit by an unexpected and untimely downgrade by Standard & Poor's on January 15th. S&P based its downgrade on moves made by the new conservative government, which according to S&P have weakened the independence of major institutions.

The downgrade could not have come at a worse time for Poland. Although Poland is relatively insulated from China and commodities, in an environment of elevated risk aversion investors have been overwhelmed and have panicked in reaction to the recent downgrade

Notable Currencies Seen as Being Relatively Insulated From Turmoil in China

Japanese Yen

The Japanese yen has surged due to a rush to safe havens in Asia.

The yen has also appreciated as carry trades are rapidly reversed as a result of the recent panic. Due to low interest rates the Japanese yen provides a cheap source of borrowing funds to put to work in other higher yielding assets. As investors have panicked and have rapidly reversed many of these positions, short positions in the yen have been closed out, driving the yen higher.

Recent strength in the yen has not been driven by anything fundamental. As the current panic begins to subside the Japanese yen is expected to depreciate relative to many of the currencies in the long basket.

Indian Rupee

Although the Indian Rupee is not seen as a safe haven it has held up relatively well during the recent panic. We believe this is due to the fact that India's underlying economic fundamentals have held up relatively well in comparison to other Emerging Markets throughout the ongoing weakness seen in commodity prices. This is in part due to the fact that India is much less reliant on China and commodities relative to many other countries.

Despite India's ability to weather the ongoing downturn in commodities the rupee has likely become overvalued relative to the currencies in the current long basket as it has not been as impacted by the recent panic.

Despite High Dependency on Commodities the New Zealand Dollar and Norwegian Krone Have Remained Relatively Stable During the Current Panic

New Zealand Dollar

Although New Zealand is highly exposed to both commodities and China the New Zealand dollar has held up very well in the recent panic.

While New Zealand is highly dependent on the export of commodities it is focused largely on the export of food products and much less focused on commodities such as steel and energy.

While demand for commodities such as steel and oil have eased as China's economy begins its transition from investment to the consumer, demand for food products (driven by consumer demand, in particular high quality food products) has remained relatively stable.

Due to these characteristics of New Zealand's economy is widely viewed as being relatively insulated from the turmoil in China and the New Zealand dollar has been shielded from the recent panic. As the current panic begins to dissipate the New Zealand dollar can be expected to depreciate against currencies in the long basket.

Norwegian Krone

While not highly exposed to China Norway is highly dependent on commodities. Despite this the Norwegian Krone has held up relatively well during the recent panic. Similar to New Zealand, Norway is widely viewed as being relatively insulated from the weakness in commodity prices as the currency is the only commodity currency with both fiscal and current account surplus. Adding to this Norway has one of the largest sovereign wealth funds in the world.

Due to these characteristics the Norwegian Krone has largely been shielded from the recent frenzy. As the current panic begins to dissipate the Norwegian Krone can be expected to depreciate relative to many of the currencies in the current long basket.

Adjusting Trade Recommended in December 2014 to Match Current Trade

Recall the last panic identified by the StatArb Algorithm in the currency markets occurred on December 16th, 2014. Similar to the current inefficiency the December 2014 inefficiency was triggered by the panic resulting from the plunge in commodity prices in late 2014.

Long and Short Baskets Recommended in December 2014

Long vs. GPB	Short vs. GPB
Australian Dollar	Canadian Dollar
Brazilian Real	Euro
Mexican Peso	Indian Rupee
Norwegian Krone	Japanese Yen
Russian Ruble	New Zealand Dollar
Swedish Krona	Polish Zloty
	South African Rand
	Swiss Franc
	US Dollar

As weakness in commodity prices remains the main driver of the panic the long and short baskets recommended by the StatArb Algorithm in December 2014 were very similar to the current baskets.

We are adjusting positions in the December 2014 trade to match the current recommended trade.

Changes to baskets include:

Swedish Krona moved from long basket to short basket

The Swedish Krona was included in the long basket in December 2014 as the currency was unjustly impacted by a flare up in concerns over weak growth in the eurozone.

As panic over the health of the eurozone economy has eased since December 2014 the Swedish Krona has appreciated against a majority of the currencies listed in the December 2014 short basket, falling just 1.4% against the GBP compared to an average drop of 2.2% for currencies included in the short basket.

While the Swedish Krona was hit by concerns over the health of the eurozone in late 2014 it has held up relatively well during the recent panic surrounding China and commodities as it is seen as being relatively insulated from these issues. As the current panic begins to subside the Swedish Krona is expected to depreciate against currencies in the current long basket.

Norwegian Krone moved from long basket to short basket

It is unclear why Norway's fiscal and current account surpluses have been able to calm panicking investors during the current panic but did not during the panic in late 2014. Many times when a country is facing multiple issues investors reach a breaking point and become overwhelmed. Concerns over the health of the eurozone in late 2014 could have been the factor overwhelming investors.

As concerns over the health of eurozone economy have begun to subside since late 2014 investors have begun to take note of Norway's ability to cope with weak commodity prices, as a result the Krone has remained relatively stable. As the current panic begins to subside the Krone is expected to depreciate against currencies in the current long basket.

South African rand moved from short basket to long basket

The South African rand was largely unaffected by the panic in late 2014. Recall the panic in late 2014 was driven by a number of factors ranging from plunging commodity prices, weak growth in the eurozone to political turmoil in specific countries.

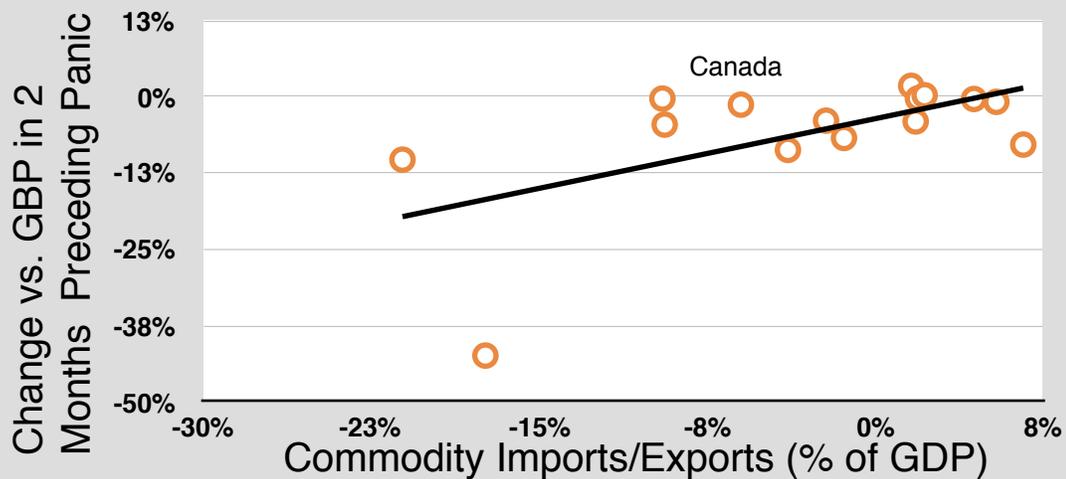
Although South Africa is highly dependent on commodity prices it is much less dependent than many countries including Norway, Russia, New Zealand, Australia, Canada and Brazil. Similarly South Africa is relatively shielded from the eurozone and at the time was not experiencing confidence destabilizing levels of political turmoil. Due to these characteristics the rand did not become a center of focus for panicking investors during the late 2014 panic.

Since late 2014 the situation in South Africa has dramatically changed. Due to a loss of confidence in its government following the firing of its finance minister and complications posed by a record drought the South African rand has become a center of focus during the current panic. As the current panic begins to dissipate the rand is expected to appreciate against the currencies in the current short basket.

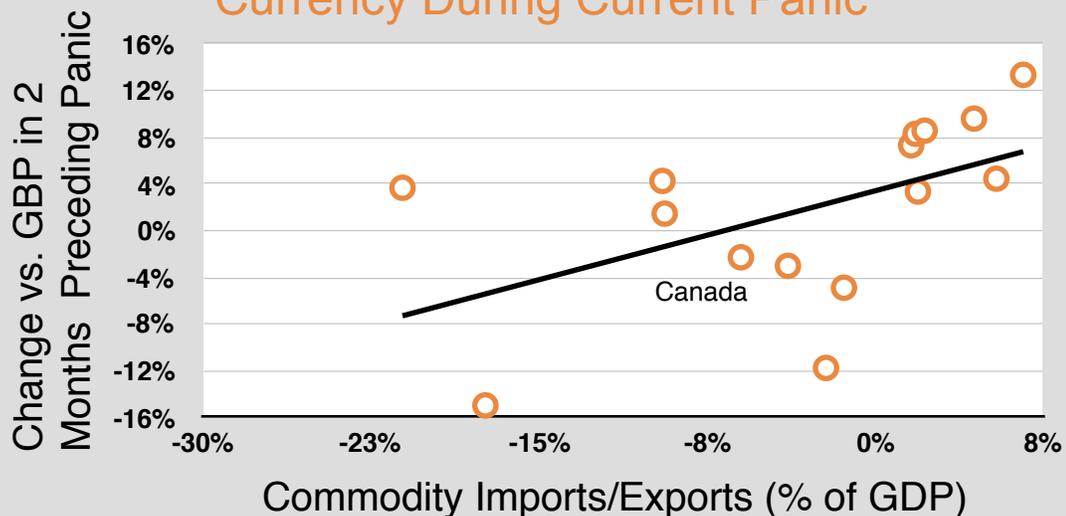
Canadian dollar moved from short basket to long basket

Despite the plunge in commodity prices the relatively commodity dependent Canadian dollar held up relatively well in late 2014. In the below two charts changes across currencies in the two months preceding identified panics is regressed on the countries commodity dependency (defined as commodity imports/exports as a % of GDP).

Commodity Dependence and Change in Currency During Late 2014 Panic



Commodity Dependence and Change in Currency During Current Panic



It can be seen that during the panic in late 2014 the Canadian dollar held up relatively well given its dependency on commodities (plotting above the regression line). This compares to the current panic in which the Canadian dollar has deteriorated in line with what could be expected given its exposure to commodities.

Panics generally occur when investors become overwhelmed with the number of obstacles facing a country. We believe the Canadian dollar was relatively unaffected by the panic in late 2014 despite its dependence on commodities as it did not face the numerous issues that other countries faced at the time. Recall that the plunge in commodity prices were just one factor driving the panic in late 2014.

For example, the Russian Ruble was among currencies most impacted by the panic in late 2014 as investors became overwhelmed with the number of issues facing the country ranging from plunging oil prices, weak growth in the eurozone and political turmoil.

Because the Canadian dollar was relatively unaffected by the panic in late 2014 the StatArb Algorithm placed it in the short basket as it was expected to depreciate against currencies that had been most impacted by the panic as the panic dissipated over the following year.

Since December 16th, 2014 the Canadian dollar has depreciated against many of the currencies in the suggested long basket, falling 9.7% against the GBP compared to 9.2% across currencies included in the long basket.

The focus of the current panic is much more singular than the panic in late 2014. Investors are extremely concerned with the further plunge in commodity prices, specifically oil. As a result commodity currencies have experienced a widespread sell-off. While the Canadian Dollar was able to avoid the late 2014 panic, it has been hit this time around.

Polish Zloty moved from short basket to long basket

Although Poland is highly dependent on the health of the eurozone the zloty was relatively unaffected by the panic in late 2014. As it is a commodity importer and was not experiencing confidence destabilizing levels of political turmoil at the time the Zloty did not become a focus of panicking investors.

Since late 2014 Poland has been hit by political turmoil with the recent election of a government viewed as being anti-market. Following this the Zloty has come under further pressure due to the recent and unexpected downgrade by Standard and Poor's.

Due to a surge in risk aversion the Zloty has become undervalued relative to currencies in the current short basket. As the current panic dissipates the Zloty can be expected to appreciate relative to many of these currencies.