Spectra Markets

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Moths to a flame

am FX

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World maps with different centering are odd and interesting

Current Views

Short AUDNZD @ 1.0476
Stop loss 1.0622
Take profit 1.0200

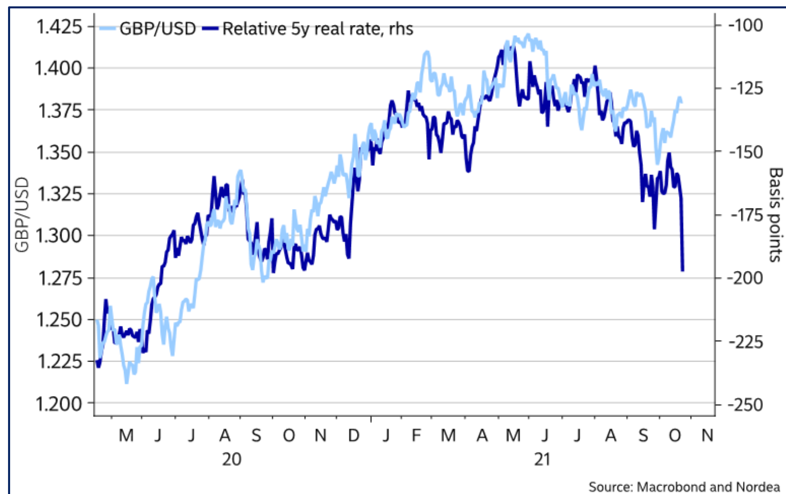
Short 01NOV and long 15NOV 1.3550 GBP put
Calendar spread
Price 21bps off 1.3730 spot

GBP

There are crosswinds at various levels of zoom in GBPUSD right now and while they don't lead to a specific call to action today, I think you need to know all this information as month end and then the Bank of England meeting approach.

The primary source of crosswinds is the swift rise in UK nominal rates and the simultaneous plunge in UK real rates. So far, nominals are winning in currency land, but that could change after BoE. This chart from the Nordea FX weekly nicely captures the current irrelevance of real rates to FX.

GBPUSD has not tracked real rates, it has followed nominals



For many, many years, G10 real and nominal rates have moved in synch as inflation was low and anchored. With inflation rising, real vs. nominals have diverged massively and the market has no idea which rates matter, and which do not. For now, higher nominal yields are attracting money to GBP. CTAs, Japanese real money, and other investors who benchmark to nominal yields are attracted like moths to a flame.

Going forward, my view continues to be that GBP will get smoked after the Bank of England as the market will hit bids once the event risk is out of the way. Furthermore, I think the market will sell GBP in days leading up to the meeting because there is not one person in the world that expects this Bank of England meeting to deliver an outcome more hawkish than market pricing. Yet plenty expect something dovish.

The run up trade is often a reliable and predictable pattern in G10 FX. The pattern is that the market takes a currency in a predictable direction into major events based on two factors:

1. What is the lotto ticket? People overpay for lotto tickets and G10 FX is no exception. If there is an asymmetry in potential outcomes, the market will put on the asymmetric side, regardless of expected value. That is, even if there is a 10% chance of a huge move lower and 90% chance of a small move higher, the market will bet on the downside. In the case of GBP, the lotto ticket is "no hike, GBP lower".

2. What is positioning? CTAs and discretionary traders reduce before events to avoid gap risk and correctly resize their risk in anticipation of higher expected volatility. If the market is long, the currency will tend to dribble lower into the event. In the case of GBP, positioning is fairly light, and should not be a major factor from here. Plenty of machines and investors are long on the rise in nominals, while some hedge funds own downside. I would say net positioning is a zero.

My view is that the market will want to get short GBPUSD as the Bank of England meeting approaches. Another crosswind here, however, is that **GBPUSD tends to rally in the last week of big up months for the S&P 500**. Here is some data:

GBPUSD outperforms in the last week of months when SPX is up more than 5%

	All data since 2010	Only last 5 days of the month when stocks are up 5% or more
GBPUSD: Average daily return	0.0%	0.1%
GBPUSD: Median daily return	0.0%	0.2%
% of days where GBP went up	50%	65%

SPX is up 5.5% this month, that is why I picked 5% as the minimum threshold. This effect in GBPUSD is real and it is not random. It is the result of large hedging by UK real money into month end. Large rises in SPX require UK pensions to sell USD to rebalance hedges and they do this in the last few days of the month.

While a 0.2% median return does not sound all that huge, it's median return *per day* over five days. Fairly meaningful! Also, a 65% win rate in a study like this is about as high as you can ever expect. This is a powerful effect that can be explained by the hedging activity of pension funds and so it should be respected.

Therefore, my conclusion is that you want to be short GBPUSD into the Bank of England meeting, but it's not safe to sell GBP until this Friday. Note that in theory the GBPUSD hedging should come on the last day of the month, but the data shows that the effect is front-loaded, and the final day of the month is actually pretty random despite heavy activity on that day into 11 a.m. NY (4 p.m. LDN). Going short GBP this Friday morning between 9 a.m. NY and 11 a.m. NYC time is probably optimal. We can revisit as the date nears.

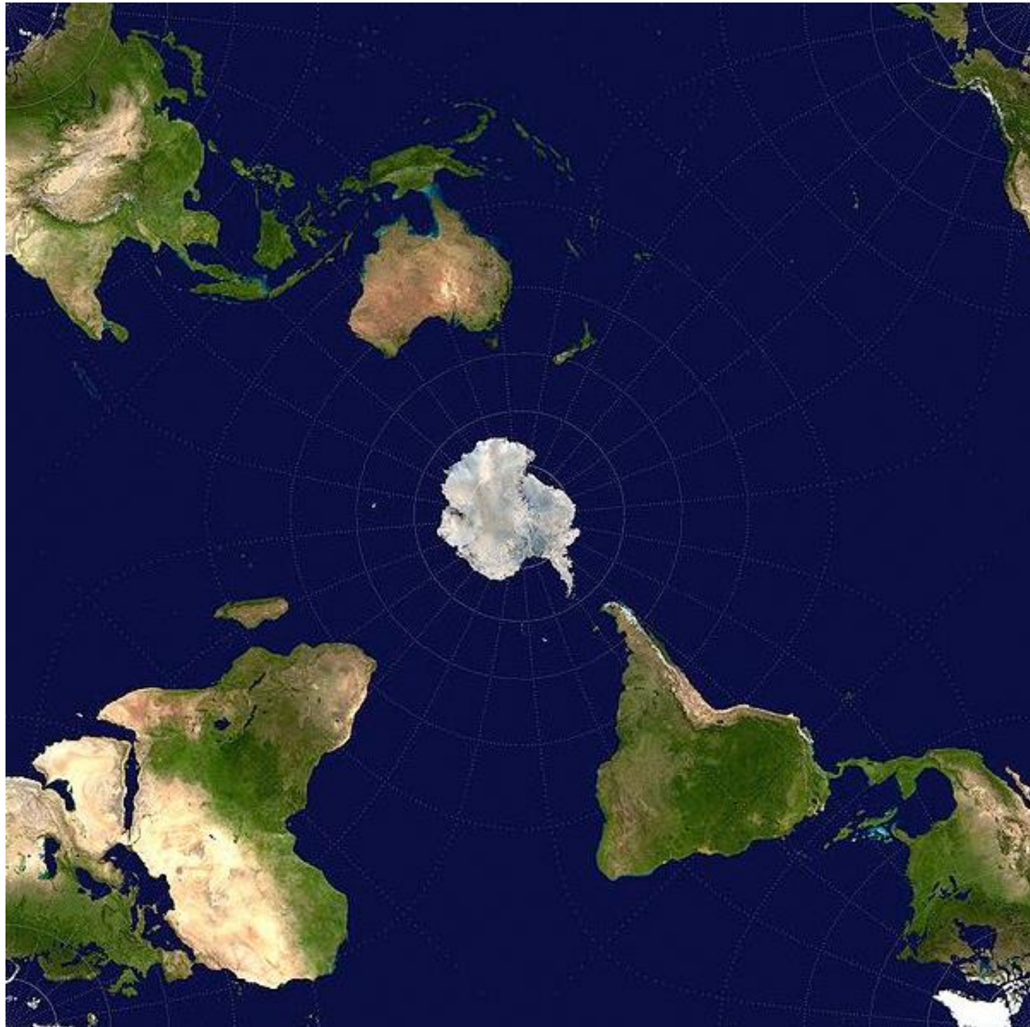
Human beings are not very good at estimating risk

A topic I have always found interesting is how poorly humans assess risk. The book "Risk" by Dan Gardner and Philip Tetlock is my favorite on this and it covers how media hysterics, recency and salience bias, and many other factors make us more scared of shark attacks than hospital infections (for example). COVID has been no exception. Almost two years into COVID, around 30% of the general US population estimates hospitalization risk from COVID to be over 50%. The actual rate is below 1% for vaccinated and unvaccinated Americans. The exact estimate:

> ...we calculate that the hospitalization rate for the vaccinated population is 0.01% (1 case in 10,914 people), and the rate for unvaccinated adults is 0.89% (1 case in 112 people).

You can see the splits by political party and more discussion here. To be clear, I'm scared of COVID too! But the overall difference in actual vs. perceived hospitalization risk is incredible to me. Have a safe day.

good luck ⇅ be nimble



Non-Mercator Projection world maps are weird.

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