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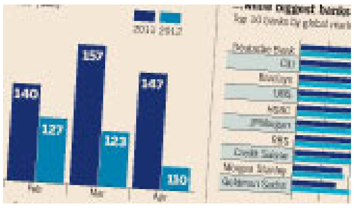
Resilience of euro frustrates forex trade

By Alice Ross

For all the fast-moving headlines on the eurozone crisis, tumbleweed is blowing across the world's largest financial market.

Investors and dealers have shied away from foreign exchange trading this year amid frustration at the strength of the euro. Investment bankers have been praying for more activity. Yet volatility among the world's most widely traded currencies dipped in April to its lowest since 2007, according to an index constructed by JPMorgan, the VXY for G7 currencies.



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For speculators and investors who rely on swings in exchange rates to place momentum trades that profit when currencies are moving in a particular direction, this dwindling volatility has been bad news. Moneymaking strategies have become more difficult to execute.

"I can't remember a time when I've seen less interest in foreign exchange from hedge funds and real money investors," says Jeff Feig, global head of G10 FX at Citigroup in New York.

The "carry trade", for example, where investors borrow in a low-yielding currency and invest in a higher yielding one, has suffered a number of recent setbacks. Australia's decision to cut interest rates last month has made spreads between low and high yielding currencies even smaller.

Foreign exchange trading on the popular EBS platform, owned by ICAP, slumped 26 per cent in April from the same period last year. That has been driven in part by lower activity in high-frequency trading funds, which use powerful computers to jump on price trends and tend to be less active when volatility is low.

Then there is the strength of the euro in the face of fundamental valuations and most analysts' predictions.

The euro dollar pair is central to the foreign exchange market, making up about a third of total turnover, according to data from the Bank of International Settlements. Citigroup says that about 60-65 per cent of its trades are through the euro. But for much of the year the euro has traded in a tight range against the dollar.

Tired of losing money betting that the single currency would fall last year, hedge funds have been avoiding the market altogether. One investment bank says it has seen a 50 per cent drop in business activity from its hedge fund clients this year, who have instead been exploiting volatility in government bond markets.

The lack of euro-dollar activity has made investment banks nervous. “I want to see a big move in the euro. I don’t care if it’s up or it’s down, I just want it to move,” says a banker at one of the biggest banks in forex trading.

Yet some areas of the market are faring better. Forex is seen as a steady if somewhat unexciting contributor to profits at investment banks. HSBC, one of the few banks to break out its revenues, said this week that foreign exchange contributed a third of its overall revenue in the first quarter of the year.

Deutsche Bank recently said that its foreign exchange volumes for the first quarter of the year reached record levels, while Citigroup says its volumes increased about 40 per cent last year.

An annual survey from Euromoney, the financial magazine, published this week has put these two banks at the top of the pack, with the first and second largest market share respectively, followed by Barclays, UBS and HSBC.

Tim Carrington, head of foreign exchange at RBS, which came seventh in the survey, says that while hedge fund and real money business has fallen, corporate business is still strong, while central banks are also more active than they were last year.

“If you’re a big global G10 and EM FX house with a corporate base, you’re doing fine. If you’re not one of those banks, I’d imagine it’s going to be a struggle,” he says.

Still, even the biggest investment banks are wary. Mr Feig at Citi says that while the bank is increasing its market share – in part due to recent successes in the technology arms race between investment banks’ foreign exchange divisions – he expects volumes to drop in the second and third quarters of the year.

And while the euro has slumped in value this week amid political turmoil in Greece, it is too early to tell whether that shift will be sustained. Volatility has picked up since the end of April, according to the JPM index, but investment banks still report no fundamental shift to sell euros.

Some believe it will take a more drastic event for the euro to finally break out of its range. All eyes are on Greece.