NZD: Back to the 90s?

- NZD (and other) currency volatility has been on a falling trend over the past several years. The low volatility environment is not unprecedented. Indeed, such low volatility, if not lower, was a feature of the currency market during 1990-1997.
- Is the low currency volatility likely to become the new norm? We don’t know for sure, but quite possibly. Less speculative activity, lower volatility in growth and inflation, and the risk of currency positions being ruined by an errant tweet might well explain lower currency volatility.
- A lower volatility environment doesn’t preclude steady moves up or down in the currency, but trading opportunities to take advantage of currency movements become fewer and far between.

The click-bait title of this note refers to the low volatility period of the 1990s, not the level of the NZD. As the first half of 2019 draws to a close, currency watchers will know that it hasn’t been a particularly volatile period for currency markets.

There have been a lot of things to contemplate this year. Key themes in play have been the US trade war with China now well entrenched and expanding into the realms of the technology sector; heightened risk of the US economy heading into recession; and a turnaround in central bank policy away from talking policy normalisation and back to providing additional stimulus.

So there have been plenty of news headlines to trade on and we’ve seen some big moves in equities and bond markets so far this year, but currency movements have been fairly well-contained. Equities haven’t been particularly volatile, although there have been a few episodes of the VIX index spiking up through 20.

Volatility in the bond market has been greater, with the MOVE Index – a measure of implied volatility for the US Treasuries market – recently touching 80, the highest level seen since 2016. By contrast, currency markets have been more subdued. The CVIX index – the implied volatility of currency markets for nine major currency pairs – fell to a five-year low in April and has remained close to this historically low level.
The second chart shows the high-low range for only the first six months of each year so we can fairly compare to the current half year. The high-low range this year has been 4.6 cents or 7.1%, the lowest since 1997 or a 22-year low. This chart also highlights the low ranges evident in the early 1990s period. It’s remarkable that in 1992, the high-low range was only 2.2 cents over the first half of the year. But ranges as narrow as the current half year were typical in the early 1990s.

The final chart shows annualised historical 3-month volatility for the NZD back to 1990. It again highlights the low volatility period of 1990-1997 and how recent volatility is falling towards those levels.

A question is why is currency volatility so low at present? Or maybe the right question is, is currency volatility back down to normal and why was currency volatility so high from 1998 through to 2017?

We don’t have the answers but can make some educated guesses. One is that speculative activity in currency markets has reduced, perhaps because of increased regulations on trading banks that have reduced such activity, and reduced hedge fund activity as their access to leverage through investment banks has been curtailed.

Low currency volatility might also reflect the current macroeconomic environment – low volatility in growth and inflation. In such a world, particularly if the global economic and policy cycle is well synchronised across countries, a lack of trading ideas prevails.

Another possible theory is the Donald Trump factor. One untimely tweet can ruin a successful trading position in a fleeting moment and this creates some hesitancy to trade currency markets.

Another theory is that volatility clusters, so one can get long periods of low volatility and long periods of high volatility. Low volatility (or high volatility) can feed on itself. This theory would suggest that a return back to the high volatility days is not necessarily on the cards and we could well be entering a currency volatility regime like the early 1990s.

Our view back in early 2017 was that as the policy tightening underway by the Fed gained some traction, and as the low global rate environment looked to be near a turning point, that ultimately currency volatility would pick-up. That view has been proven wrong and, indeed, with global rates heading lower again there’s even less reason to believe that currency volatility will recover to any meaningful extent. A return to significant trade protectionism and a period of de-synchronised world growth could increase volatility, but that currently isn’t our expectation.

At this juncture the honest thing to say is that we just don’t know how currency volatility will pan out over the years to come. On the “low volatility begets low volatility” theory, one could easily see a return back to the 1990s environment. The implication for corporates is that a lower volatility environment doesn’t preclude steady moves up or down in the currency, but trading opportunities to take advantage of currency movements become fewer and far between.

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