SPECTRA MARKETS

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am

FX

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The Naica crystal caves are completely insane

Current Views

Flat

Wonky

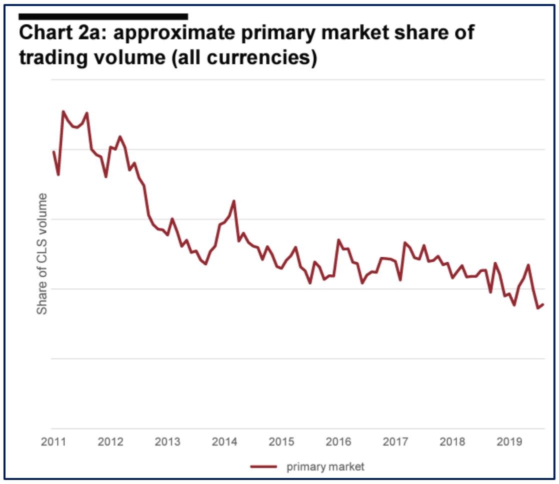
Stocks

I have removed the bearish S&P idea from the sidebar. The idea was a tactical short based on extreme readings in sentiment and the fact VIX and SPX both rallied in tandem last Friday. Now, the S&P 500 has dropped 90 handles off the Friday/Monday highs, somewhat relieving the sentiment situation and there is some bullish headline risk coming up with the Biden / Xi virtual summit tentatively scheduled for Monday. I don't think my tactical bear thesis applies anymore.

SNB speech

Maechler and Moser of the SNB presented an interesting speech yesterday: "Structural change in the foreign exchange market: implications for the SNB". You can read the full speech here, but I know you're busy so let me boil it down for you. This is the intro:

> In recent years, new technologies, new players and new tools have substantially altered not only the outward appearance of these markets but also their inner workings, their underlying dynamics. Market participants and central banks must therefore confront the following questions: Where can innovations be exploited, what opportunities will they create, and how should any risks be managed? Where is 'mere' technological progress in play, and where do the ongoing changes have more far-reaching, fundamental consequences?
>
> Today, we wish to focus on the structural change – indeed the transformation – taking place on the foreign exchange (FX) market. The developments and challenges are particularly evident in the FX market, where trading activity has accelerated markedly in recent years. The FX market is now a so-called 'fast-paced electronic market' – high-frequency, electronic and complex.



The speech documents a few well-known and important trends in FX market structure. One, the market is increasingly fragmented as volumes move away from the primary market and toward multiple ECNs, HFTs, dark pools, and internalization. See chart at right, excerpted from the slides used by Maechler during the speech. The y-axis is not labeled for some reason, but you get the idea.

A second trend is a reduction of transparency due to internalization. As banks become more sophisticated in their ability to skew price and attract the other side of a trade without dealing externally, less information is available to other market participants and regulators.

The slides from the speech also include a nice diagram summarizing the various tensions and tradeoffs faced by customers executing FX trades (see "Chart 4" below). Whether you choose to trade by algorithm, risk transfer, limit order, or at best, you must find the optimal tradeoff between conflicting factors. The three tradeoffs faced are diagrammed below and I will address them starting with the top of the triangle and moving clockwise.

Tradeoff 1 (market impact vs. spread cost): The faster you execute, the larger your impact will be on the market. There is a nonlinear "time to transact" vs. "units executed" relationship, so if you try to sell 500 million EURUSD in 14 seconds, you are going to move the market much more than if you do that trade over 14 hours. This time vs. units relationship is not constant, and it's hard to measure. It depends on time of day, volatility, and idiosyncratic factors such as the presence of nearby stop loss orders and behavior of correlated markets at the time of execution. This trade off is captured by the top of the triangle in the diagram below.

Tradeoff 2 (execution probability vs. transaction costs): A risk transfer price has 100% chance of execution, but the executing bank or broker is compensated for market risk via spread. In contrast, a limit order can reduce transaction costs but is not guaranteed to be executed. If you seek to achieve lower market impact and spread costs by using limit orders, you reduce your execution probability. If you don't get done, you may have to trade at a far worse price later on. You will sometimes see this type of situation:

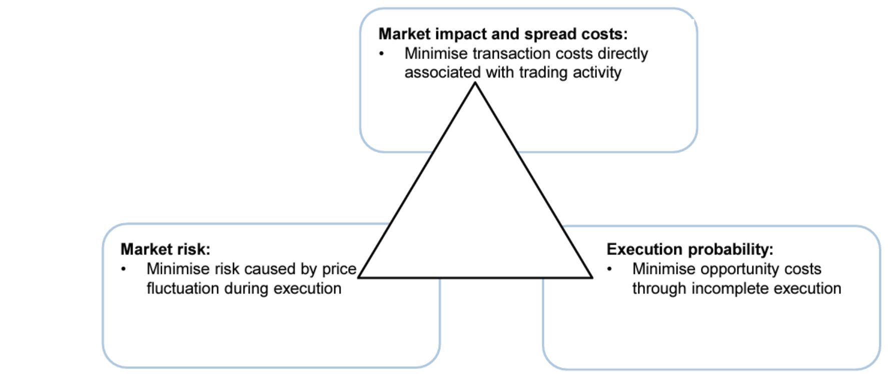
USDCAD is 1.2492/94. A market participant who hates to cross the spread leaves an offer to sell at 1.2500[1], then USDCAD drops to 1.2444/45 and they move their offer down to 1.2450. Spot goes to 1.2424 and they move their offer down to 1.2430. They get done on a small bounce. The client was trying to save a few pips by working a limit order and instead, they sold 62 pips below market. Sometimes, you're better off hitting a bid. The skill, of course, is in correctly identifying those times.

Tradeoff 3 (market risk vs. footprint): This risk was vastly underappreciated when clients first started using algorithms. There is a lot of fancy quantitative analysis that will show you a TWAP costs less than a risk transfer, but when you are selling 200 USDCAD over 30 minutes and you start your TWAP at 1.2580 and then two minutes in, the market is 1.2565/66, you understand market risk can dwarf transaction costs.

This is why I have always believed that a one-size fits all execution strategy is suboptimal (e.g., firms that go to systematic, 100% TWAP execution). Execution strategy should be situationally dependent, and not rigid. A standard execution strategy can be used most of the time, but there should be room for judgment because even the best VWAP models don't always take all relevant factors into account.

For example, if your standard approach is to TWAP and it's 9:55 a.m. and you need to sell 185 AUDUSD. And Powell is speaking at 10:00 a.m.…. A 10-minute TWAP is probably not optimal! This is an extreme example but there are plenty of reasons why every execution system should have manual supervision, input, and override.

Chart 4: the 'execution algorithm trilemma'



If you ever have any random FX execution questions. I'm here for you!

Have a crystal-clear day.

good luck ⇅ be nimble

[1] Round number bias.

https://science.howstuffworks.com/environmental/earth/geology/mexico-giant-crystal-cave.htm

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