Monthly analysis – June

Gábor Orbán: The gainers from the decline in volatility

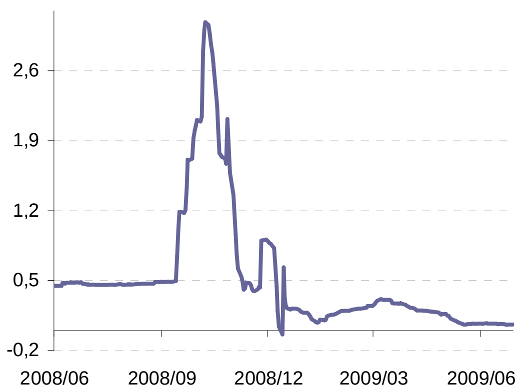
Last month we discussed a possible resurgence of carry trade, as a combination of the weakening dollar, low interest in mature markets, high interest on carry currencies and the declining volatility in the global money markets has fuelled demand for the high-interest-rate currencies. In line with our expectations, this process has continued and strengthened, and it is the forint that has emerged the greatest winner.

Volatility is declining worldwide: by mid-year it had fallen to levels not seen since before the Lehman bankruptcy of last autumn, as the VIX index, a widely used measure of volatility, dropped to around the 26-point mark from last autumn's 60-70 points. Priced-in counterparty risk, which had emerged as a new risk element at that time (or rather had been attributed greater importance than ever before), fell back to a moderate level. This is reflected, for example, in the index that measures tensions in the US money market; that is, the difference between the one-month dollar money-market interest rate and the Federal Reserve's target rate, which shot up last autumn and only stabilised to within the 5-7-basis-point band typical of previous years in mid-May.

VIX index

Source: Bloomberg

Difference between 1-month money-market dollar rate and Fed Funds target

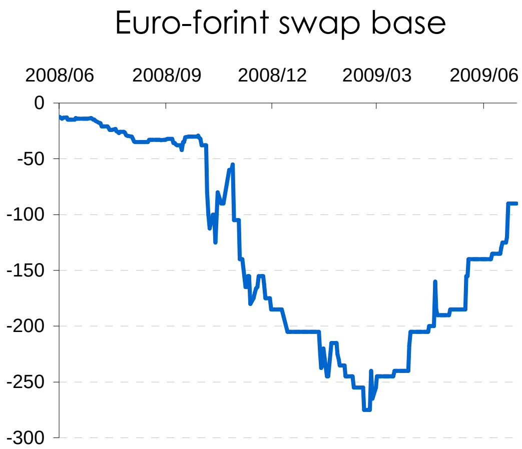


Source: Bloomberg

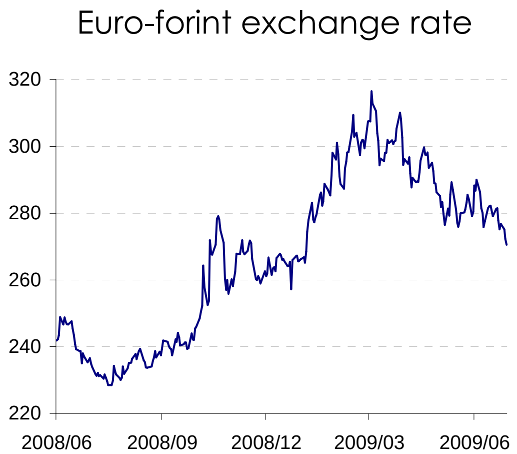
The upshot of all this from the Hungarian perspective has been an improvement in FX liquidity. In the darkest days of the crisis the cost of foreign-currency funds rose by a dramatic extent. The foreign-currency interest rates charged in forint-euro interest swaps exceeded the euro rates of mature money markets by some 280 basis points. The "base" indicator of the relative "expensiveness" of foreign-currency funds began to deteriorate after the Lehman collapse, prior to the launch of Hungary's IMF assistance program – before going on to peak in February. Behind this lay the high demand for foreign currency among Hungarian market participants, coupled with a worsening risk perception, which manifested itself in a general failure of confidence in the region as well as in a withdrawal of capital.

Onshore and offshore money-market euro rates (foreign-currency interest rates) diverged, which upset one of the most fundamental financial correlations: the covered interest parity formula, which should always apply where there is a free flow of capital.

To put it one way: due to the emergence of counterparty risk the theoretical correlation changed. Or to put it another way, the very concept of the open market itself was compromised in these months. As a result, the forint-euro carry available to domestic players, and the negative carry attainable by foreign investors, fell dramatically, and this rendered the forint vulnerable. Although the hedge funds (which under normal circumstances would have pounced like hyenas), had already knocked themselves out, the spot rate underwent a severe weakening in the process.



Source: Bloomberg



Source: Bloomberg

A detailed description of this process was necessary because it was precisely this tendency that reversed in the spring, when the disparity between demand and supply in the currency market eased perceptibly. As investors regained their appetite for risk, the level of observed or priced-in counterparty risk declined. Of course, the National Bank of Hungary also contributed to the improvement in FX liquidity through the sale of euros, as it injected its incoming EU transfers and a part of the IMF-EU-World Bank assistance package into the market, which in turn led to reductions both in the domestic banks' hunger for foreign currency and in the risks of refinancing. As domestic foreign-currency funds became cheaper, the HUF-EUR interest spread grew in absolute terms. In relative terms the interest premium also rose, due to the steady decline in money-market rates in the region (specifically in the Czech, Polish, Romanian and Turkish markets). The decline in volatility mentioned earlier, accompanied by this interest premium, made the forint exceptionally attractive, which in turn precipitated a substantial influx of hot money.

The forint is showing signs of a return to health on the technical front, having clearly broken out of its 200-day rolling average and moved into a lower trading band. Forint government bonds, which were (and at the long maturities continue to be) oversold, also broke through their critical levels, prompting a major rally. Besides investor sentiment, the strengthening of the forint and of government securities was also underpinned by fundamentals, as the prospect of a return to market financing (and thus a reduction in dependency on supranational funding

sources) gives rise to a genuine possibility of interest reductions by both the state and the banking sector this month. The substantial improvement in the balance of payments in the first quarter rested on broad foundations.

The trade surplus doubled in comparison to last year, and the income balance was also more favourable due to the lower interest burdens and a fall in profits generated by foreign-owned entities in Hungary, while an improvement in the services balance was also observable. Together with EU transfers, which amounted to an exceptionally high EUR 1.1 billion this quarter, the total external financing requirement of the Hungarian economy turned positive for the first time since 2003.

In the short term, therefore, the factors influencing the forint exchange rate are clearly favourable. However, three potential threats continue to hang over investors in the local currency:

1. The fall in GDP will be considerable this year, and the improvement in the balance of payments also reflects this to a great extent; that is to say, this trend is largely cyclical (the saving patterns of participants in the local economy, or the terms of trade, have not changed that much). The weak growth prospects do not favour a rise in the currency's value in real terms, and the sustainability of the high level of external debt could also soon come into question against the backdrop of protractedly low GDP.
2. The decline in volatility (which according to my logic is an important factor underlying the strengthening of the forint) could reverse at any time. The same can be said of the short-term investments that have been seen in the past months.
3. Sustained political uncertainly could still prompt a flight of capital, although this is probably the most transitory of the three potential threats.

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