

FX - Yen weakness and the carry trade

The G7 Yen distortion

THE G7 INTERVENTION HAS HAD UNINTENDED CONSEQUENCES...

...BY LIMITING THE DOWNSIDE FOR USD-JPY AND CREATING UNLIMITED POTENTIAL UPSIDE

...IT HAS ENCOURAGED THE RETURN OF THE YEN CARRY TRADE...

...RISKING INSTABILITY RATHER THAN STABILITY

G7 co-ordinated intervention has effectively removed the JPY from the normal currency landscape.

In the wake of the intervention, volatility in USD-JPY has fallen and should continue to do so. The USD-JPY is already back above pre-disaster levels and there is increasing appetite to buy the carry favourites.

The intervention is offering downside protection on USD-JPY, and suppressed volatility. Carry currencies such as AUD, BRL, TRY, and ZAR are all now benefiting.

This has distorting consequences for the CHF as well. If the market turns risk averse the JPY no longer offers a safety valve. This leaves the much less liquid CHF at the mercy of those looking for safety. So suppressing volatility in the JPY could cause increased volatility in the CHF.

INSTABILITY OUT OF STABILITY

In essence the idea of creating "stability" in the FX markets sows the seeds of instability. It creates an artificial FX "level" that allows investors to take risks and positions they might not have otherwise taken. That means the JPY is unable to trade at an equilibrium level and is kept at an artificial level. So in essence the G7 co-ordination will lead to unintended consequences of a strong CHF in a "risk off" environment and a stronger AUD, ZAR, TRY and BRL in a "risk on" environment.

As usual with these carry trades, they will work brilliantly for a time and then unravel very quickly. As always with the carry trade it is up the stairs and down the elevator.

The unintended consequences of the G7 intervention are a major theme for now - until of course the end of QE2 becomes dominant.

See Currency weekly March 28th. As the ugly get uglier, EM and others benefit

Disclosure appendix

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Issuer of report

HSBC Bank plc

8 Canada Square, London
E14 5HQ, United Kingdom
Telephone: +44 20 7991 8888
Telex: 888866
Fax: +44 20 7992 4880
Website: www.research.hsbc.com

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