FX markets and interest rate opportunities

Over the past nine months we've seen increasing examples of distortions in short-term money markets giving rise to attractive, low-risk investment opportunities for fixed income managers.

These have included the switch from 6-month funding to longer-dated funding by the major banks, the large increase in demand for short-term funding driving higher bank bill rates, and the increase in repo rates which has in turn pushed other cash rates higher.

The newest entrant in this area is the foreign exchange market, where shifts in market pricing have created attractive relative value opportunities in Australian interest rates, relative to those of the other major currencies.

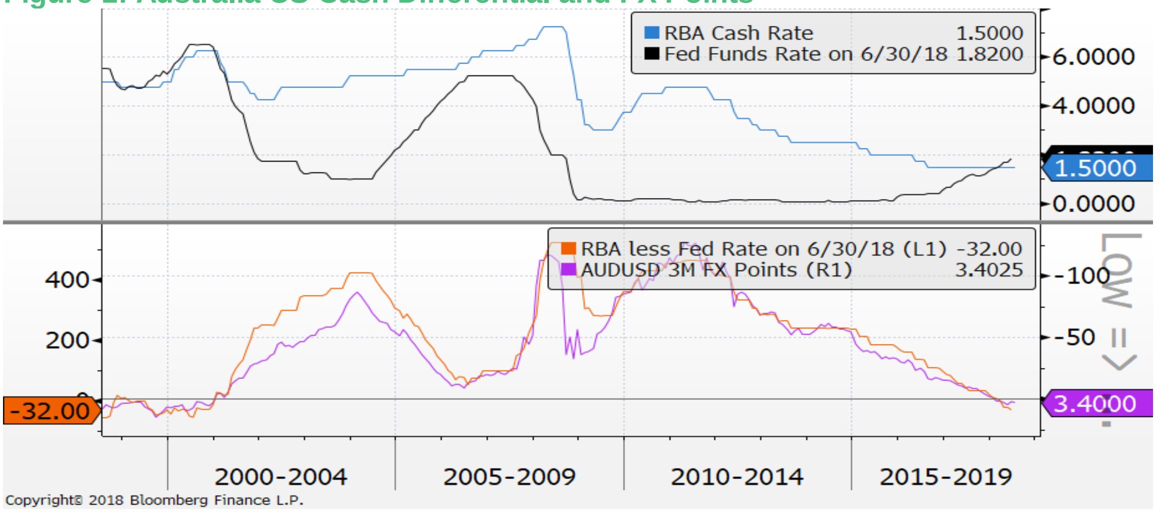
These opportunities arise in a specific part of the foreign exchange market, namely in forward exchange rates. The forward exchange rate is the exchange rate for delivery of currencies at some future date, say in three months' time. This is in contrast to the spot exchange rate, which is the exchange rate for transacting today, with delivery in two days' time.

The difference between the spot and forward exchange rates represents the cost differential between delivering a currency in two days, compared to delivering in three months. Just like any other future cash flows, the time value of money applies: immediate cash flows have a higher present value than future ones, even just three months later.

Because different currencies have different interest rates – that is, the RBA Target Cash Rate of 1.5% is currently below the Federal Reserve's target for the Federal Funds Rate of 1.75%-2% – the difference between the spot and forward exchange rates, known as the forward points, will reflect this interest differential.

That's how things are meant to work in normal market conditions, and that's what students of finance mean when they say "covered interest parity". We know this works over long periods of time, as the interest rate differential between say the US and Australia is tracked very closely by the forward points (Figure 1).

Figure 1: Australia US Cash Differential and FX Points



Source: Ardea Investment Management, Bloomberg

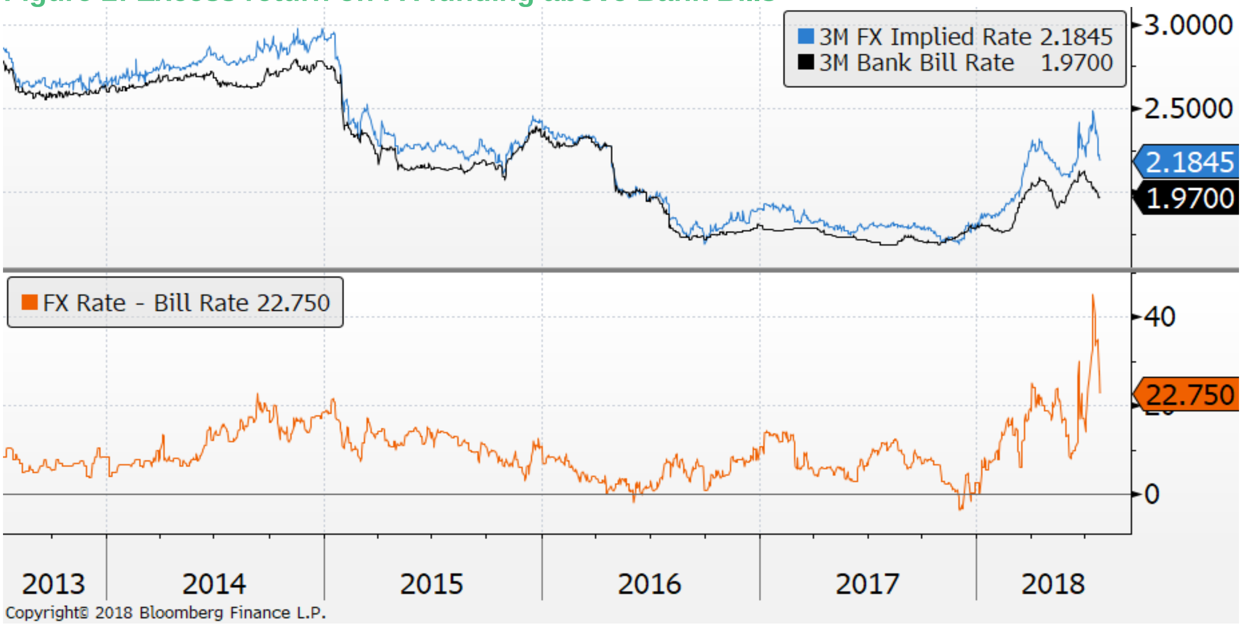
Today's financial markets are very different however, and far from the textbook case studies of perfectly functioning efficient markets. This has meant that the forward points have diverged from what pure interest rate differentials would imply, creating a difference in funding rates.

This has arisen because of shifting flows in the foreign exchange forward market. Whether due to foreign investors seeking to purchase Australian financial assets, or perhaps for foreign direct investment, this has created strong demand to hedge Australian foreign exchange risk. This has resulted in more sellers of Australian dollars for forward delivery than buyers.

The resulting imbalance has meant that the forward points have declined, and thus the implied interest rate from delivering Australian dollars today and receiving them back in three months' time has surged. In fact this implied interest rate is now well above other domestic interest rates, such as the rate earned on bank bills.

In recent weeks, the additional income available to investors from this strategy has consistently provided an extra 0.2% return above the rate available on domestic bank bills, and it has peaked at as high as 0.4% above bank bills (Figure 2). While these numbers may appear small, with the RBA cash rate at 1.5%, the additional return is clearly worthwhile.

Figure 2: Excess return on FX funding above Bank Bills



Source: Ardea Investment Management, Bloomberg

From a broader market perspective, the developments in foreign exchange markets have led to greater differentiation among the various short-term funding rates which can be earned by Australian investors. In our view these developments are ultimately a positive for the market, as investors can now benefit from a greater pool of market participants who are all actively competing to pay attractive rates on short-term cash of various forms.

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26 July 2018