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# Chart Pack for ECB FXCG Meeting June 2023

June 2023

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Head of Macro Strategy EMEA

# FX Market conditions

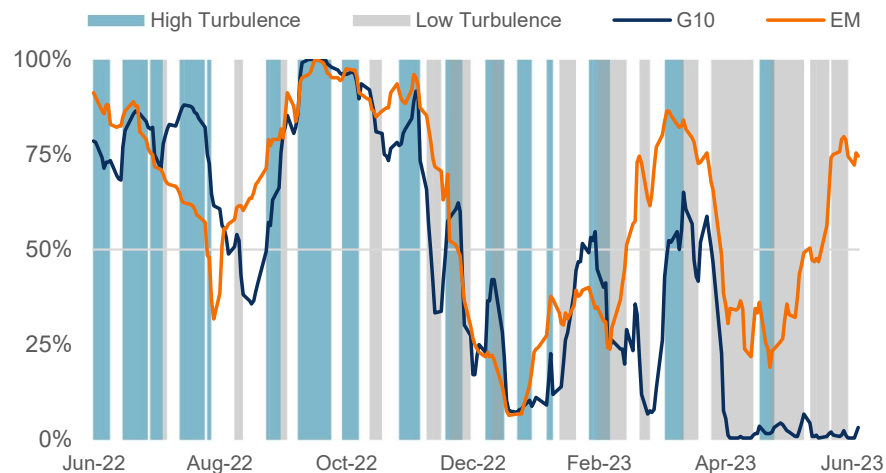
## Volumes way down, with decent liquidity

Despite a few central bank surprises, G10 volumes have collapsed. EM holding up much better.

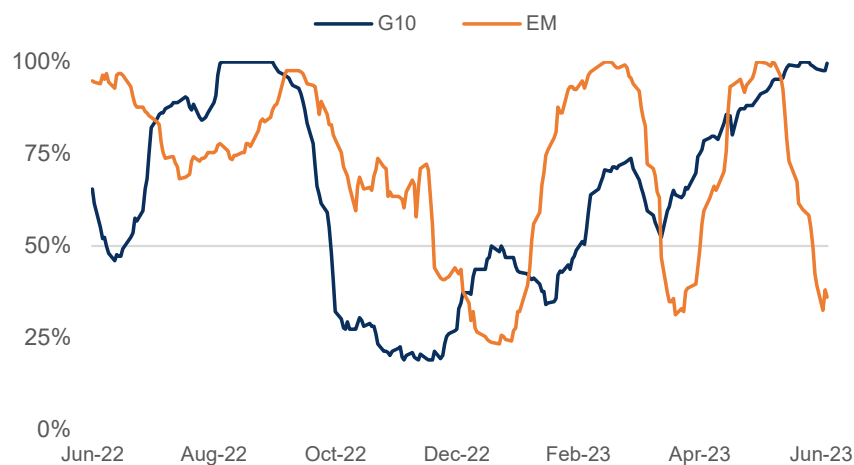
G10 liquidity healthy. USDTRY and USDZAR responsible for recent impairments in EM.

After a steady grind lower, spreads have bottomed out. EM ex-TRY is OK but no longer tightening.

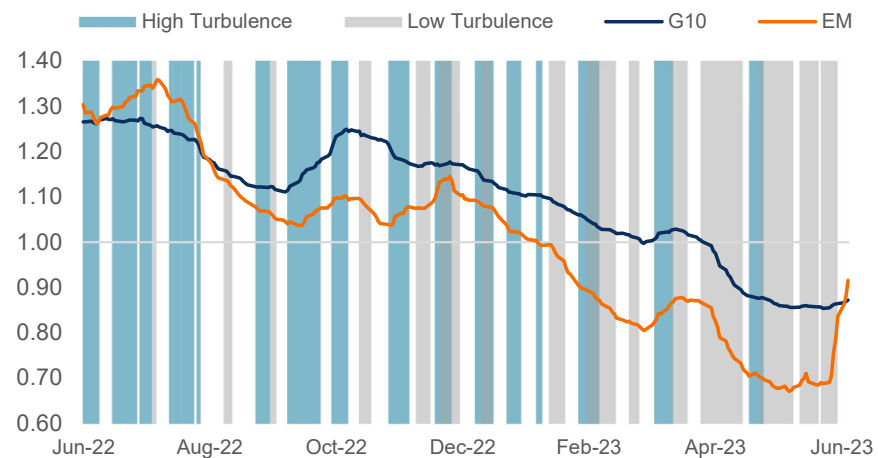
### Volumes (percentile)



### Liquidity (depth of book)



### Spreads



# EURUSD conditions

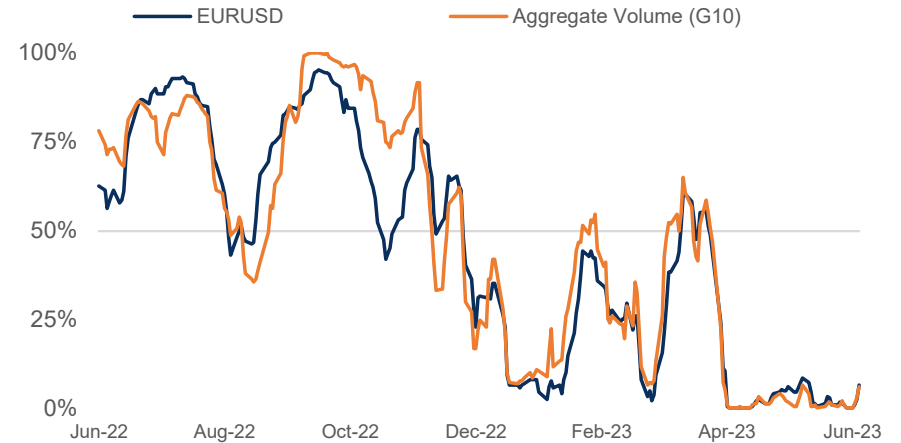
## A microcosm of broader market conditions

Volumes at trailing one-year lows

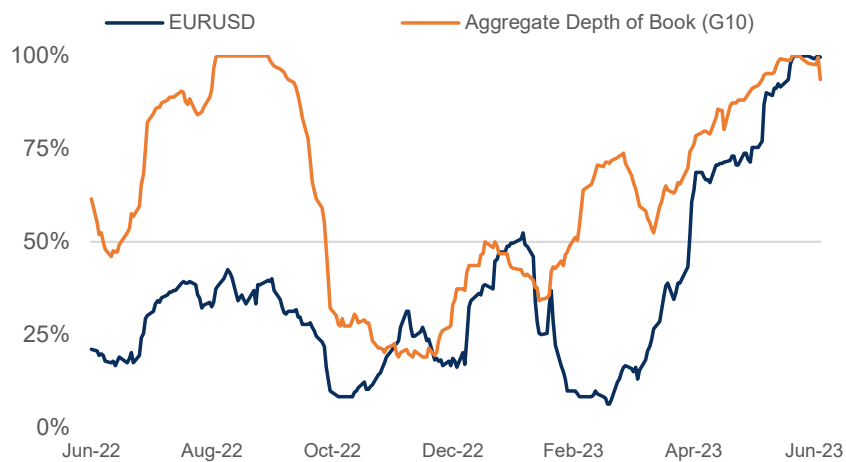
EURUSD depth of book very healthy

Spreads are stable at lows of the last year

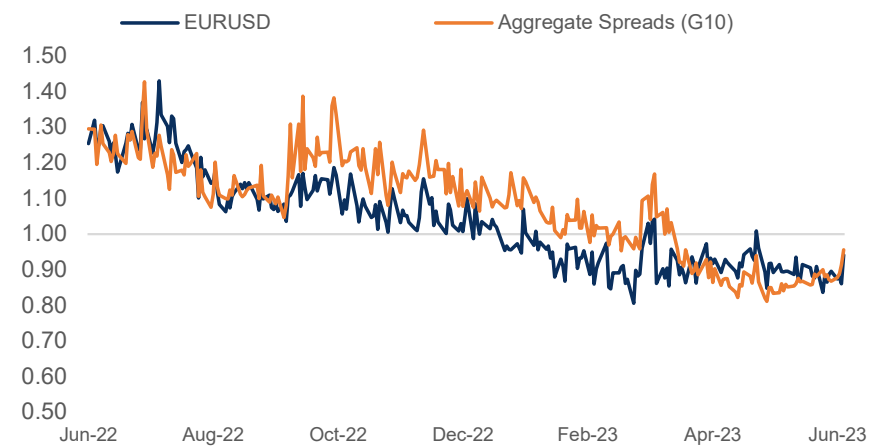
### Volumes (percentile)



### Liquidity (depth of book)



### Spreads



# Crisis conditions have passed

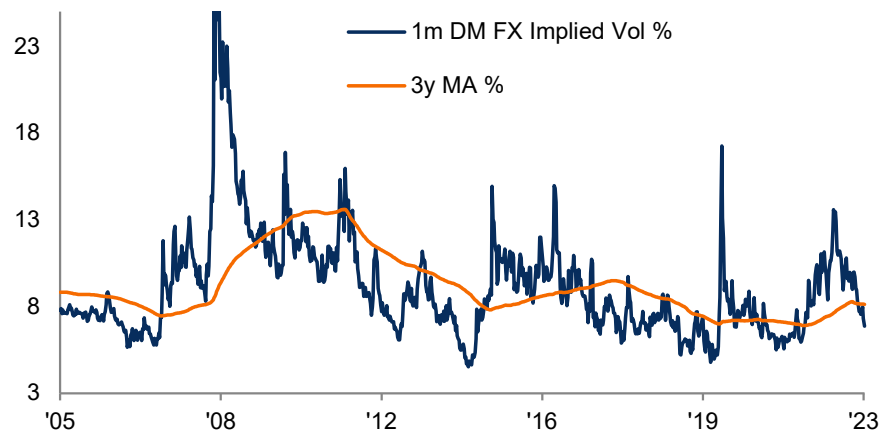
## Volatility and skew both reflect a much more benign outlook

DM FX implied volatility is now at a discount to what had been a rising long-run moving average. The main 'unknown unknown' risk is the prospect central banks that have to surprise hawkishly.

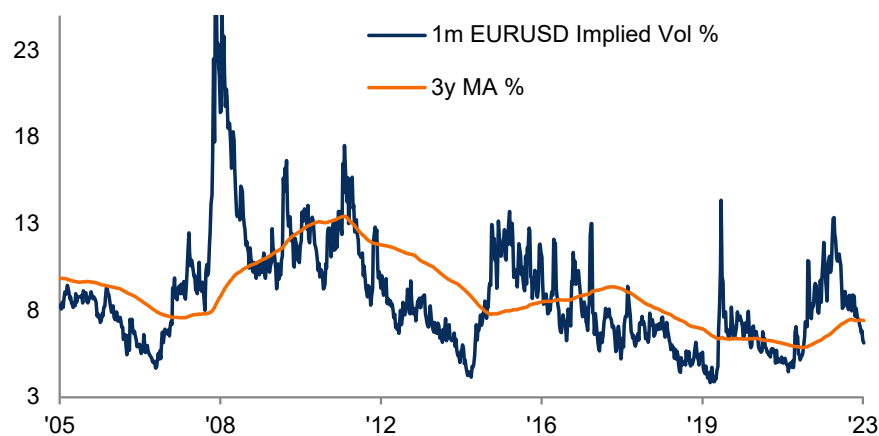
Discount of EURUSD to its long-run moving average is wider than that for most DM pairs and heading into troughs seen in 2007, 2014, 2020.

EURUSD skew has a slight bias for puts but is only a touch above its long-run median value and a rolling long-term moving average.

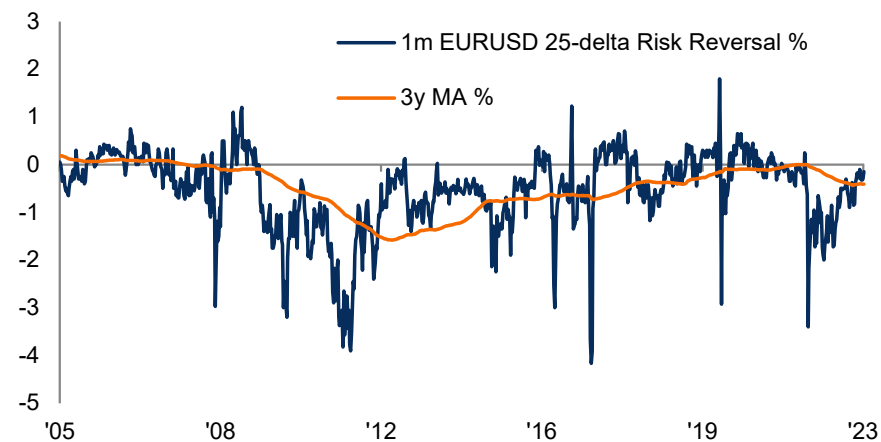
### DM Vol environment



### EURUSD Volatility



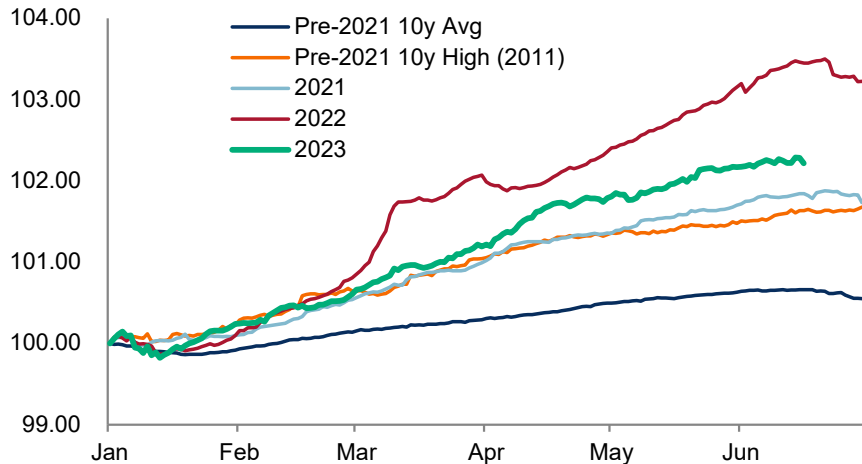
### EURUSD Skew



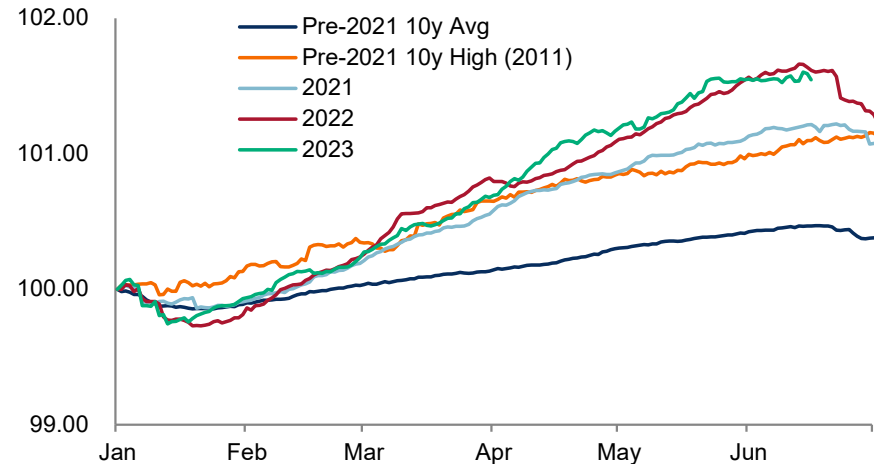
# Eurozone inflation still sticky – but the worst may be over

## The ECB slowing down just in time

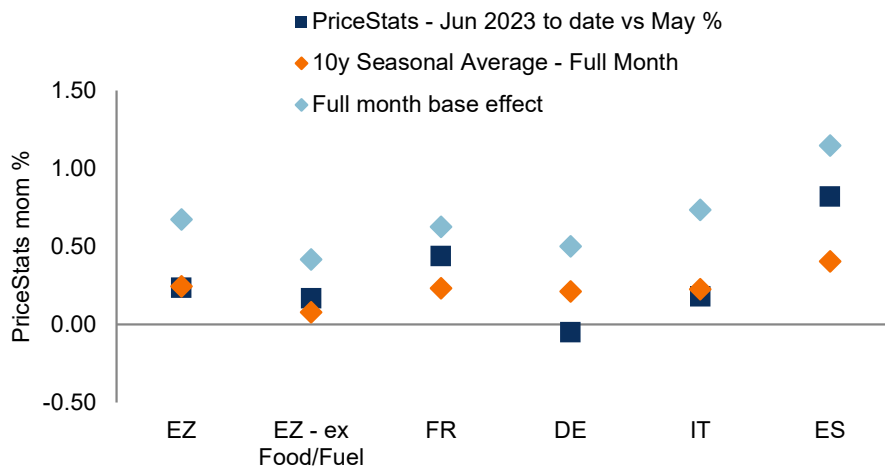
**Headline online inflation – flatter than last year but no energy shock**



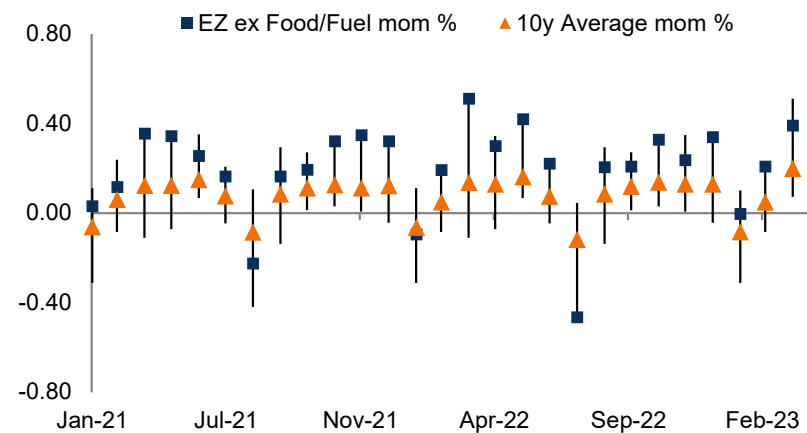
**Ex-food/fuel inflation - still strong, flattening is seasonal**



**Early data for June are still robust, Germany looks better**



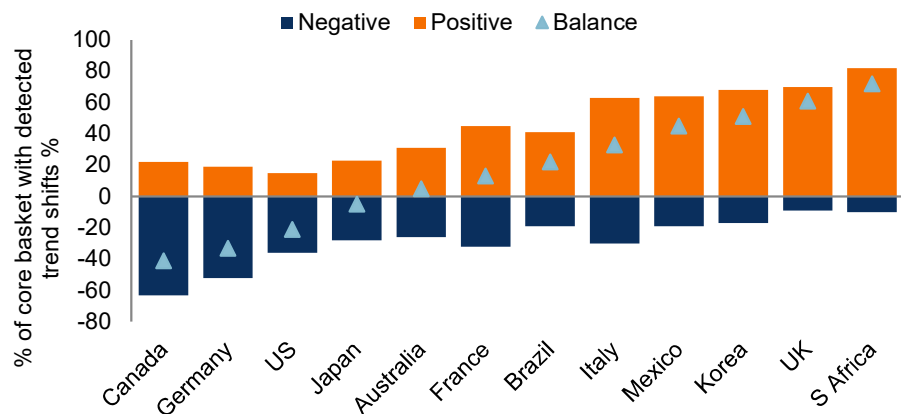
**Two weeks in and still strong**



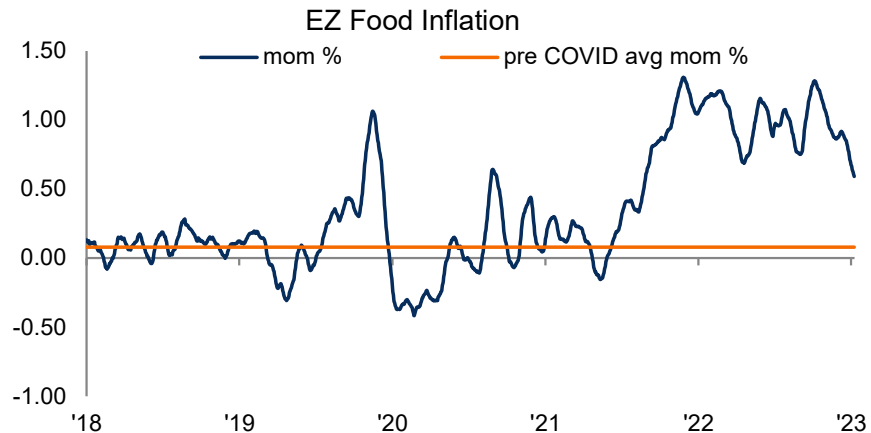
# Breadth is starting to improve but expectations high

Our view: 4.00% terminal

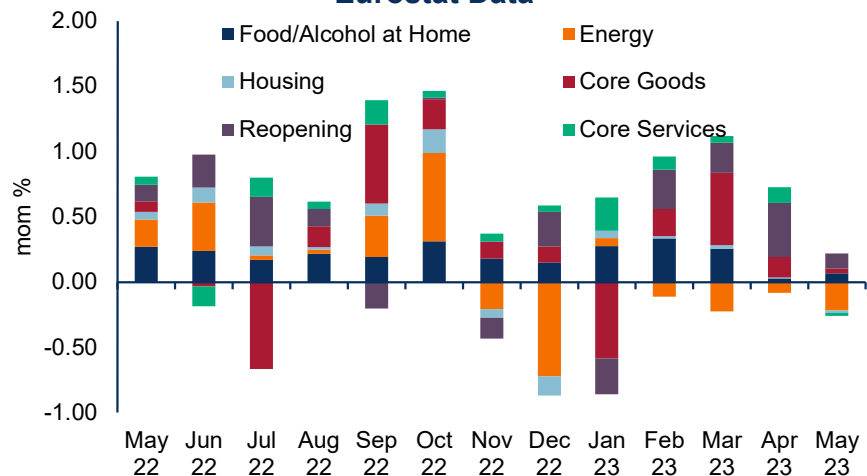
More trend breaks in the German basket – Data from PriceStats



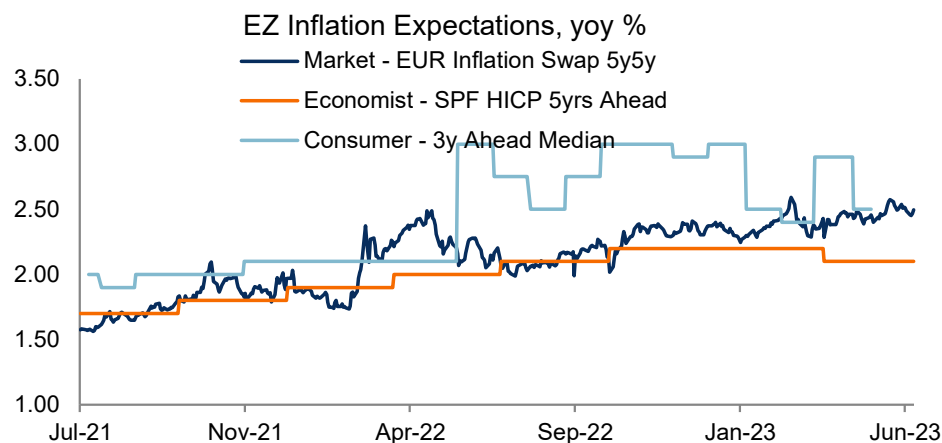
Food inflation off the peak but still too high – Data from PriceStats



Reopening (Hotels + Restaurants) still playing a big part – Eurostat Data



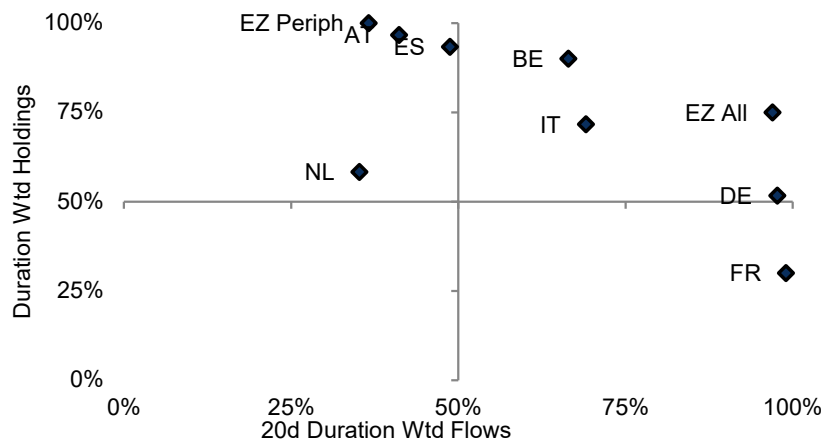
Market expectations are contained but elevated



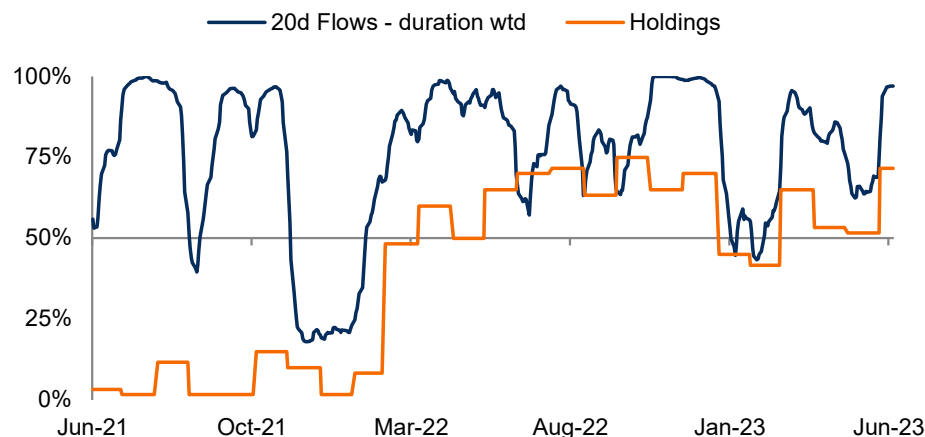
# Investor Behaviour in Eurozone Assets and the EUR

Institutional demand for Eurozone assets is healthy but hedged, and equity positions look full

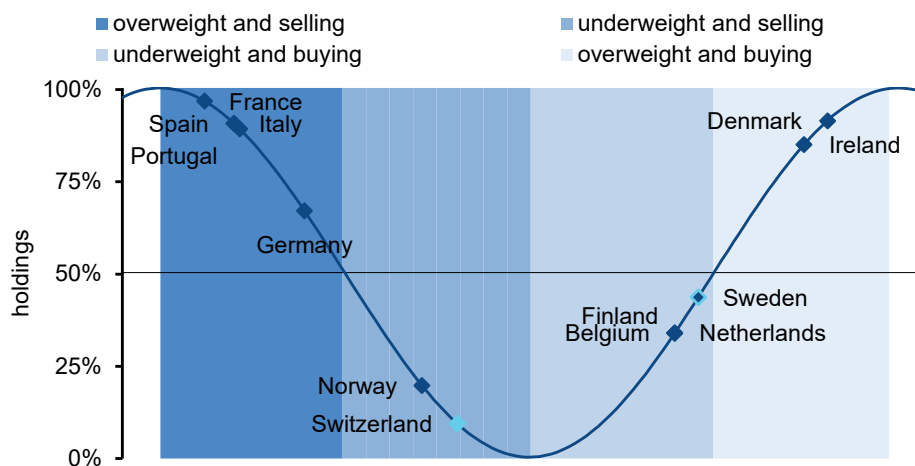
**Demand for sovereign debt remains very strong – SSGM Sovereign Bond Flows and Holdings**



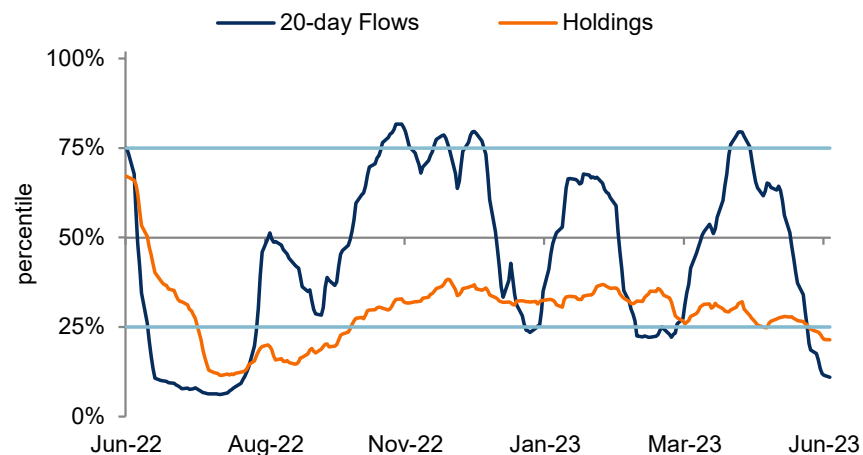
**Spread risk – BTP holdings a steady, rebuilt overweight**



**Major equity markets are all crowded and selling emerging**



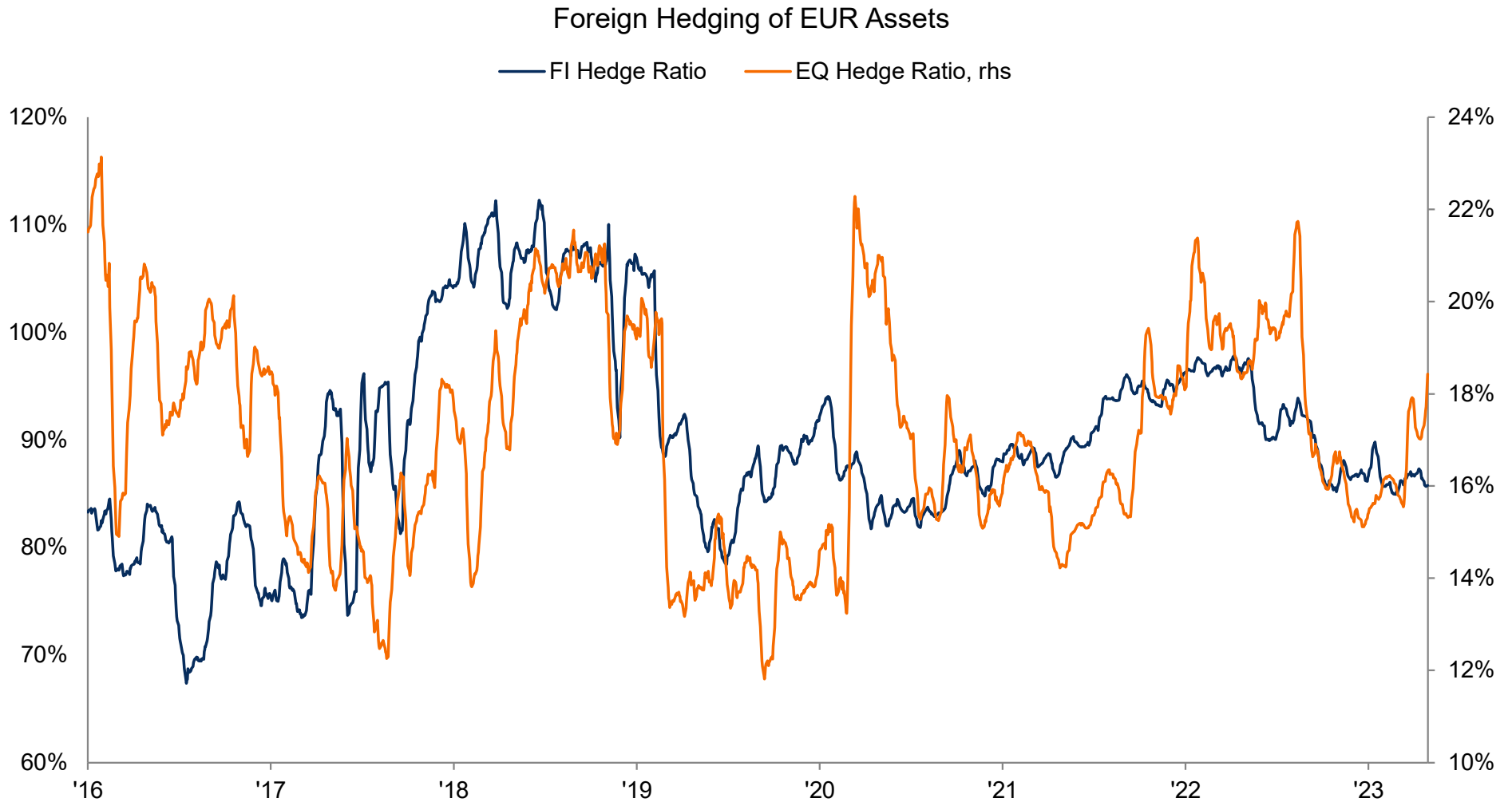
**EUR – investor underweight still sizable and growing**



7 Source: State Street Global Markets, data as of 12 June 2022

# Hedge Ratio Estimates – Foreign Holders of EZ Assets

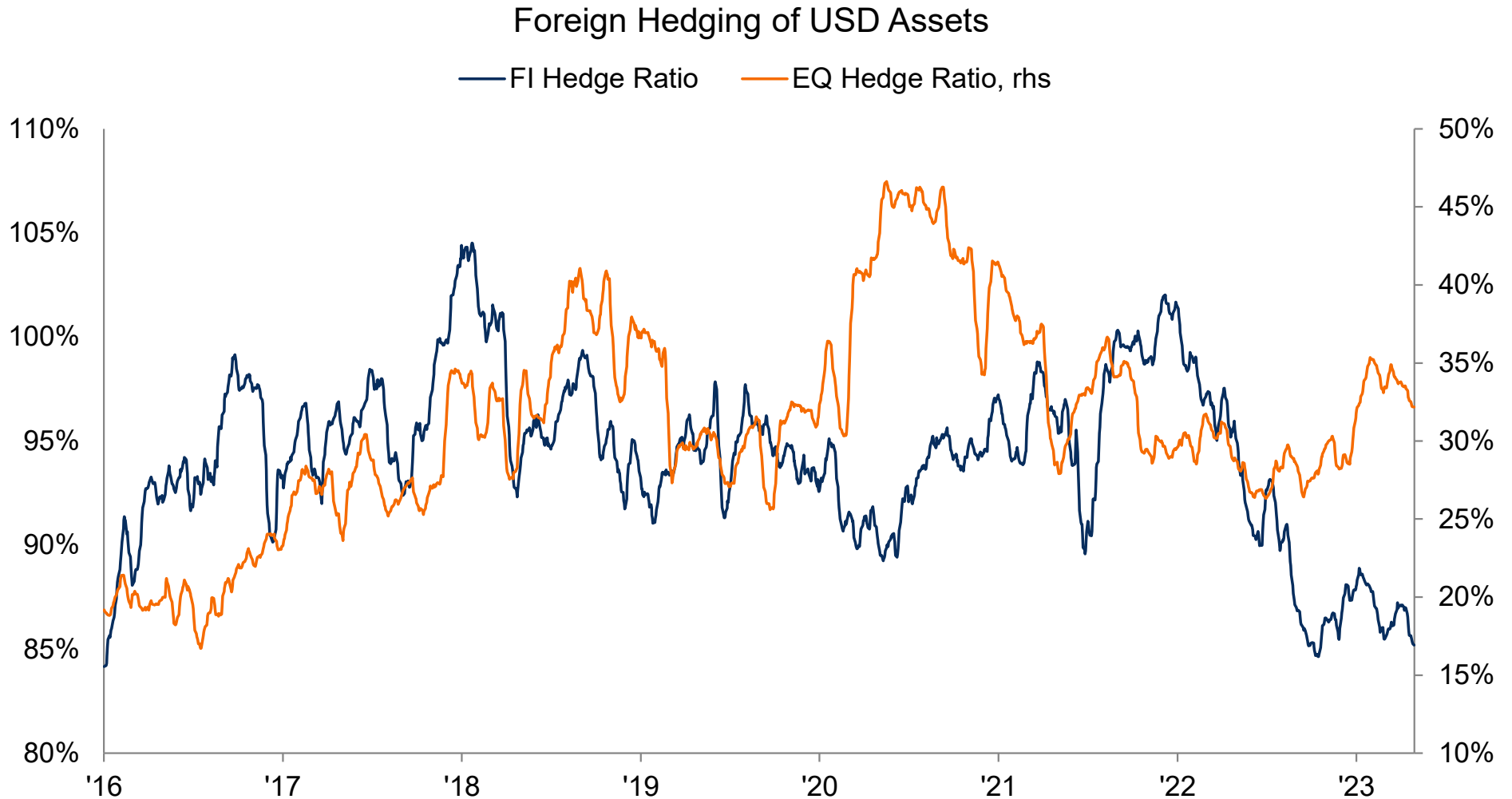
Desire to hedge EUR risk has declined in FI, risen in EQ





# Hedge Ratio Estimates – Foreign Holders of US Assets

Hedging of US assets is low relative to last five years and is now at levels when previous strong dollar regime (2014-2016) ended



# Questions for discussion

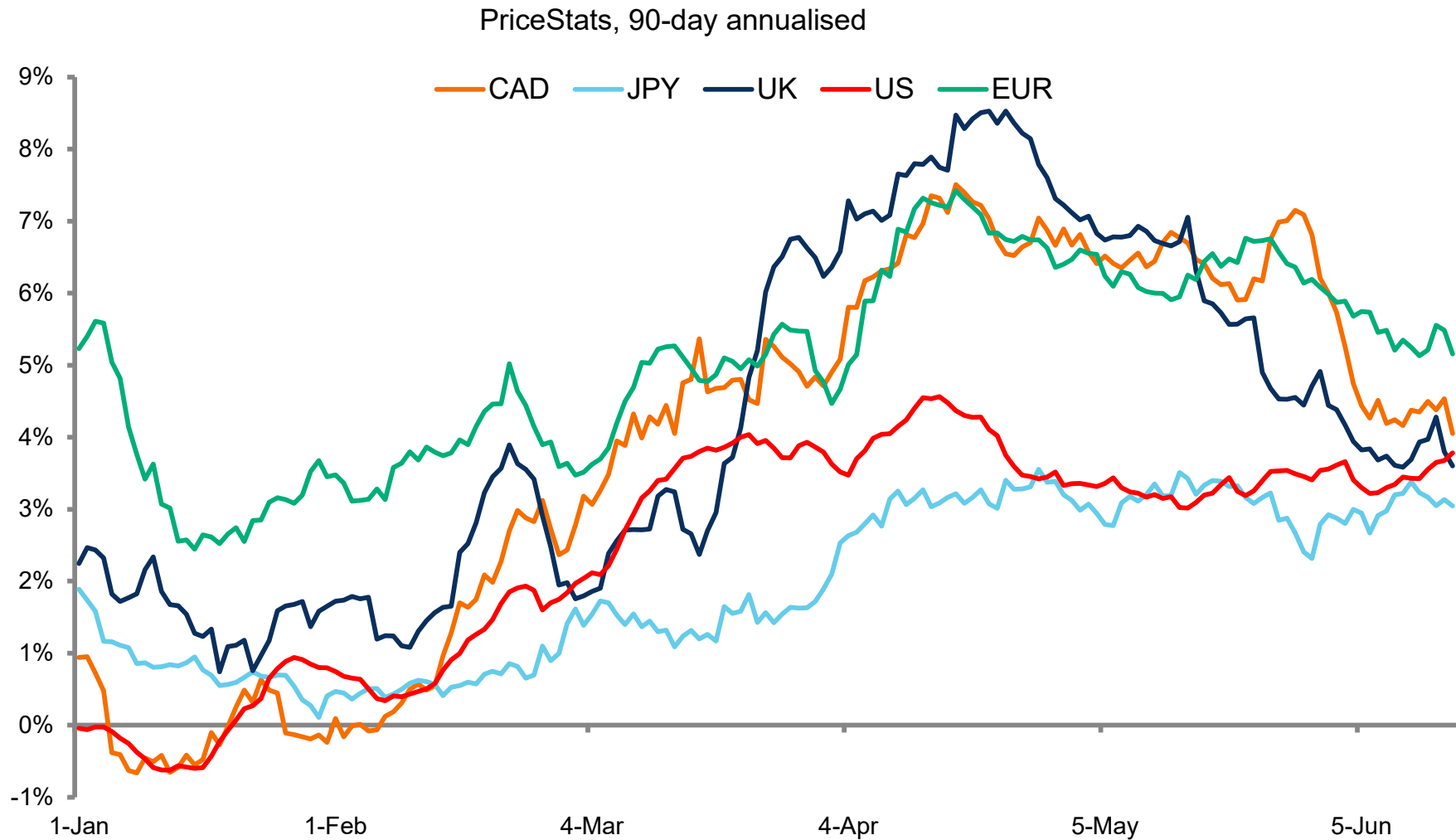
- Is the EUR entering a prolonged trough in volatility?
- What are the most likely catalysts for a return in volatility in the EUR and FX markets more generally?
- How do we square the data we have showing decent liquidity and low trading costs with very low volumes?
- The end of negative rates has led to much reduced hedging of EUR assets by foreign investors, yet we still see a reluctance for them to reduce broader underweights to benchmark – what factors are most likely to drive such a trend?

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# Appendix

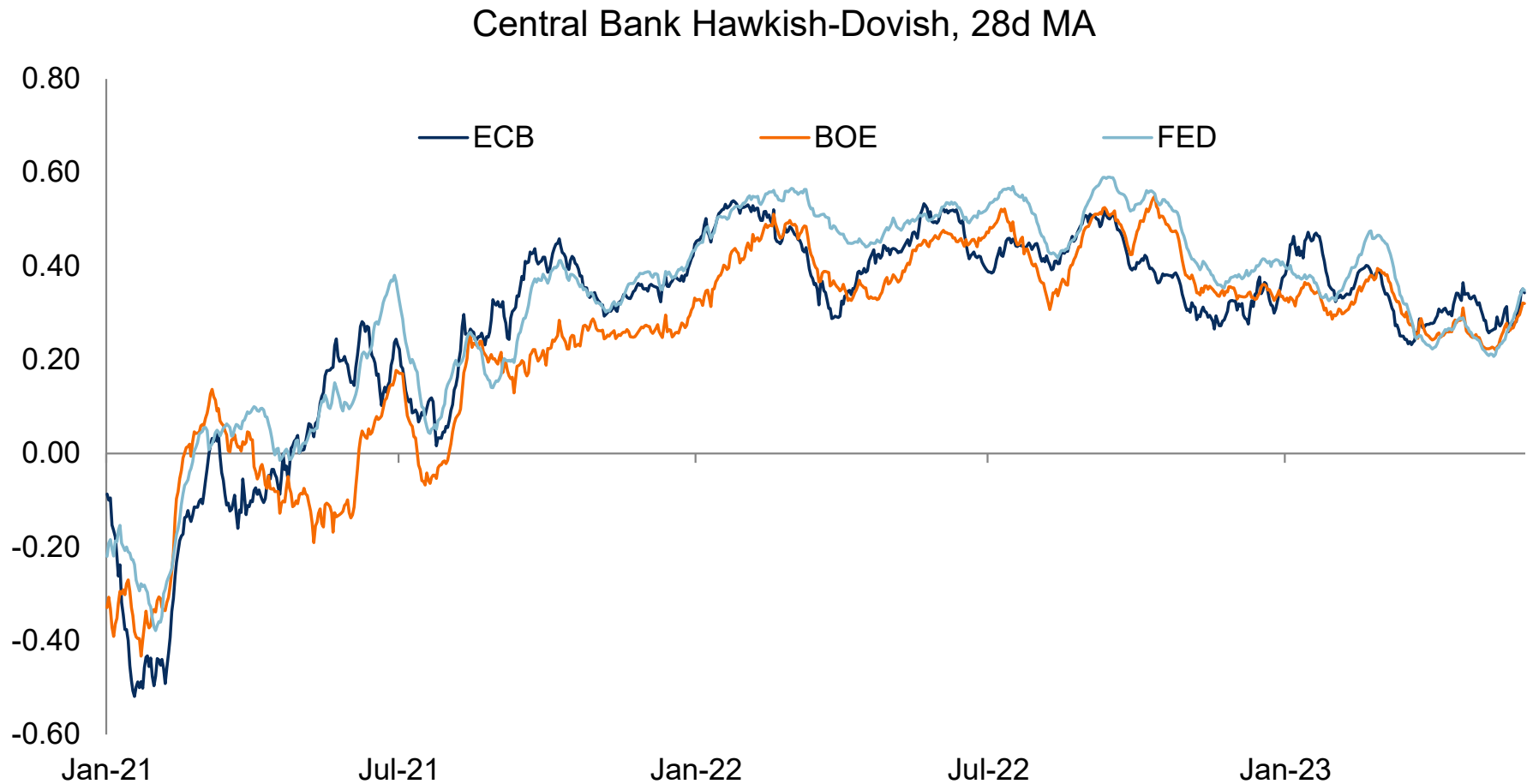
# Settling down, but at too high a level

Inflation is proving stickier than hoped



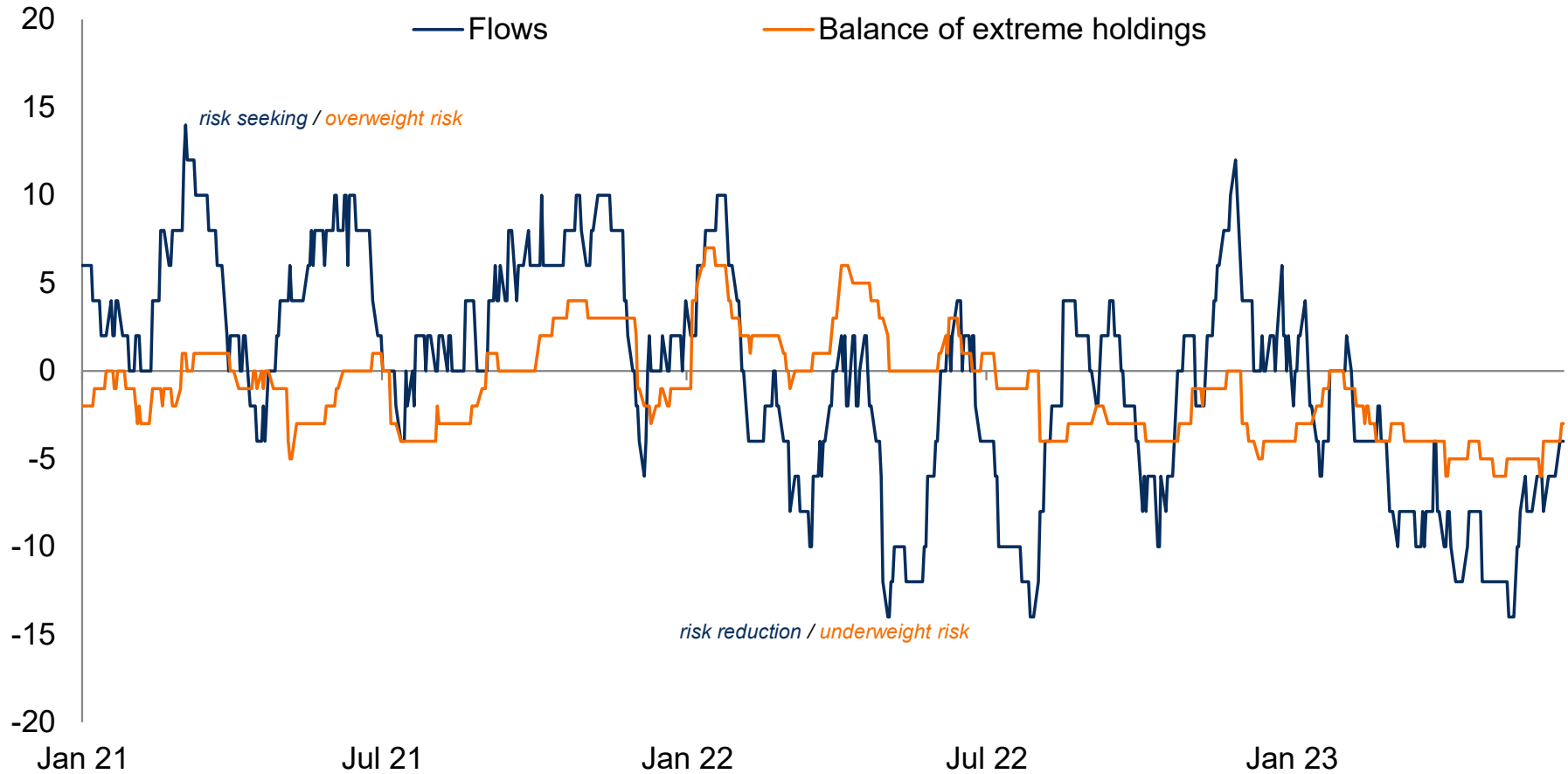
# Hawkishness drifting – but not gone

CB coverage tone biased to hawkishness, no sign of a turn



# Negative sentiment dominates but be wary

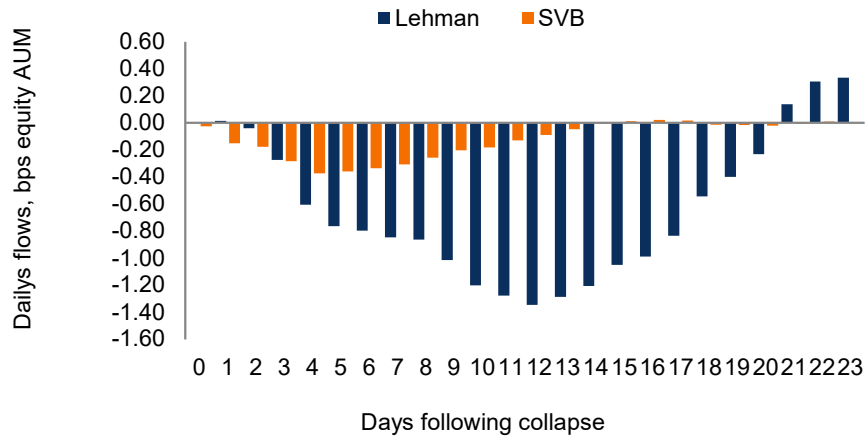
Positions are already pessimistic and flows starting to slowly improve



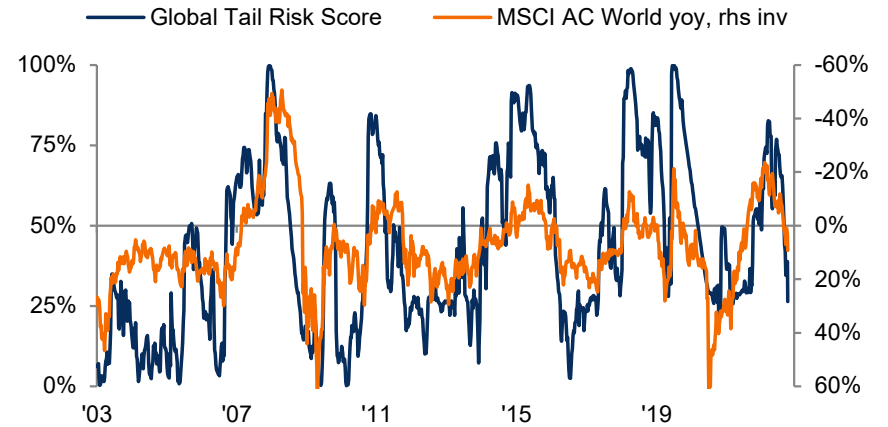
# What's the big worry?

Bank stress, tail risk already fading – everyone expects a recession

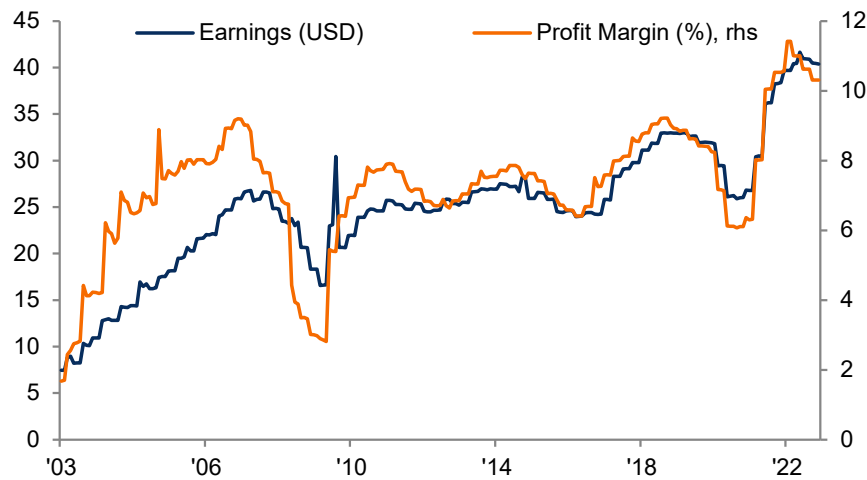
**US Bank Equity flows**



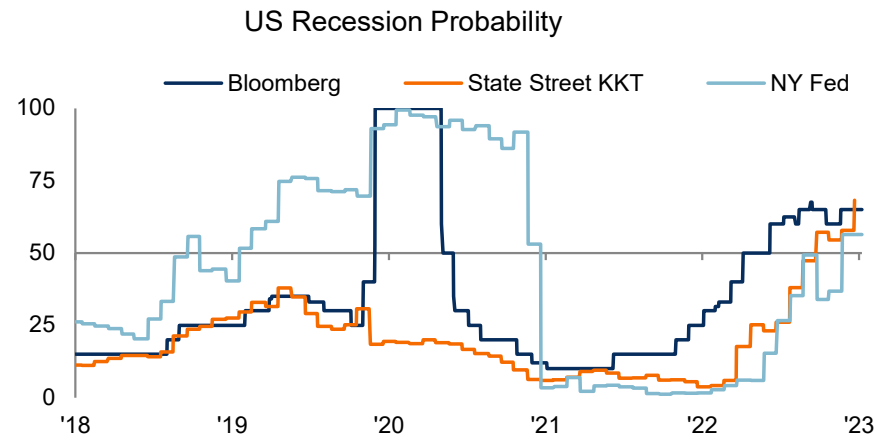
**Tail risk is elevated – but starting to fall**



**Profits and margins are still super high**

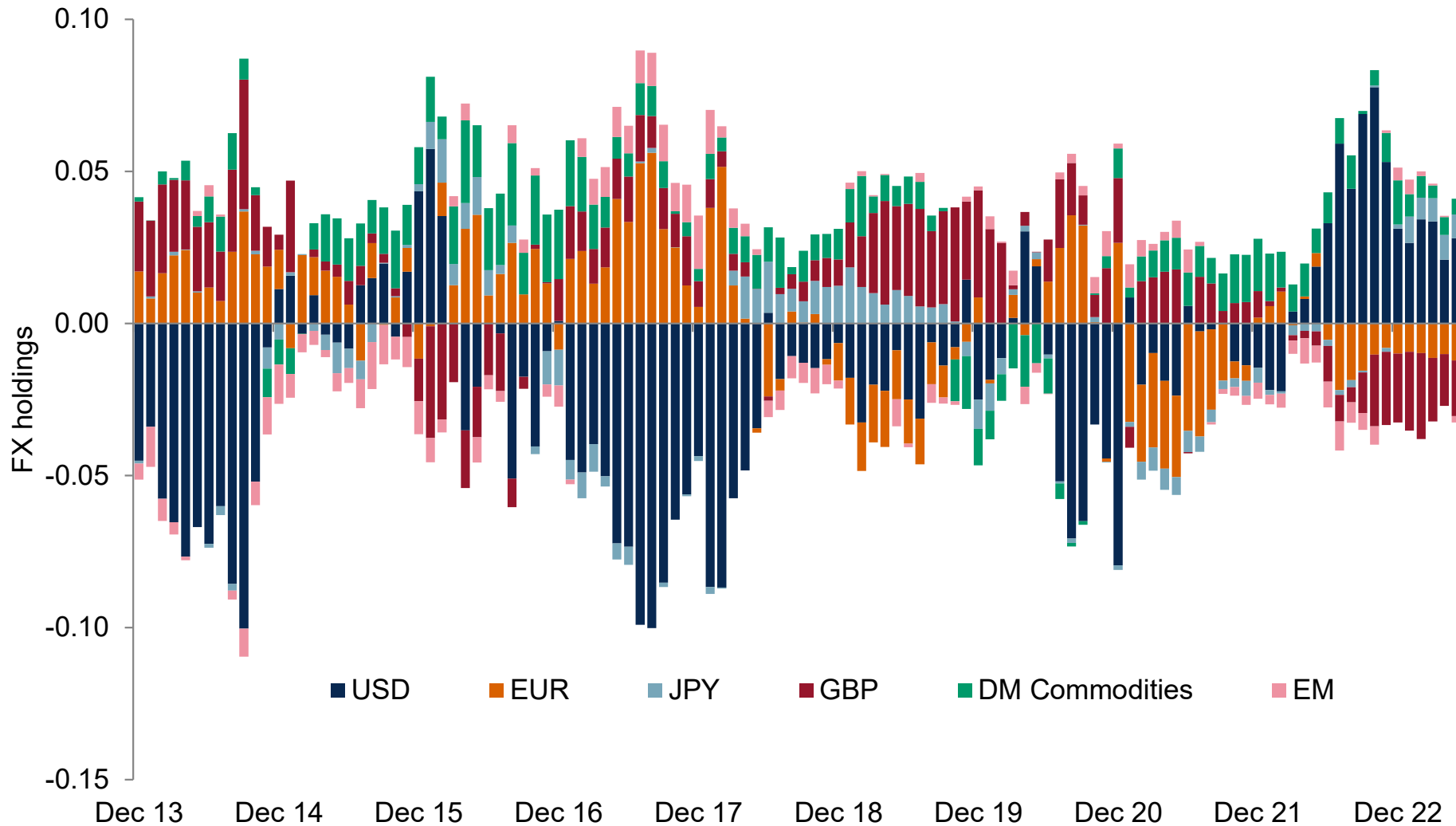


**Everyone expects a recession**



# USD positions are still overweight, no longer unwinding

GBP, EUR still the consensus shorts; JPY longs built up in a hurry

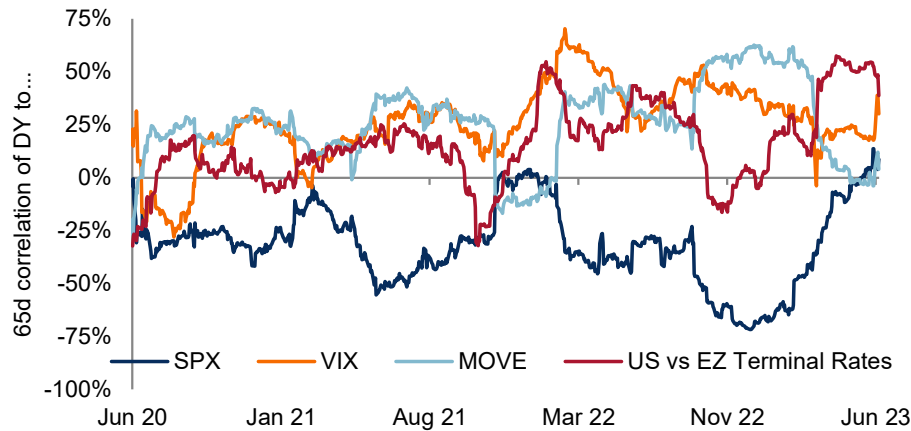




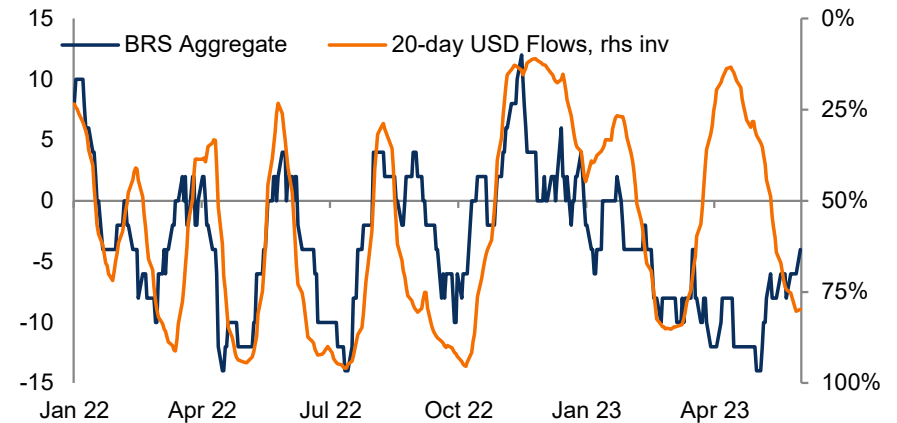
# USD: Buying picks up again

Correlation of USD to risk is positive now, rates still matter – long USDJPY

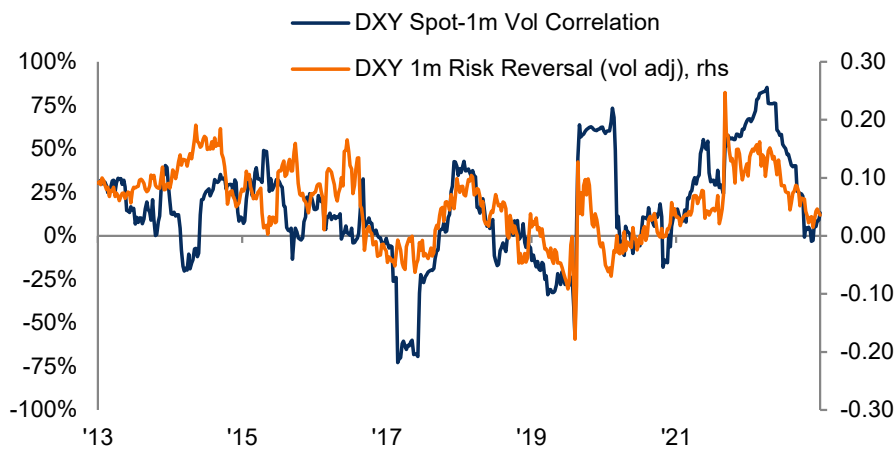
Rate expectations the main driver



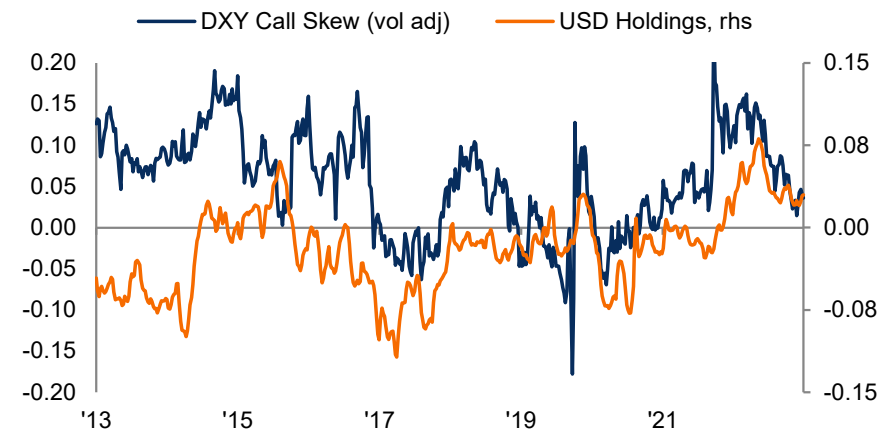
The Great Intersection



Spot-vol sensitivity in USD options is gone



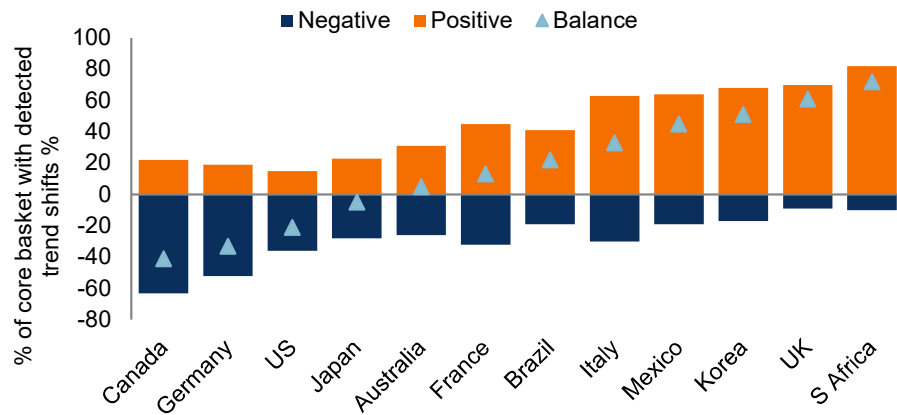
USD risk premia in options is repricing rapidly – but should skew for downside due to rates



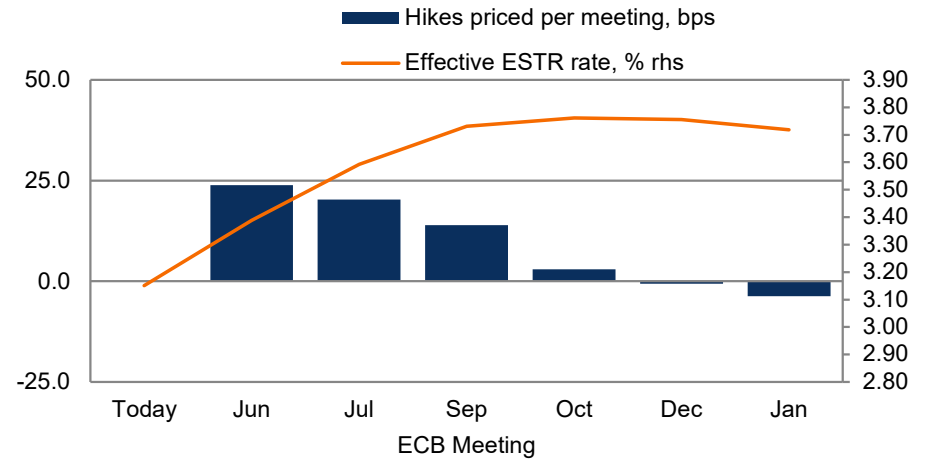
# EUR: On better footing with no position risk – but selling

## Valuation argument less compelling, still underweight

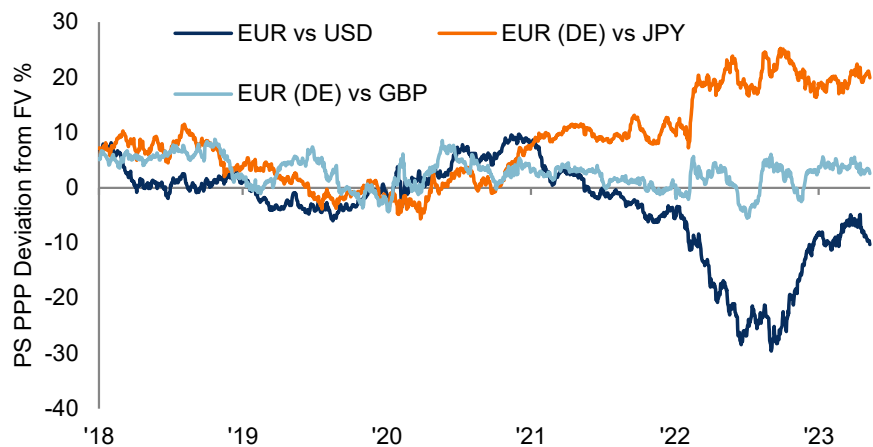
**Inflation is finally starting to cool across more economies**



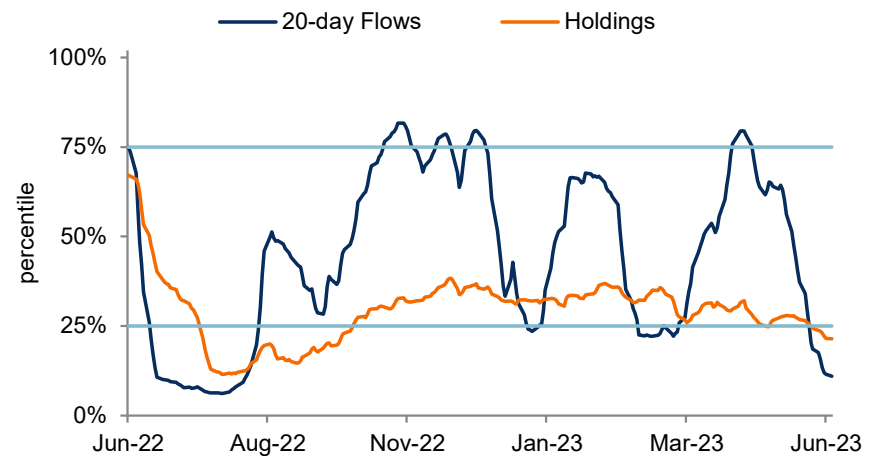
**Terminal priced at 3.75% - a third likely, but not more**



**EURUSD the best valuation story of the crosses**



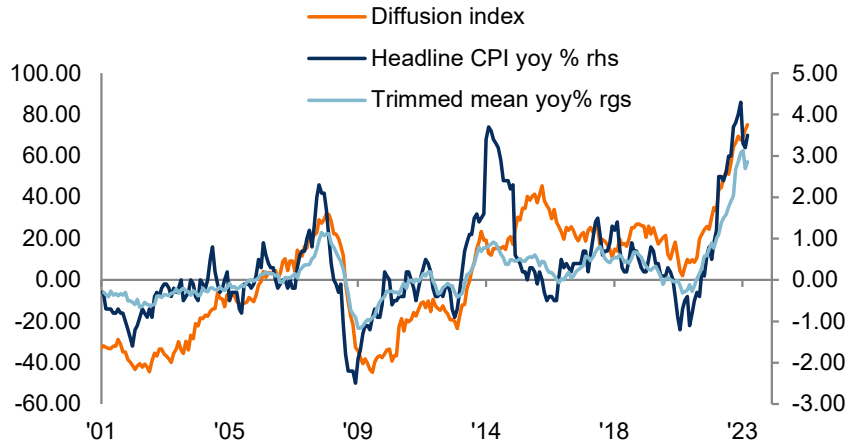
**EUR Flows and Holdings**



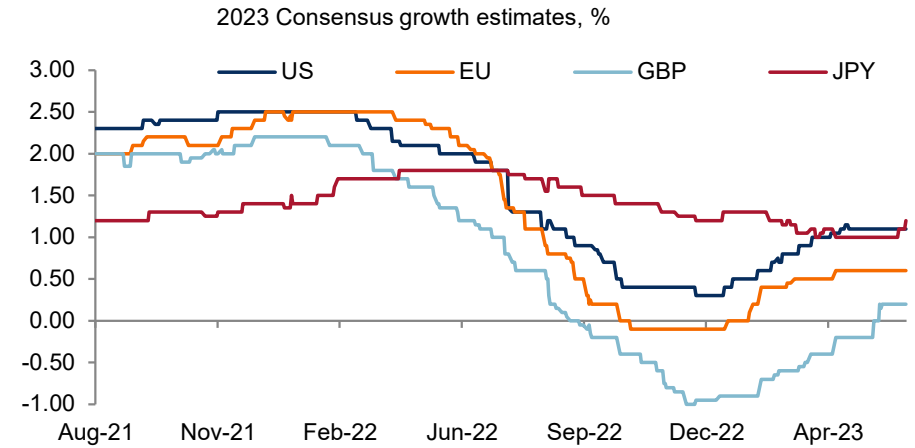
# JPY: Now a consensus long

## Inflation still a problem

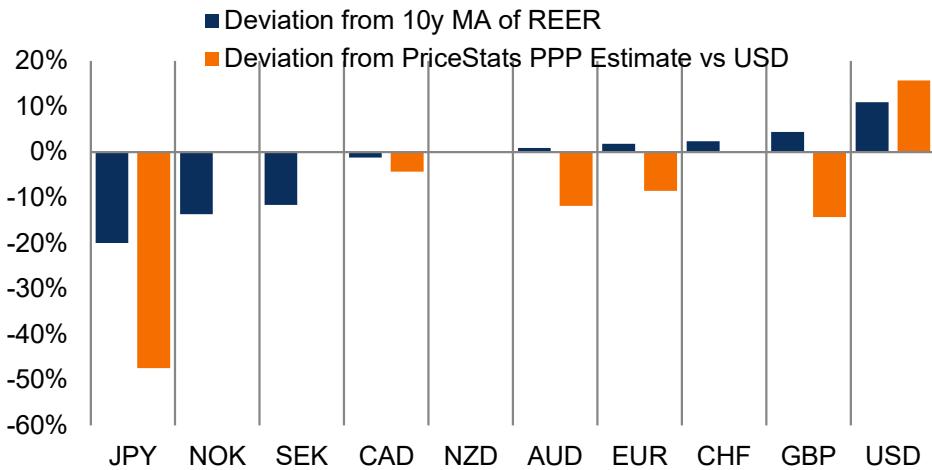
### Inflation is a massive headache



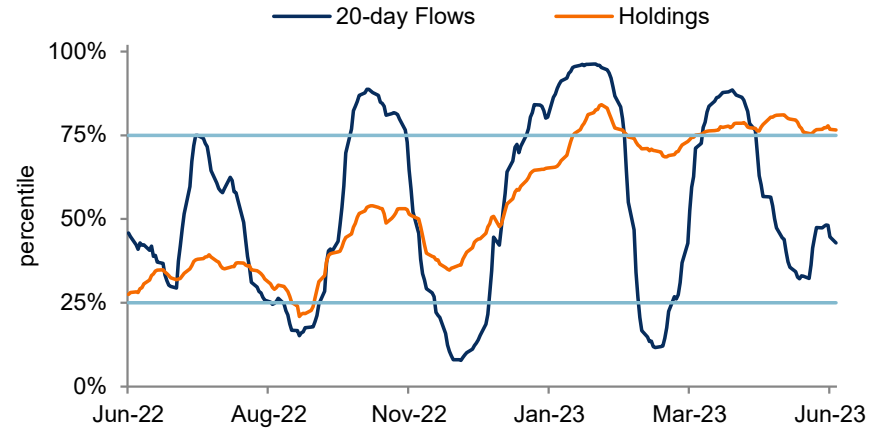
### There's a first time for everything



### Still the clear value play in G10



### JPY Flows and Holdings



19 Source: State Street Global Markets, Bloomberg, bottom left data as of 15 Jun 2023

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# Presentation to ECB FXCG

## Focus on FX Swaps

Jasper Livingsmith  
22nd June 2023

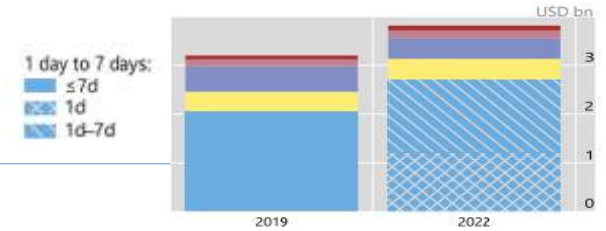


**European Bank**  
for Reconstruction and Development

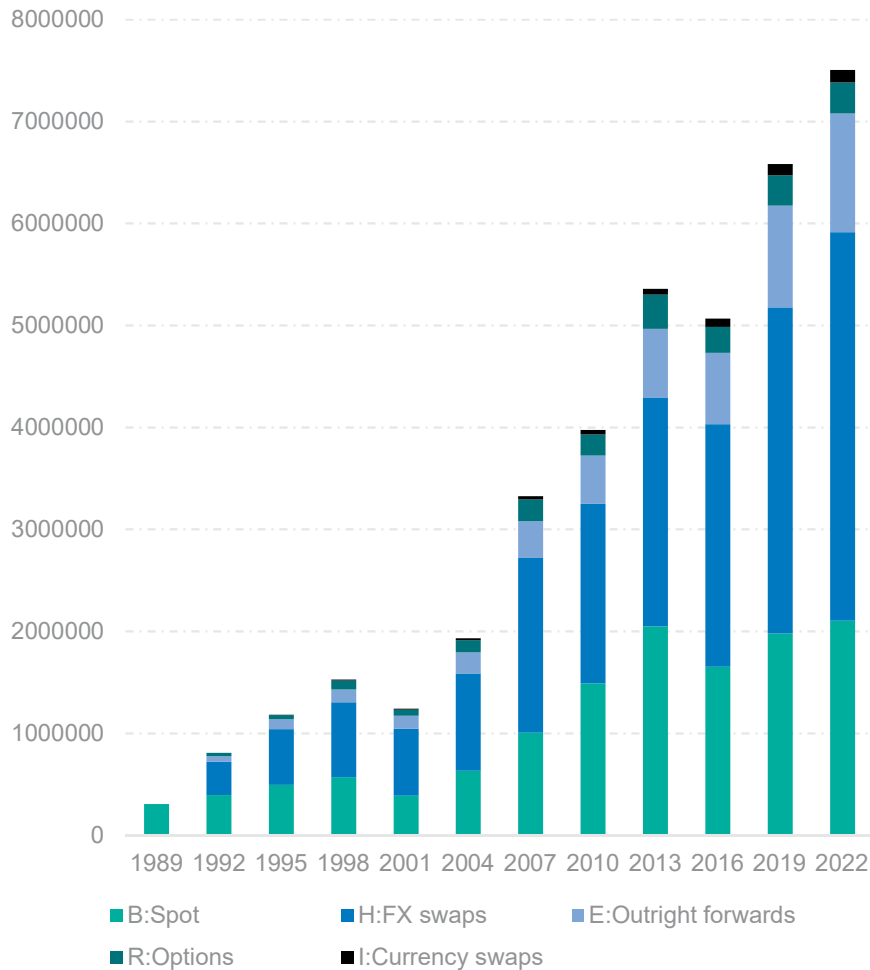
# FX Swap Volumes per BIS

Consistently ~50% of total

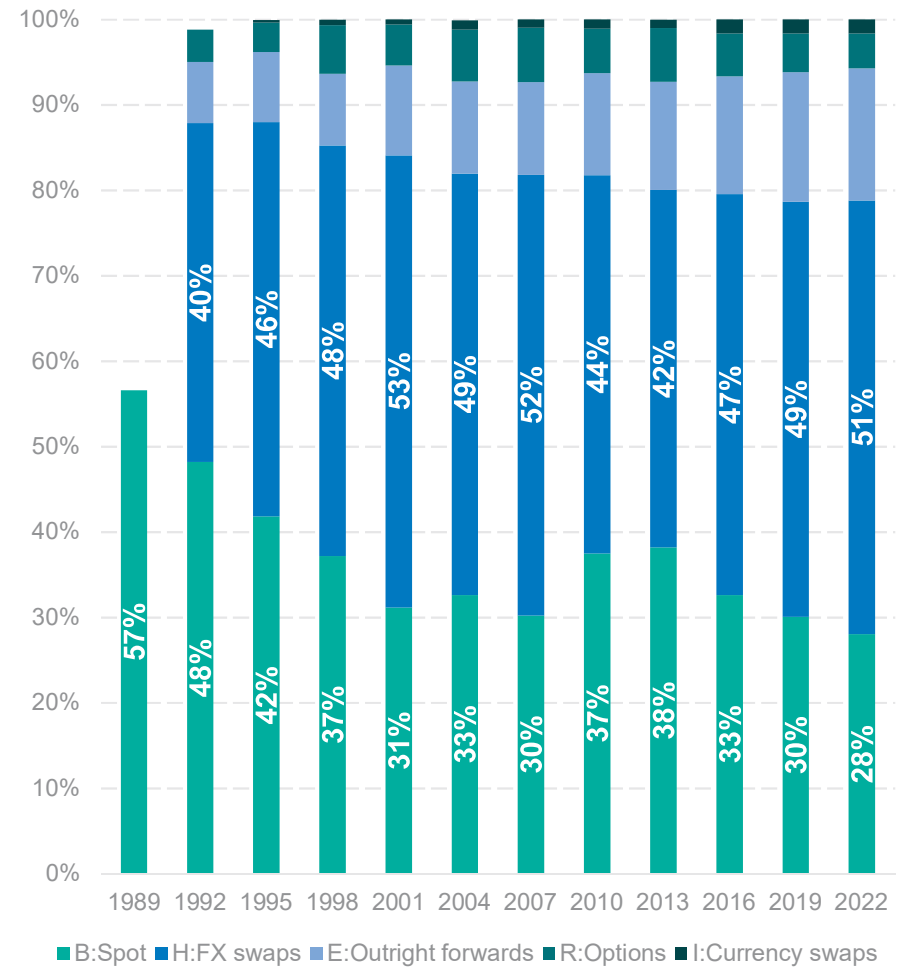
Maturity profile of FX swaps



BIS Triennial FX Data

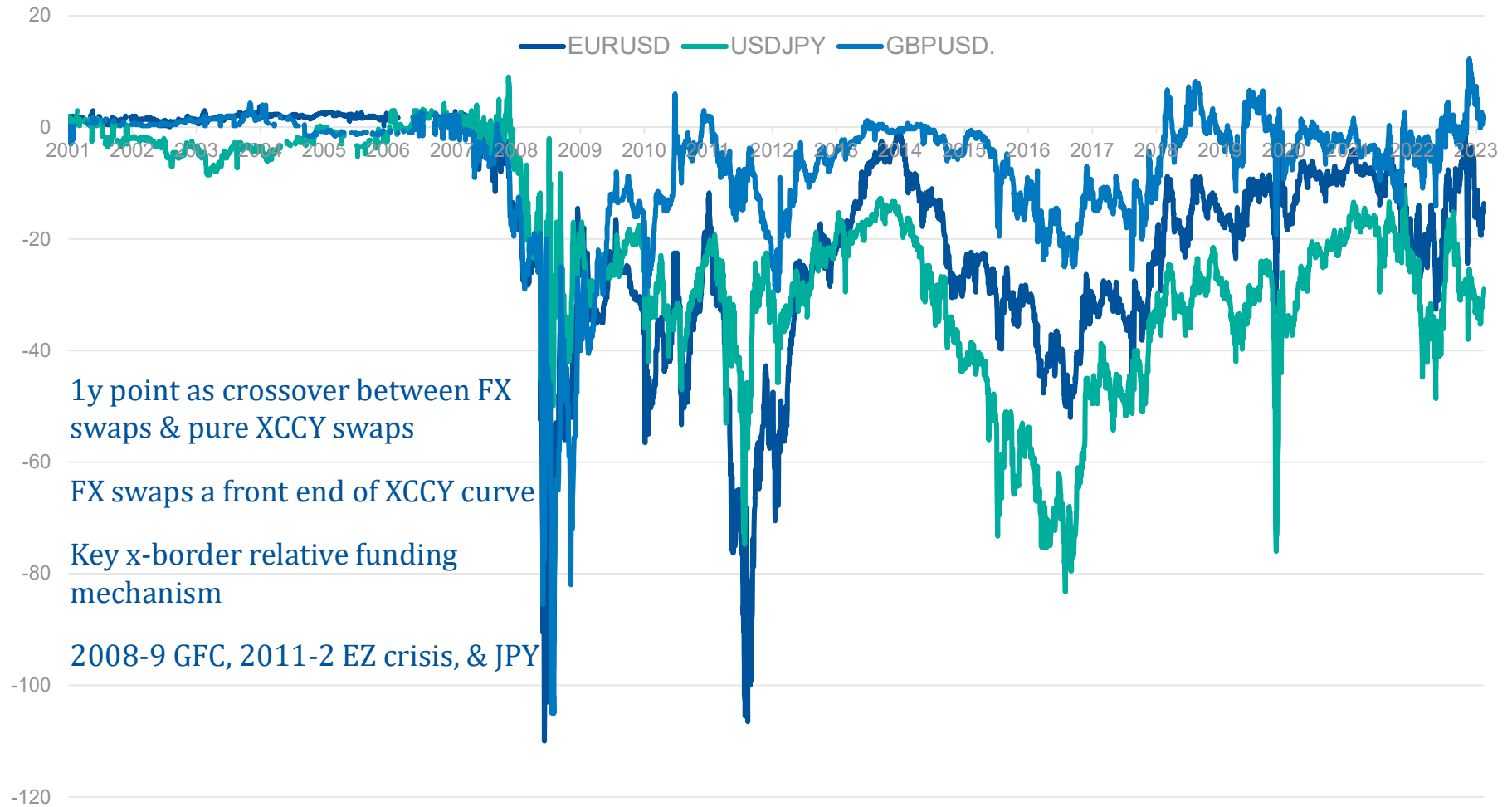


BIS Triennial FX Data by % Share



# GFC 2008: XCCY wakes up

1y bor xccy basis 2001 to present (bps)  
(Source: Bloomberg)

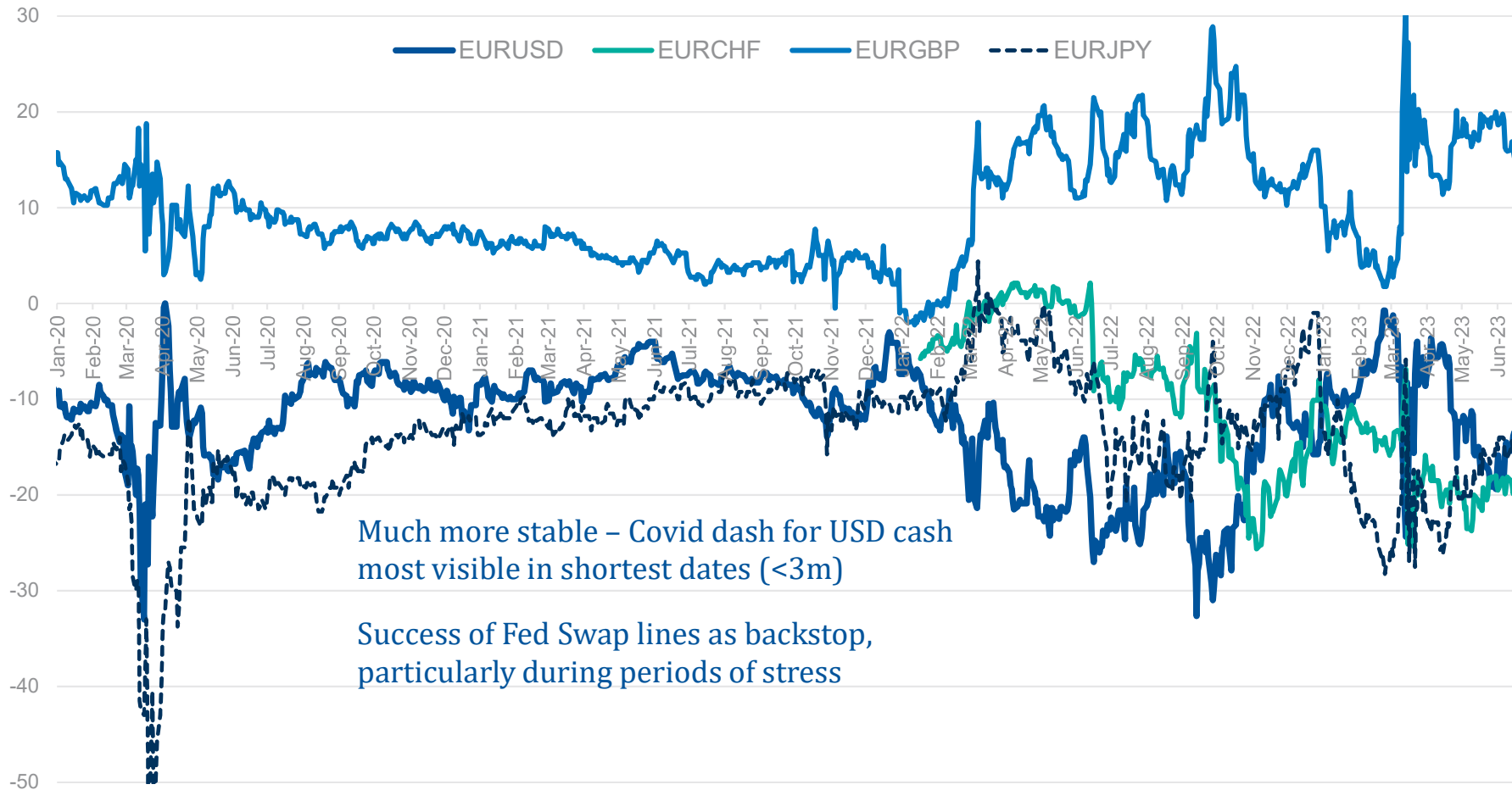


# Zooming in: EUR crosses 2020 to date



European Bank  
for Reconstruction and Development

1y EUR DM XCCY (bps)  
(Source: Bloomberg)



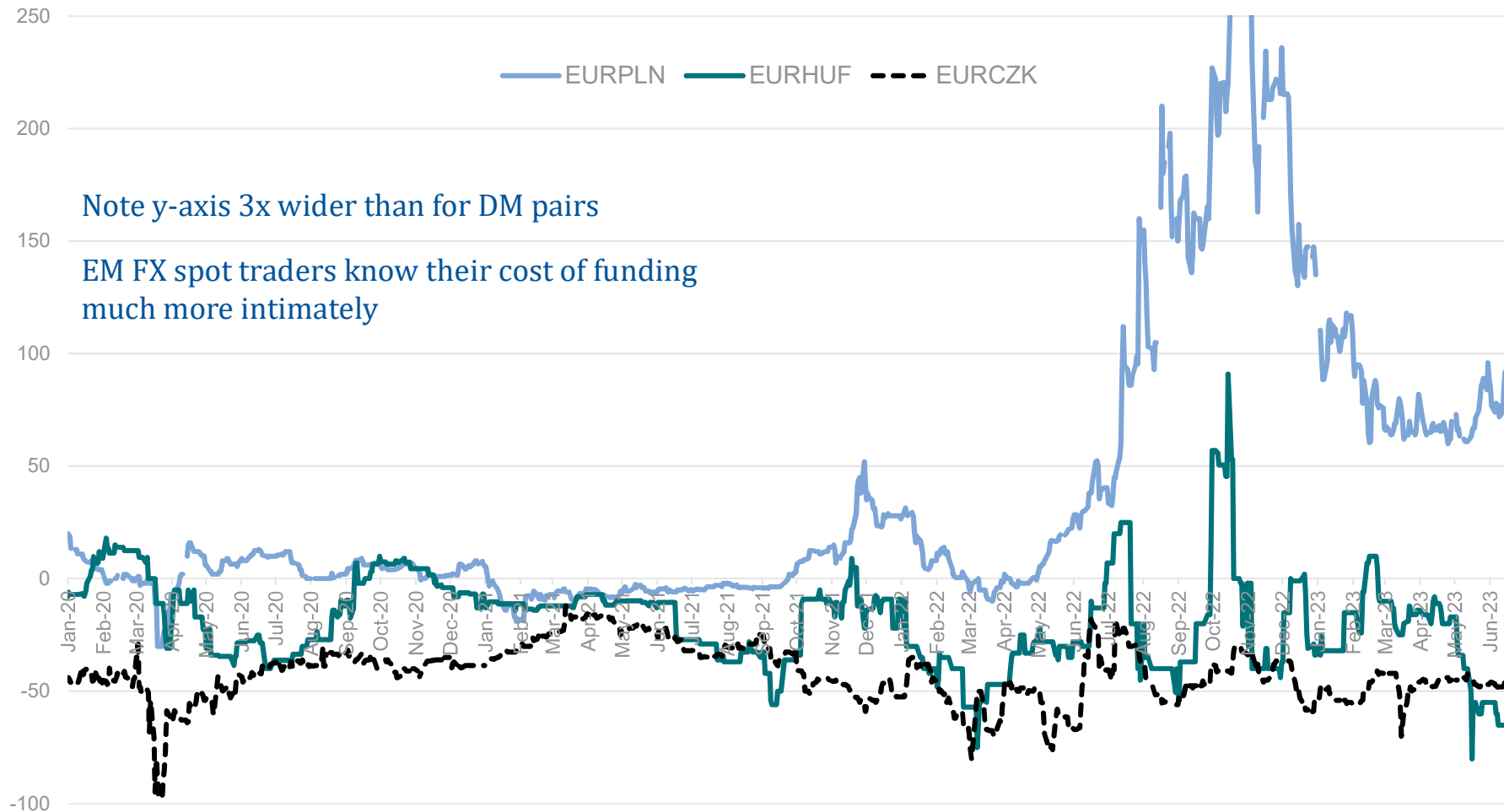


# For contrast: CEE3 2020 to date



European Bank  
for Reconstruction and Development

1y EUR EM XCCY  
Source: Bloomberg



# Conclusion & Questions

- FX Swaps, and the implied basis, merit attention – do you agree?
- Volumes consistently ~50% total FX
- Volatility of funding: the basis moves, EM >> DM
  - Drivers: FX rates, relative CB policy (rates & QE/QT), regs & BS constraints, xborder funding needs, “Flight To Quality”, etc...
- For future discussion:
  - The year end turn
  - Focus on short dates, especially 1w & T/N

# References

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- <https://libertystreeteconomics.newyorkfed.org/2020/05/have-fed-swap-lines-reduced-dollar-funding-strains-during-the-covid-19-outbreak/>