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G10 FX Strategy

FX Markets Are Underpricing Risks from the June FOMC Meeting

Carry remains the dominant FX theme – for now. We think markets underprice the risk of an FX market reaction to the June FOMC meeting, which could upend existing narratives and create new tradable trends for the USD and FX more broadly.

Key Takeaways

- Carry remains the dominant FX theme as realized and implied FX vol trend toward record lows, but we think the June FOMC has the capacity to change the game.
- In addition to the new SEP 'dots', forecasts, and statement, Chair Warsh's inaugural press conference will be closely watched by investors.
- We estimate EUR, JPY, AUD and NZD are most vulnerable to large moves post-FOMC based on their rate sensitivity, implied vol, and positioning.

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Currency & Foreign Exchange

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FX volatility continues to grind lower as markets have found a new equilibrium. Indeed, 3m implied volatility for EUR/USD has fallen to the 3rd percentile (Exhibit 1). The term structure of implied volatility suggests that markets expect this low-vol period to last, particularly in the case of EUR/USD (Exhibit 2).

On the one hand, this is understandable. As much as implied vol has fallen, realized volatility has fallen substantially too (Exhibit 3). Carry trades remain a clear and dominant theme in the market, and we see a clearer relationship between positioning and carry on offer in our positioning data compared to a couple of months ago (Exhibit 4).

Exhibit 1: FX volatility has approached near historical lows

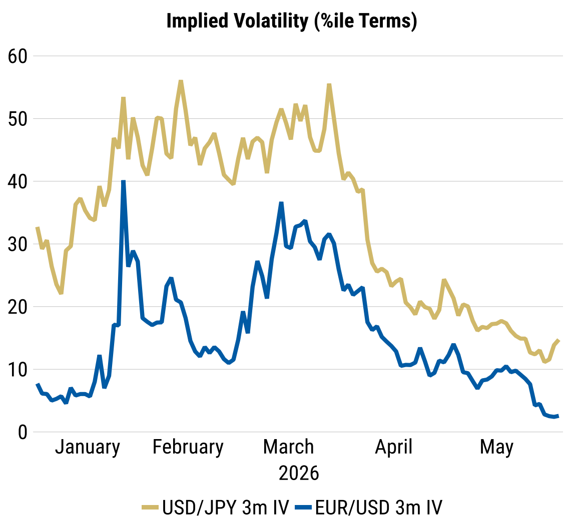
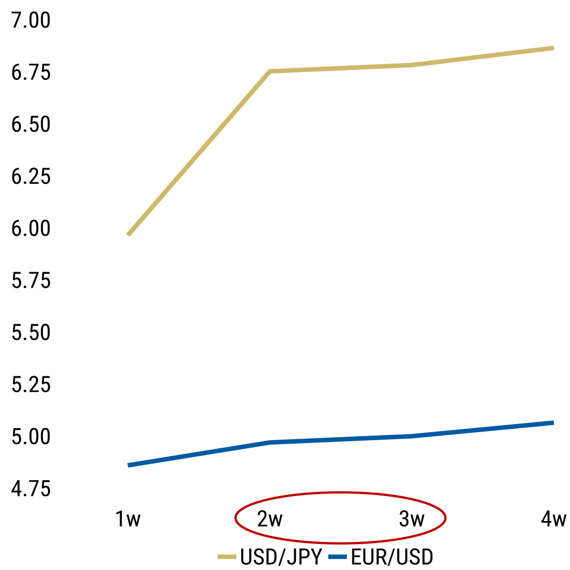


Exhibit 2: FX vol markets imply limited risks of large moves, even during the June FOMC meeting



Note: Data as of Tuesday, June 2nd, red circle indicates the 'switch' to the contract including the June FOMC

In the absence of an increase in realized volatility, carry trades will likely dominate. We think the price action in certain pairs like AUD/NZD, NOK/SEK, USD/JPY and even EUR/GBP demonstrate that lower-carry currencies are struggling to rally.

But on the other hand, clear and important catalysts are on the horizon. The US NFP report on Friday June 5th and US CPI on June 10th are both important guideposts, which markets may be underpricing as risks.

But we think the June FOMC is the clearest, underpriced standout event as a key risk to both the low-vol environment and consensus positions.

This meeting carries considerable information content. It will include a new FOMC statement and Summary of Economic Projections (SEP). Given the hawkish surprise at the April FOMC meeting, where 3 FOMC members voted to remove an easing bias from the statement, and given the subsequently strong US data (Exhibit 5).

Exhibit 3: Realized volatility has fallen alongside falling implied vol

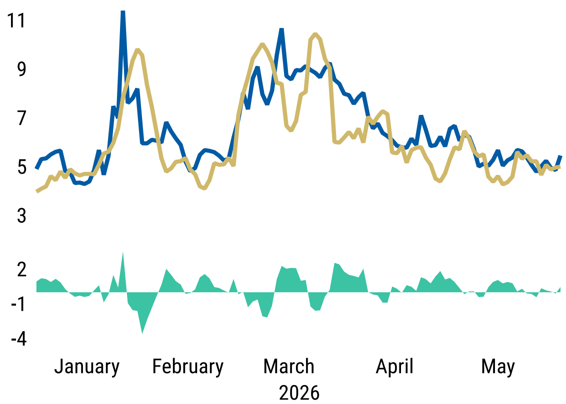
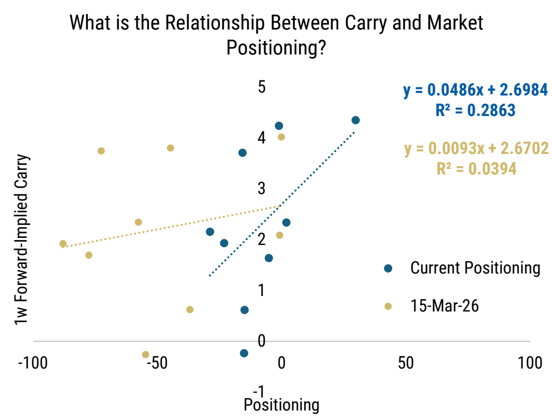


Exhibit 4: Carry has played an increasingly important role in explaining FX positioning



Beyond the 'usual' (and important) releases from the FOMC Statement and Summary of Economic Projections, this is also expected to be Chair Warsh's first press conference in his new role.

In our conversations with FX investors we sense that clients increasingly anticipate that the hawkish messaging from the April FOMC will be reflected in new 'dot plot' projections and perhaps the statement language too. On the one hand, a hawkish validation of market expectations could lead to an unwind in carry trades and generate volatility. But on the other hand, the Fed could also surprise markets by continuing to imply that the more likely outcome for rates is lower, not higher. In either case, we think the USD could respond more than markets are pricing.

But we think the larger potential risk for vol could come from the press conference. Our conversations with investors have led us to think there is a wide dispersion of views as to what may be communicated. Given that this press conference will be the first for Chair Warsh, we think there is a larger-than-usual chance that new information content is provided, leading to greater volatility in the market.

Granted, the historical record for this potential 'new Fed Chair volatility' is mixed. To test this hypothesis, we looked at the magnitude of the reaction in EUR/USD relative to the implied volatility ahead of the meeting for the first four press conferences of Chair

Yellen's and Chair Powell's tenure, and compare it then to the average performance at the remaining press conferences using the SF Fed's event study database for Fed meetings.

Specifically, we calculate a Z-score based on the change in EUR/USD relative to the vol implied for the event, adjusted for the 70min sample window. A Z-score of 1 implies a EUR/USD move equal to what vol implies. Results can be found in Exhibit 6 .

Exhibit 5: US economic data have continued to beat expectations, while other economies have largely tracked as expected

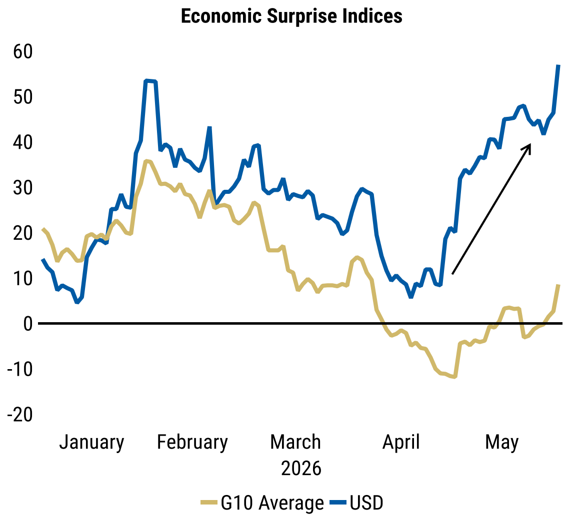


Exhibit 6: How does FX react in the first few press conferences of a new Fed Chair?

Chair	Sample Press Conf.	Average Abs. EUR/USD Move	Average Implied Vol	Average Abs. Z-Score	Difference Between First Four and Later Press Conf.
Yellen	First 4	0.38%	8.1	3.99	1.36
	Remaining	0.29%	9.5	2.63	
Powell	First 4	0.18%	7.7	2.06	-1.05
	Remaining	0.28%	7.7	3.11	

In the case of Chair Yellen, her first four press conferences saw an average reaction of 38bp in EUR/USD compared to 29bp in later press conferences, which in normalized vol-adjusted terms is +1.36σ. But for Chair Powell we see the opposite; his first four press conferences saw an average absolute reaction of 18bp in EUR/USD compared to 28bp for the rest of his press conferences, or -1.05σ.

Still, **our subjective estimation is that FX markets may be underestimating the impact of the June FOMC meeting as a potential vol-event**. We think the range of probability-weighted outcomes is larger than vol markets imply, presenting value for vol-focused investors. To this end, we think investors should prepare for a potential increase in volatility, market activity, and discussion around the Fed, the path for US monetary policy, and the appropriate level of USD risk premium.

Exhibit 7: Which currencies are most vulnerable to a June FOMC surprise?

Where Could the FX Reaction to a June FOMC Surprise Be Largest?

	30d Daily Corr. To US 2y	Positioning (%ile)	1m IV (%ile)
AUD/USD	-0.53	70	13
NZD/USD	-0.48	56	6
JPY/USD	-0.49	59	16
EUR/USD	-0.49	39	5
NOK/USD	-0.08	54	6
CAD/USD	-0.33	30	2
CHF/USD	-0.41	48	15
GBP/USD	-0.37	42	11
SEK/USD	-0.39	49	20

Which currencies are most at risk of a large move? To assess this, we create a scorecard of potential currency attractiveness to express a view on FX responsiveness to the June FOMC, summarized in Exhibit 7 . Specifically:

- Rates: Currencies with a higher correlation to the US 2y are more likely to see larger moves
- Market positioning: More stretched positioning raises the likelihood of an outsized move
- Implied vol: Lower implied vol suggests more room for markets to reprice

The results suggest that the Antipodeans, EUR, and JPY are most vulnerable to large moves in response to a June FOMC surprise. All four show an elevated sensitivity to the US 2y, positioning appears biased on the long side (except EUR), and implied vols appear low, particularly for EUR and NZD.

In sum, we think FX markets are underestimating the risks around the June FOMC and a potential increase in volatility thereafter. AUD, NZD, JPY and EUR screen as particularly vulnerable to large moves should this transpire.

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